

CHAPTER 6

Financial Fundamentals for Contracting Professionals

OVERVIEW

As a contracting professional, you will be making financial decisions every day of your career. Smart buyers understand how financial concerns, such as cash flow, financing, and payment terms influence the overall price of goods and services they are purchasing. In addition, government buyers must also understand how Congress regulates how much money the government spends and for what purpose. This means that accounting for the funds you spend is a complex but vital part of the acquisition process. Misunderstandings about financial management can cause contracting officers to violate regulations or, more importantly, laws governing the use of taxpayer funds.

Learning Objectives

Given acquisition situations, determine the relationship between the financial and acquisition communities and how fundamental financial principles and requirements are important factors to consider so that you will be able to develop a smart business arrangement. Specifically upon completion of this chapter, you should be able to:

- 6.1 TRACE the budget cycle.
- 6.2 EXPLAIN the different types of appropriations, including their purpose and time period in which funds must be obligated.
- 6.3 DESCRIBE the different situations in which the Anti-Deficiency Act, Misappropriations Act, and Bona-Fide Need Rule would apply.
- 6.4 TRACE the Defense Planning, Programming, Budgeting, and Execution System of resource management.
- 6.5 OUTLINE the mission and functions of the government financial community.
- 6.6 DISCUSS the business process interfaces and interdependence between the acquisition and financial functions in the federal government.

BUDGET CYCLE

The federal budget is more than a reflection of proposals for a specific period in the future. It is an interplay between the executive branch comprised of its many agencies and Congress with its committees and subcommittees. Congress makes the budget decisions, while the executive branch is responsible for budget formulation and execution.

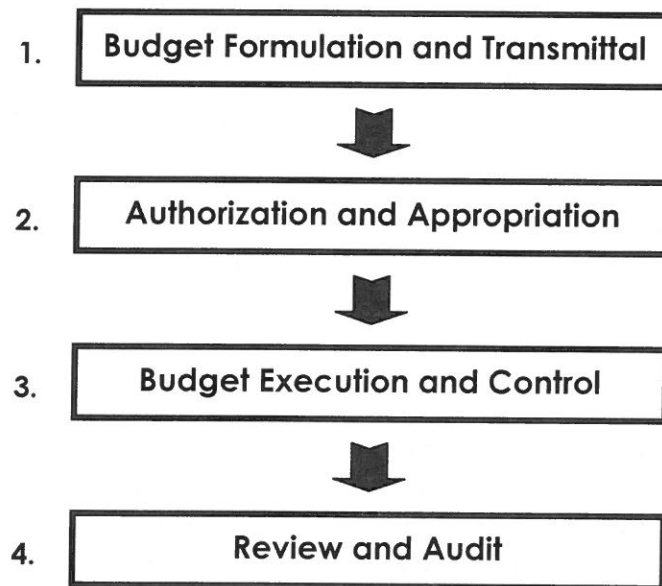
The federal government operates on a fiscal year basis. The government's fiscal year begins on October 1 and ends on September 30 of the next calendar year. Fiscal years are referred to by the year in which they end. Thus, the federal fiscal year that starts on October 1, 2007, would be fiscal year 2008 (FY08) since it ends on September 30, 2008.

The President's budget is based upon long-range budget estimates. In the case of major acquisition requirements, six-year forecasts are often developed. This fact-finding and planning is performed in part by program managers. Among other things, managers forecast the acquisition requirements of their programs and estimate related costs for the fiscal year to come and for a number of out-years thereafter. Such estimates are made long before the managers initiate the corresponding purchase requests (PRs) to contracting offices.

Proposed acquisition requirements and cost estimates enter the stream of information, evaluations, and policy decisions that influence the President's general guidelines for preparing agency budget requests.

Phases of the Budget Cycle

The government's budget for any given fiscal year is established and executed in four basic phases:



Budget Formulation and Transmittal — Preparation

Each February, the President transmits a budget to the Congress for the fiscal year that begins on the following October 1. This transmittal is the final step in many months of collaborative fact-finding, planning, and analysis by the President, OMB, other executive office units, and federal agencies. This process is set in motion by the issuance of budget guidelines that the Presi-

dent provides 19 months before the budget is prepared. For instance, guidelines for the FY 2006 budget were prescribed in the spring of 2004.

In support of the budget guidelines, managers forecast the acquisition requirements of their programs and estimate related costs for the fiscal year to come and for a number of subsequent years. In the summer before the budget is submitted, agencies prepare their budget requests. At this time, managers have another opportunity to revise their forecasts of acquisition requirements and bring them into line with the budgetary guidelines. Agency budget requests are reviewed in detail in the fall by the agencies and OMB and presented to the President in January. The President submits an overall budget to the Congress on the first Monday in February.

Authorization and Appropriation — Legislative Considerations

Congress begins its formal review of the President's budget proposals in February. Congress can approve, modify, or disapprove these proposals. The result of the Congressional deliberations is a series of appropriation acts that are sent to the President and, upon signature, become laws. These acts provide the federal agencies with budget authority, which provides permission to obligate funds. The concept of budget authority requires an understanding of two terms that are basic to federal financial management — obligations and outlays.

- **Obligations** are legally binding commitments (e.g., contract awards) made by federal agencies during a given period that will require outlays during the same or some future period.
- **Outlays** are checks issued or cash disbursed by the U.S. Treasury.

When appropriating funds, Congress does not vote directly on the amount of money to be spent (outlays) in the next fiscal year but rather on budget authority or the amount of obligations that can be incurred. The appropriation act gives an agency the authority to obligate the government to outlay funds at some point in the future. The most usual method of obligating funds is through a contract. For that reason, the term obligation has special importance for the contract office.

Budget Execution and Control

Upon signature by the President, the appropriation acts become law, and OMB distributes the funds to the agencies. This distribution process is

known as apportionment. The amount apportioned determines the availability of funds for issuing contracts.

After the requiring activity receives the funds, they initiate the process that leads to the award of a contract. Figure 6-1 is the typical sequence of events in the financial management process.

Figure 6-1 Financial Management Process	
Who Takes Action	Action Taken
Requiring Office	Prepares a purchase request and forwards it to the organization's comptroller.
Comptroller/Funds Holder	Reviews the funds on the PR and certifies they are available in the amount requested and in the correct fiscal year and appropriation for the work to be done.
Comptroller/Funds Holder	Makes a commitment that reserves these funds and forwards PR to the contracting officer.
Contracting Officer	Awards the contract.
Comptroller	Records previously committed funds as obligated.
Contractor	An invoice is submitted upon completion of work and the government issues a check, which results in an expenditure.
U.S. Treasury	Payment is made when the check is cashed and that is the outlay.

The contracting officer may not process a contractual action without written assurance from the responsible financial authority that adequate funds are available. Occasionally, schedule demands are such that the contracting process must begin before funds are available and in such a case, the contracting officer must condition the contract upon availability of funds. Risks, however, are associated with allowing contractors to work before Congress appropriates money, and certain actions are required to mitigate this risk.

Review and Audit

Individual agencies are responsible, through their own review and control systems, for making sure obligations incurred and the resulting outlays adhere to the authorization and appropriations legislation. In addition, GAO audits and investigates agency programs and management focusing on fraud and mismanagement.

TYPES OF APPROPRIATIONS

An appropriation is a law enacted by Congress that authorizes government agencies to incur obligations, and the Treasury to make payments for designated purposes. Appropriations are the most common type of budget authority provided by Congress. Appropriations differ by both purpose and the time period during which funds are available for obligation.

Since each appropriation has distinct characteristics, the different appropriations are often referred to as the *color of the money*. In the private sector, all money is “green.” One dollar is the same as any other dollar and money does not “expire.” In the government, however, the situation is not that simple. Agencies may spend only as much and only for those purposes that Congress authorizes. Individual appropriations govern what goods or services you may buy with that “color” of money. In general, one type of money may not be used to purchase goods and services in another category. As you might imagine, there are detailed regulations that specify what goods or services fall within each category.

For example, in DoD, there are five general “colors” of money:

- Procurement
- Research, Development, Test, and Evaluation (RDT&E)
- Operations and Maintenance (O&M)
- Military Personnel
- Military Construction

Annual Appropriations

Programs funded by annual appropriations:

- require the passage of annual legislation to continue;
- may not carry funds over into the next fiscal year; and
- are the most common type of appropriation.

All appropriations are presumed to be annual appropriations unless the appropriating act expressly provides otherwise.

Annual appropriations are provided for in 13 regular appropriations bills, each one under the jurisdiction of parallel House and Senate Appropriations subcommittees, which recommend spending levels to the full committees. Each bill comes to the House and Senate floor separately.

The details of the appropriation bills are contained in conference committee reports. These reports contain specific language related to funding levels for programs and activities not specified in the more general language of the appropriation bill. The conference committee reports are not law, but are the express wishes of Congress and are ignored only at great peril to an agency.

Multiple-Year Appropriations

Multiple-year appropriations:

- last for several years — the length of the appropriation is stated in the appropriating law (two, three, and five year appropriations are most common);
- are provided in cases where typical projects take years to complete, as in research and development, construction, and procurement; and
- allow funds to carry over until the appropriation expires.

No-Year Appropriations

With no-year appropriations, there is **no fixed limit** to the number of years for which the appropriation is available. The obligation authority remains available until the activity for which the funds were appropriated is completed, or two years elapse without an obligation against the account.

No-year appropriations are usually made for activities (such as large construction projects) that take many years to complete. For example, an appropriation may be signed this year that results in contracts being signed over a period of several years. No-year appropriation language will say that “funds are available until expended.”

Supplemental Appropriations

Supplemental appropriations provide additional budget authority when regular appropriations are insufficient or for activities not funded in the regular

appropriation. For example, Congress usually enacts supplemental appropriations in the fall to cover some of the costs associated with federal salary adjustments made earlier in the year. Emergencies and natural disasters are also funded through supplemental appropriations. Iraq is a current example where Congress has authorized supplemental appropriations.

Supplemental appropriations can also be used to rescind budget authority previously provided.

Continuing Resolutions

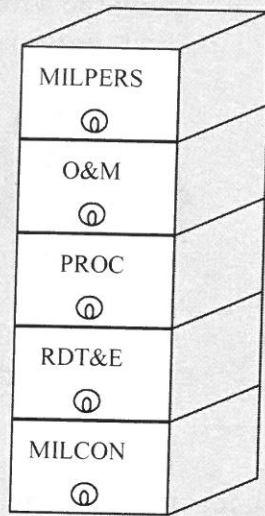
When Congress fails to enact all of the regular appropriations bills by the start of the fiscal year, it may provide interim funding in “continuing resolutions”. Congress must pass a continuing resolution for any or all outstanding appropriations bills by October 1 to avoid a shutdown of the affected agencies. The President must sign the continuing resolution for it to take effect.

A continuing resolution authorizes funding based on the lesser of:

- the Senate passed appropriation;
- the House passed appropriation;
- the budget estimate for next year; or
- the “current rate” (last year’s amount prorated for the length of the continuing resolution).

Defense Appropriations

DEFENSE APPROPRIATIONS



MILITARY PERSONNEL

ACTIVE FORCES
RESERVE FORCES

OPERATION AND MAINTENANCE

CIVILIAN SALARIES
SUPPLIES
SPARES
FUEL
SOFTWARE

PROCUREMENT

AIRCRAFT
MISSILES
WEAPONS AND TRACKED COMBAT
VEHICLES
PROCUREMENT OF AMMUNITION
OTHER PROCUREMENT
CHEMICAL AGENTS MUNITIONS
DESTRUCTION
WEAPONS
SHIPBUILDING AND CONVERSION
PROCUREMENT, MARINE CORPS
PROCUREMENT, DEFENSEWIDE
NATIONAL GUARD AND RESERVE
EQUIPMENT

RESEACH, DEVELOPMENT TEST, AND EVALUATION

BASIC RESEARCH
EXPLORATORY DEVELOPMENT
ADVANCED DEVELOPMENT
DEMONSTRATION & VALIDATION
ENGINEERING & MANUFACTURING
DEVELOPMENT
RDT&E MANAGEMENT SUPPORT
OP SYSTEMS DEVELOPMENT

MILITARY CONSTRUCTION

FACILITIES
HOUSING

ANTI-DEFICIENCY ACT, MISAPPROPRIATIONS ACT, AND BONA-FIDE NEED RULE

When contracting officers sign a contract as agents of the government, they are certifying that they have complied with all laws and regulations, including those governing the use of taxpayer dollars. The Anti-Deficiency Act, Misappropriation Act, and Bona-Fide Need Rule refer to a number of legal restrictions on how an agency can spend money. They help ensure that agencies do not spend more money than Congress intends. Specifically, these restrictions cover how much you can spend, when you can spend it, and what you can buy with the money. Using more money than is available can result in a violation of the Anti-Deficiency Act. Using the wrong "color" of money can result in violation of the Misappropriations Act. Using the wrong fiscal year funds violates the Bona-Fide Need Rule. These Acts operate in conjunction with each other.

Violations

Anti-Deficiency Act

- Using money before Congress has authorized the money to be spent.
- Spending more money than exists in the account.

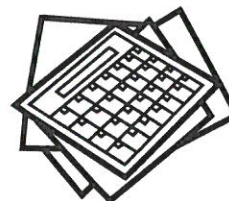
Misappropriations Act

- Using the wrong “color” of money.



Bona-Fide Need Rule

- Using the wrong fiscal year funds.



Importance

The Anti-Deficiency Act is taken very seriously because of the penalties attached to violations. Personnel who violate the Act are subject to administrative penalties including, when the circumstances warrant it, suspension or removal from office. If an individual knowingly violates the Act, criminal penalties may be assessed.

The most basic rule of thumb to avoid potential problems with the Anti-Deficiency Act is to never exceed the amount listed on the certification that accompanies the purchase request when you award a contract.

Seek Advice

The Anti-Deficiency Act and its application are complicated and the information presented here is only a very cursory overview. To learn more about government fiscal law, see:

- GAO's five-volume *Principles of Federal Appropriations Law*, commonly referred to as the “Red Book” at:

<http://www.cfo.doe.gov/budget/gao/>

Although these materials can help you understand fiscal law issues, regulations and laws change all the time. When questions arise regarding the Anti-Deficiency Act, Misappropriation Act, or Bone-Fide Need Rule, it is always wise to seek the advice of your activity's fiscal attorney.

THE DEFENSE PLANNING, PROGRAMMING, BUDGETING AND EXECUTION (PPBE) PROCESS

The Planning, Programming, Budgeting, and Execution process was established to revolutionize internal DoD budget efforts, increase effectiveness, and add additional emphasis to execution. DoD will formulate two-year budgets and use the off year to focus on fiscal execution and program performance. The two-year cycle will guide the department's decision processes, which include:

- strategy development;
- identification of needs for military capabilities;
- program planning;
- resource estimation and allocation; and
- acquisition and other decision processes.

This process will more closely align DoD's internal cycle with external requirements embedded in statute and administration policy.

Years before the budget is prepared and submitted, requirements are identified. This planning cycle allows contracting officials to anticipate their workload as well as participate in the formation of acquisition plans. The planning cycle is as follows:

- **Phase 1 —Planning.** DoD assesses capabilities, analyzes the threat and national defense policies, and develops resource informed program guidance. This guidance defines the requirements for the military services.
- **Phase 2 —Programming.** The services translate guidance into a plan to allocate resources to accomplish mission requirements. They cost out force objectives and personnel resources for six years in the future.
- **Phase 3 — Budgeting.** The most significant phase, since it is here the President's budget is prepared, reviewed, and sent to Congress. This phase concentrates on the funding requirements necessary to do the job.

- **Phase 4 — Execution Review.** Execution reviews allow assessments to be made concerning current and previous resource allocations and whether DoD achieved its planned performance goals. Performance metrics will be applied to ascertain whether an appropriate allocation of resources exists in current budgets. Recommendations may be made to replace a program with alternative solutions or make funding adjustments to correct resource imbalance, if performance goals are not met.

The Quadrennial Defense Review (QDR) will continue to serve as DoD's major statement of defense strategy and business policy. It also will continue to be the single link throughout DoD that integrates and influences all internal decision processes. QDR 2001 shifted the basis of defense planning from a "threat-based" model that dominated thinking in the past to a "capabilities-based" model. The "capabilities-based model" focuses on how an adversary might fight rather than specifically who the adversary might be or where a war might occur. It also recognizes that it is not enough to plan for large conventional wars in distant theaters. Instead, the U.S. must identify the capabilities required to deter and defeat adversaries who will rely on surprise, deception, and asymmetric warfare to achieve their objectives.

FINANCIAL MANAGEMENT

Financial Management Community

You will be working with a number of people from the financial management community who are important members of the acquisition team. Of most importance to contracting are the funds holders who will be responsible for providing the money and the finance office payment specialists, who are responsible for ensuring the contractors get paid on time.

Funds Holders

Funds holders are the financial specialists responsible for managing funds provided to the agency by Congress. Generally, funds holders are located at the buying activity and may be called financial analysts, budget analysts, or resource managers. They keep records of what funds have been committed (set aside to buy goods or services), what funds have been obligated (used on contracts), and what funds have been expended (paid to vendors). For these

specialists to perform their mission, it is vitally important that contract specialists accurately enter financial data into contract writing systems. It is equally important the contracting systems accurately transfer this information to the financial management systems in a timely manner.

NOTE: If there is a problem with the financial data when writing a contract (e.g., the information is illegible or appears inaccurate), the funds holder is the first point of contact to resolve the issue. Entering data that is clearly wrong or trying to guess what the data should be will only cause larger problems “down the road”. These problems can result in your contractor not getting paid and could even result in the contractor refusing to continue work on your contract. It is very important for you to resolve and correct any issues related to financial data as soon as they appear.

Payment Clerks

Another important individual in the acquisition process is the payment clerk at the finance office. For example, in DoD, these individuals are located at the Defense Finance and Accounting Service (DFAS). This person is responsible for ensuring your contractor gets paid on time and in accordance with the instructions you have included in your contract.

Payment Problems

Many times, problems can occur if the:

- payment clerk cannot locate contract documents;
- contract accounting information is incorrect; or
- the contractor’s payment instructions are missing or ambiguous.

When there is a problem in the government funding process, payment could be issued later than the contractor expected. Lack of cash flow may put the contractor in an awkward position...a position of risk.

Often, these problems are uncovered as soon as the finance office gets the contract. They may send you a contract deficiency notice indicating something is wrong with the way the contract is written. It is vital you respond to these notices and correct the problems immediately.

Each contract is assigned to a particular payment office and, sometimes, to a division within that office. It is good practice for contracting professionals to

become familiar with whoever is responsible for making payments on their contracts. When a problem arises, knowing whom to contact at the payment office can make all the difference in the world.

BUSINESS PROCESS INTERFACES

The contracting process is only one step in a longer and more complicated acquisition process. Of all the other processes, the one with which contracting is most closely intertwined is the financial management process. After all, the contract is the source of accounting transactions that must be captured in the financial management systems. In addition, the contract is also the source for all information required to ensure that the government keeps its side of the contractual bargain — to pay the contractor correctly and on time.

Financial Management Process

The financial management process starts when you receive a commitment of funds from the funds holder. Generally, the purchase request contains a certification that the funds have been “committed” or set aside for the purpose of buying the goods or services identified in the purchase request. At this point, the contract specialist must check to ensure the funds are the correct year and type and are sufficient to cover the estimated purchase price.

Figure 6-2
Source of Funds

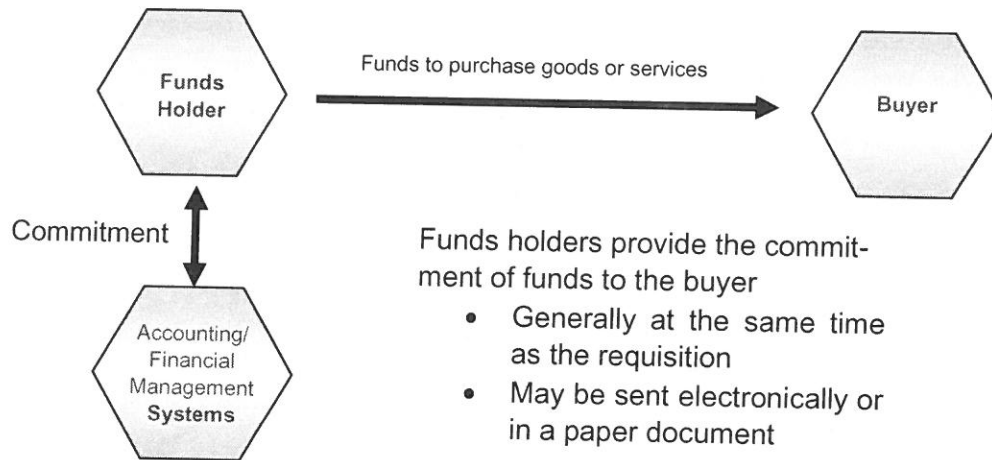
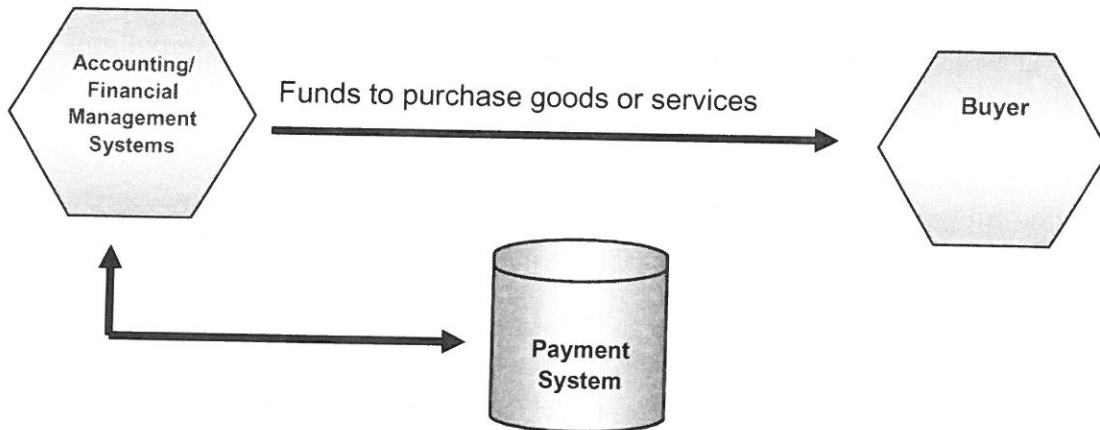


Figure 6-3
Link to Payment System



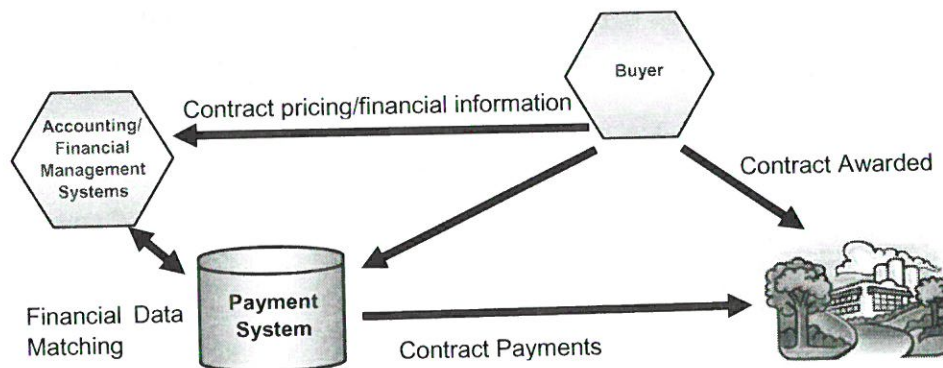
The payment system is linked to the accounting system so that no payments will be made unless funds have been set aside and are currently available in the accounting system.

Payment Process

If the funding is sufficient, the rest of the contracting process may continue and a contract is eventually awarded to a vendor. At the same time you send the contract is sent to the vendor, you must send a copy to the accounting office so the funds holders know that you have obligated the funds. In addition,

you must send a copy to finance office to alert them that another contract has been awarded and to expect a bill sometime in the future. This is a critical stage of the process. The contract information must be entered into the payment system accurately and quickly or else the vendor's invoices may not get paid. An illustration of this process appears below.

Figure 6-4
Payment Process



When the contract is awarded to a company, the funds are obligated and the financial information is sent to the payment system and the accounting system.

The finance office makes payments to the contractor in accordance with contract terms and sends payment information to the accounting system.

Payment Complexity

The payment process can become quite complicated depending on the type of contract and how complex it is. Low dollar-value contracts may last a short time (often less than one year) and may require the finance office to make only one payment when the goods or services are delivered. On the other hand, contracts for major weapons systems may span many years and contain many complex financing and payment provisions. The longer and more complicated a contract is, the greater the chance that accounting and payment errors will occur.

Reconciliation Process

When a contract is finally completed and before the contract can be closed and sent to storage, the information in the contract must match with the in-

formation in the payment system and the accounting system. This step ensures that no mistakes were made and the vendor received the right amount of money, no more and no less, than it was due in accordance with the contract terms and conditions. This process is called contract reconciliation.

The reconciliation process can become expensive and time-consuming, particularly if funding issues and mistakes are not caught and corrected early in the process. Some agencies may have computerized systems to point out errors in the process. For example, DoD is designing new contract writing and financial management systems to help ensure that financial data is accurate at every step of the process. To that end, the systems will contain edits and validations to assist you with accurate data entry. In the long run, though, agencies still rely on their contracting professionals to ensure that critical financial data is processed accurately and quickly in the contract writing systems to avoid the needless waste of scarce resources correcting errors and reconciling contracts.

Audit Process

Auditors oversee every step of these processes, and therefore are critical to acquisition and financial management processes. Agencies can conduct regular audits of buying activities to determine whether or not contracting officers are complying with all the laws and regulations regarding contracting and financial management. They may also audit contractors and the financial management systems and processes. Usually, the agency's inspector general audit staff conducted these audits. For agencies that have no inspector general, other organizations may be given that authority.

Defense Contract Audit Agency

The Defense Contract Audit Agency conducts regular audit reviews of contractors. In terms of the acquisition and financial management interface, these audits are conducted to find out if the contractor is:

- accounting for costs correctly;
- preparing invoices correctly; and
- maintaining accounting systems sufficient to meet government accounting requirements.

GAO

Another source of audits is GAO. They may audit buying activities or contractors. In the last few years, they have conducted many audits of executive agency payment and accounting systems to determine if agencies are paying their bills correctly and properly accounting for all transactions.

SUMMARY

Money issues are an integral component of the contracting process and every contracting professional should learn and understand the budget cycle and key elements of financial management as they apply to the acquisition process.

Some of the key financial management elements are:

- source and type of funds;
- the life cycle of the funds you are using;
- interfaces between contracting and financial management systems;
- financial management points; and
- contract financing and payment as elements of the business arrangement.

The more familiar you become with these concepts, the more expert and valuable you will be as a business advisor.