



*Current Practices Might Be Preventing Use of
the Most Advantageous Contractual Methods
to Acquire Goods and Services*

February 10, 2009

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 10, 2009

MEMORANDUM FOR DEPUTY COMMISSIONER FOR OPERATIONS SUPPORT

FROM: (for) Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Current Practices Might Be Preventing Use of the Most Advantageous Contractual Methods to Acquire Goods and Services (Audit # 200810012)

This report presents the results of our review of the selection of contract type. The overall objective of this review was to determine whether the Internal Revenue Service (IRS) is using appropriate contract types, as presented in and directed by the Federal Acquisition Regulation (FAR),¹ to accomplish its mission of tax administration. The review was requested by the IRS Office of Procurement. It was also part of the Treasury Inspector General for Tax Administration Fiscal Year 2008 Annual Audit Plan coverage under the major management challenge of Erroneous and Improper Payments.

Impact on the Taxpayer

Cost-reimbursement contracts, which reimburse contractors for all their costs, represent the highest monetary risk to the Federal Government. In our sample of 40 contracts, we found that only 2 were negotiated on a fully firm fixed-price basis (lowest monetary risk) and 33 were awarded on a cost-reimbursement basis. We also identified little coordination between program offices and the IRS Office of Procurement regarding selection of the most advantageous contract type prior to the program offices submitting their requirements. The IRS' predisposition to use cost-reimbursement contracts could result in inefficient use or misuse of taxpayer funds.

¹ 48 C.F.R. ch. 1 (2006).



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Synopsis

We reviewed a sample of 40 contracts—representing a total of approximately \$339 million—negotiated by the IRS with private vendors between February 2007 and January 2008.

Thirty-three (83 percent) of the 40 contracts were negotiated to reimburse contractors for costs, time and materials expenses, and/or labor hours incurred. These types of contracts present a greater risk of the IRS paying more funds than necessary. Five of the contracts did contain fixed-price elements in addition to reimbursing the contractors for some costs or time and materials expenses incurred.

Overall, the contract types we reviewed were not improper based on their associated statements of work² and the definitions of contract types in the FAR. However, improved controls in three areas related to the coordination and planning of the contract type prior to award could facilitate a better review and selection of the contract type. First, contract files lack appropriate justification for the selection of contract type and methodology. According to the FAR, Contracting Officers are required, with limited exceptions, to include in each contract file documentation to show why the particular contract type was selected. However, in only 9 of the 40 contracts reviewed, the Contracting Officers' written determinations explaining their decisions to award a contract included a rationale as to why a less risky contract type could not have been selected. In addition, the Office of Procurement issues a call to the program offices to complete an Advanced Acquisition Planning Agreement. These Agreements contain information addressing the appropriateness of using Performance-Based Acquisition methods in proposed contracts, which could affect contract type. The Agreements were not submitted by the program office to the Office of Procurement in 6 (15 percent) of the 40 contracts. In the 32 forms that were submitted, use of Performance-Based Acquisition methods was not addressed for 9 (28 percent) of the contracts.

Second, contract type decisions are being made within the program offices rather than in collaboration with the Contracting Officers. For all 40 contracts reviewed, we found that the IRS program office selected the type of contract prior to sending the requisition to the Office of Procurement. Office of Procurement personnel stated that the statements of work provided by the program offices are generally directed toward a certain contract type, typically cost-reimbursement plus a fixed fee. The FAR states that the planner should coordinate with the Contracting Officer in all acquisition planning. This would include discussing the appropriate contract type to ensure successful performance and the best value for the Federal Government.

² The portion of a contract that describes the actual work to be done by the contractor by means of 1) specifications or other minimum requirements, 2) quantities, 3) performance dates, 4) time and place of performance of services, and 5) quality requirements. The statement of work is the key element in deciding the selection of a contract type. The level of detail, clarity, and identification of performance objectives and expectations in the statement of work drive all other conditions of the contract, including pricing structure, contractor's entitlement to payment, and level of contract administration.



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For 38 of the 40 contract files we reviewed, the IRS was unable to provide documentation of any discussions of the contract type between the program office and the Contracting Officer assigned to oversee the procurement prior to the submission of the statement of work to the Contracting Officer. While choosing the contract type should be a cooperative effort between the program manager and the Contracting Officer, ultimately it is the Contracting Officer who has the sole authority to enter into a contract on the Federal Government's behalf, including negotiation of contract type.

Finally, cost-reimbursement contracts are used routinely, and little effort is made to convert follow-on work to less risky contract types. Eighteen of the 40 contracts we reviewed contained operations and/or maintenance as part of the contract. However, the operations and/or maintenance elements of the contract were fixed-price in only 4 (22 percent) of the 18 contracts. The FAR states that cost-reimbursement contracts should be used only when uncertainties involved in contractor performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract. For example, the longer a contract for maintenance services goes on, the better the agency is able to estimate the monthly costs, such as those associated with routine operations and/or maintenance, which might enable the Contracting Officer to issue subsequent procurement actions as fixed-price.

In January 2008, the Office of Procurement established a Contract Review Board to review modernization and information technology requisitions that meet certain criteria prior to award of a contract. In addition, in April 2008, the Office of Procurement issued a Policy and Procedure Memorandum establishing an executive review process in coordination with appropriate program personnel for any proposed acquisitions that exceed \$10 million and are other than firm fixed-price. Because the Contract Review Board and the executive review process were implemented after the period of our audit, we did not review any actions that might have gone through these new processes.

Recommendations

We recommended that the Director, Procurement, ensure that Contracting Officers document the contract file with their detailed justification for awarding a cost-reimbursement contract and/or a contract that does not use Performance-Based Acquisition methods. The Deputy Commissioner for Operations Support and the Chief, Agency-Wide Shared Services, should establish and implement guidance that requires members of the acquisition team, including Office of Procurement and program office personnel, to meet and coordinate prior to writing the statement of work to ensure that the best value contract type can be negotiated. Finally, the Deputy Commissioner for Operations Support should require the program offices to routinely review contracts prior to exercising option years or recompeting the contracts for follow-on work, for the possibility of converting all or portions of the contracts to less risky contract types.



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Response

IRS management fully agreed with our first two recommendations and partially agreed with the third recommendation. To ensure that the Contracting Officers document their decisions for awarding a cost-reimbursement contract and/or a contract that does not use Performance-Based Acquisition methods, the Office of Procurement Policy is developing templates for documenting contract type decisions and rationale when Performance-Based Acquisition methods are not used. The Deputy Commissioner for Operations Support and the Chief, Agency-Wide Shared Services, have issued a memorandum emphasizing the use of the “7 steps to Performance-Based Acquisition.” In addition, a module entitled “Types of Work Statements, Appropriate Contract Types and Risk” will be included in the annual Advance Acquisition Planning conference to emphasize the importance of the acquisition team selecting the appropriate contract type. In Fiscal Year 2008, the Office of Procurement established a Contract Review Board in the Office of Information Technology Acquisition that reviews all information technology acquisitions meeting established dollar thresholds. The Contract Review Board reviews the rationale for contract type and any justification for not using Performance-Based Acquisition methods. Finally, IRS management agreed that contracts should be reviewed when recompeting for follow-on work to less risky contract types, but disagreed with changing the contract type at the time of exercising an option because a material contract change could result in possible violation of the Competition in Contracting Act. The IRS will look for opportunities to use firm fixed-price contracts on an ongoing basis. Management’s complete response to the draft report is included as Appendix IV.

Office of Audit Comment

We would like to clarify our third recommendation. If the existing contract type is no longer in the best interest of the Government, the option should not be exercised and the contract should be recompeted. We are not suggesting that the IRS unilaterally change contract type before exercising option years.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Nancy A. Nakamura, Assistant Inspector General for Audit (Management Services and Exempt Organizations), at (202) 622-8500.



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Abbreviations

AAPA	Advance Acquisition Planning Agreement
CRB	Contract Review Board
FAR	Federal Acquisition Regulation
IRS	Internal Revenue Service
PBA	Performance-Based Acquisition
SOW	Statement of Work



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Background

As of March 31, 2008, the Internal Revenue Service (IRS) Office of Procurement was responsible for administering 709 contracts of varying types, representing \$34 billion. A wide selection of contract types is available to the Federal Government to provide needed flexibility in acquiring the large variety and volume of supplies and services required by Federal agencies. When an agency needs to procure goods and services, one of the key early decisions is the type of contract to use (i.e., the form or structure the contract will take). The type of contract determines how the contractor will be paid during the term of the contract and what the contractor's responsibilities and level of risk are for performance. Consequently, choosing the appropriate contract type is essential to successful performance and obtaining the best value for the Federal Government. However, no single contract type is right for every contractual situation. Rather, selection must be made on a case-by-case basis considering contract risk and incentives for contractor performance.

***No single contract type is
right for every contractual
situation.***

There are two broad categories for the type of contract:

- Fixed-price – the contractor is paid a fixed price, regardless of how much it costs the contractor to deliver the goods and/or services. Consequently, the contractor has full responsibility for the performance costs and resulting profit (or loss), and the financial risk to the Federal Government is limited. Use of the firm fixed-price contract type is preferred when possible.
- Cost-reimbursement – the contractor is paid a fee in addition to being reimbursed for direct costs incurred in the performance of the contract. Consequently, the contractor has minimal incentive to keep costs low, and the financial risk to the Federal Government is increased.

In between these two broad categories are various contract types in which the contractor's responsibilities for the performance costs and the profit or fee incentives that are offered are tailored to the uncertainties involved in contract performance. Contract type options include a cost-plus-incentive or award-fee contract, which reimburses the contractor for costs incurred while tying additional payments to the contractor's performance. Time and materials contracts reimburse the contractor for the cost of materials in addition to paying a fixed, hourly rate for time spent performing services for the Federal Government. The fixed hourly rate includes wages, overhead, general and administrative expenses, and profit. Because the profit is already included in the hourly rate, there is no other positive profit incentive for the contractor to control costs in a time and materials contract.



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The Federal Acquisition Regulation (FAR)¹ Part 16 stipulates that each contract file shall include documentation to show why the particular contract type was selected. The exceptions to this documentation include firm fixed-price acquisitions made under the simplified acquisition procedures, contracts negotiated on a firm fixed-price basis other than those for major systems or research and development, and awards on the set-aside portion of sealed bid partial set-asides for small businesses.²

IRS program offices are requested by the Office of Procurement to evaluate whether Performance-Based Acquisition (PBA) methods can be used for proposed contracts for the coming fiscal year and to provide rationale in the acquisition plan when proposing not to use PBA methods in planned contracts. PBA methods incorporate incentives and/or awards for contractor high performance into contracts signed with private vendors. Using PBA methods can affect the type of contract ultimately used to acquire services. The FAR directs agencies to use PBA to the maximum extent possible,³ and PBA is the preferred method for acquiring services. One reason for this is that a contract that incorporates PBA methods will more closely associate contractor performance with the fees the contractor ultimately receives in payment for the services it performs. Contracts that do not contain PBA methods might pay the contractor a fixed fee for providing a good-faith effort⁴ and not on whether the desired outcome was achieved.

This review was performed at the Office of Procurement in Oxon Hill, Maryland, and various program offices in New Carrollton, Maryland, and Washington, D.C., within the IRS Criminal Investigation Division, Office of the Chief Information Officer, Wage and Investment Division, Small Business/Self-Employed Division, and Office of the Chief Secretariat during the period January through September 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

¹ 48 C.F.R. ch. 1 (2006).

² An award made to a small business where a portion of the procurement was restricted for award only to small businesses.

³ Architect-engineer services acquired in accordance with 40 U.S.C. Section 1101 *et seq.*, construction, utility services, and services that are incidental to supply purchases are exempt from the FAR requirement to use PBA methods to the maximum extent practicable.

⁴ An implied obligation of all contracting parties to treat each other fairly during the performance and enforcement of a contract.



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Results of Review

We reviewed a sample of 40 contracts—representing a total of approximately \$339 million—negotiated by the IRS with private vendors between February 2007 and January 2008 and determined that the contract type selected was not improper based on the statements of work (SOW) and definitions of contract types in the FAR. However, only 2 of the 40 contracts we reviewed were negotiated on a fully firm fixed-price basis. The majority of the contracts (33 or 83 percent) were negotiated to reimburse contractors for costs, time and materials expenses, and/or labor hours incurred. These types of contracts present a greater risk of the IRS paying more funds than necessary. Five of the contracts did contain fixed-price elements in addition to reimbursing the contractors for some costs or time and materials expenses incurred.

We also found that contract files often did not contain justification for the type of contract selected and that little coordination or discussion regarding contract type occurred between program offices and the Office of Procurement Contracting Officers prior to submission of the SOW.⁵ Instead, program offices selected the contract type they preferred and developed an applicable SOW tailored to that particular contract type for submission to the Contracting Officer. As a result, the SOW received by the Contracting Officer generally did not provide many other options for the Contracting Officer to consider. We determined from our sample cases and through discussions with the Contracting Officers that the initial contract type selected by the program office was routinely used by the Contracting Officer when awarding the contract. As a result, we believe that the IRS' current practices of allowing program offices to make the decision on contract type and to write an SOW that supports the type they have chosen, independent of any participation or guidance from the Office of Procurement, have increased the risk that the IRS is paying more for contracts than it should. This practice has also increased the IRS' vulnerability to contracting fraud, waste, and abuse because cost-reimbursement contracts, as opposed to fixed-price contracts that do not include reimbursements to contractors for expenses, can result in the need for more oversight.

In 2008, the IRS took positive actions to reduce the use of cost-reimbursement contracts, including the establishment of a Contract Review Board (CRB) that must review and approve all proposed modernization and information technology requisitions proposed as cost-reimbursement contracts for more than \$1 million. However, given the overall increased monetary risk to the Federal Government from cost-reimbursement contracts, strong measures

⁵ The portion of a contract that describes the actual work to be done by the contractor by means of 1) specifications or other minimum requirements, 2) quantities, 3) performance dates, 4) time and place of performance of services, and 5) quality requirements. The SOW is the key element in deciding the selection of a contract type. The level of detail, clarity, and identification of performance objectives and expectations in the SOW drive all other conditions of the contract, including pricing structure, contractor's entitlement to payment, and level of contract administration.



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must be in place to reduce the customary use of this contract type. As such, we believe that improved controls in three key areas related to the coordination and planning of the contract type prior to the awarding of the contract could facilitate a better review and selection of the contract type. Specifically, we found that:

- Contract files lack appropriate justification for the selection of contract type and methodology.
- Contract type decisions are being made within the program offices rather than in collaboration with Contracting Officers.
- Cost-reimbursement contracts are used routinely, and little effort is made to convert follow-on work to less risky contract types.

Contract Files Lack Appropriate Justification for the Selection of Contract Type and Methodology

Contracting Officers did not always justify their contract type selection

In only 9 of the 40 contracts we reviewed, the Contracting Officers' written determinations explaining their decisions to award a contract included a rationale as to why a less risky contract type could not have been selected. In addition, when the Contracting Officers did include justification of the selected contract type, the justification appeared to use template language and did not include a comprehensive explanation for the specific contract in question. Twenty-two of the 40 contracts were awarded as cost-reimbursement contracts and were actually task orders⁶ issued against a contract. Only two of these contracts contained justification for selecting the contract type. In the remaining 20 instances, a template was used by the program office to request the task order. A section in the template required the requestor to indicate the type of contract using only a checkmark; no further narrative justification was required.

According to the FAR, Contracting Officers are required, with limited exceptions, to include in each contract file documentation to show why the particular contract type was selected. Due to the overall increased monetary risk to the Federal Government from cost-reimbursement contracts, it is imperative that all proposed contracts between the Federal Government and private vendors be considered first as firm fixed-price types. However, due to the absence of documentation in the contract file justifying the selection of the contract type, we could not determine whether the most appropriate contract type was considered. Without this important consideration of contract type, the IRS cannot be sure that it is contracting for goods and services in the most effective way possible.

⁶ An order for supplies or services placed against an established contract.



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Further, without a full and specific explanation justifying the contract type ultimately selected, IRS employees and managers might be unable to adequately evaluate previous contract type decisions when considering future contract awards or exercising option years. For example, once a contract has concluded or the base year has ended, a new contract might be required to continue the work on the previous contract, or an option year might be exercised to continue the work on the existing contract. At the IRS, it is common practice to use the same type of contract for the new contract or continue with the same type of contract when exercising an option year. Therefore, if the contract type is not sufficiently evaluated at the time of the new award, the impact to the Federal Government could be experienced in several future years.

Program offices did not always provide information regarding use of PBA methods in proposed contracts

According to the FAR, the preferred method of acquiring services is through use of PBA methods, which incorporate into contracts performance-based aspects such as contractor incentives and awards for high performance. Although PBA methods are not a contract type, use of these methods can result in contract types that contain performance-based measures as opposed to those contract types that result in payment of a fixed fee to the contractor for providing a good-faith effort and not on whether the desired outcome was achieved. In fact, Federal Government agencies are directed to use PBA methods to the maximum extent possible, and priority should be given to negotiating contract types that include performance-based approaches.

The Office of Management and Budget established a Federal Government-wide goal of incorporating PBA methods into 45 percent of contracts during Fiscal Year 2007. IRS procedures require program offices to attest to the appropriateness of using PBA methods in proposed contracts as part of their submission of the Advance Acquisition Planning Agreement (AAPA) form to the Office of Procurement. The AAPA form provides details about the planned procurement and allows the Office of Procurement to plan accordingly.

We requested the AAPA forms for the 40 contracts we reviewed. In 2 of the 40 cases, the task order had expired and an AAPA submission was not required. The AAPA form or an equivalent document containing the necessary information was not submitted in 6 (15 percent) of the 40 contracts. In the 32 AAPA forms or equivalents that were submitted, use of PBA methods was not addressed for 9 (28 percent) of the contracts. We also found that the AAPA form does not require a justification when the program office submitting the form states that the contract is not appropriate for PBA methods.

Contracts that lack the incorporation of PBA methods can increase the financial risk to the IRS by minimizing incentive for the contractor to keep costs low. In addition, similar to contract files lacking justification regarding the selection of contract type, when contract files do not contain a determination of the appropriateness of using PBA methods, the IRS cannot be sure that the contract used contains measures that will enable it to obtain goods and services at the best price.



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Recommendation

Recommendation 1: The Director, Procurement, should ensure that the Contracting Officers document their decisions for awarding a cost-reimbursement contract and/or a contract that does not use PBA methods with complete, detailed justifications in the contract file.

Management's Response: The IRS agreed with the recommendation. The Office of Procurement Policy is developing templates for documenting contract type decisions and rationale when PBA methods are not used. The templates will be incorporated into the Guidebook for Acquisition Practices. Each of the Office of Procurement's operating divisions has implemented an Office Instruction to establish a quality review program and internal review procedures to ensure that required documentation is contained in the contract files. In addition, in Fiscal Year 2008, the Office of Procurement established a CRB in the Office of Information Technology Acquisition that reviews all information technology acquisitions meeting established dollar thresholds. The CRB reviews the rationale for contract type and any justification for not using PBA methods.

Contract Type Decisions Are Being Made Within the Program Offices Rather Than in Collaboration With Contracting Officers

For all 40 IRS contracts reviewed, we found that the IRS program office selected the type of contract prior to sending the requisition to the Office of Procurement. Office of Procurement personnel stated that the SOWs provided by the program offices are generally directed toward a certain contract type, typically cost-reimbursement plus a fixed fee. Cost-reimbursement contracts and SOWs are easier for program offices to create because they do not require the inclusion of well-defined requirements or knowledge of reasonably detailed specifications, which sometimes are not known by the program offices when the SOW is prepared. In addition, the FAR states that the planner should coordinate with the Contracting Officer in all acquisition planning which would include selecting the contract type.

For 38 of the 40 contract files we reviewed, the IRS was unable to provide documentation of any discussions of the contract type between the program office initiating the request for service and the Contracting Officer assigned to oversee the procurement prior to the submission of the SOW to the Contracting Officer. Therefore, we believe that the program offices are not including the Office of Procurement sufficiently in their acquisition planning process and do not request guidance for selecting a contract type appropriate to the circumstances of the acquisition.

Further, the Office of Procurement Contracting Officer assigned to the procurement routinely accepted the contract type proposed by the program office without further review or discussion with program office personnel. The Contracting Officer proposed using a different type of contract than that proposed initially by the program office in only two contracts we reviewed.



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In one of those two cases, the Contracting Officer attempted to negotiate a different contract type with the contractor, but the contractor would not agree to accept the type proposed. The IRS program office was determined to use that specific contractor. Therefore, the type of contract the program office proposed was the type selected when the contract was awarded. In the second case, the Contracting Officer questioned the use of a cost-type contract. However, after discussions with the program office and upper level Office of Procurement management, the Contracting Officer selected a cost-type contract that incorporated PBA methods, with the intention to set fixed prices for some of the elements as soon as it became practical to do so.

While choosing the contract type should be a cooperative effort between the program manager and the Contracting Officer, ultimately it is the Contracting Officer who has the sole authority to enter into a contract on the Federal Government's behalf, including negotiation of contract type. Contracting Officers receive training on selecting the most appropriate contract type and, as the FAR stipulates, contracts may be entered into and signed on behalf of the Federal Government only by Contracting Officers. Contracting Officers have authority to enter into, administer, or terminate contracts and make related determinations and findings. The FAR does not delegate to the program offices the authority to make final contract type decisions. Contracting Officers, however, do not have the technical knowledge of the program office's needs for the goods or services. It is the program and project managers who are accountable for the planning, programming, budgeting, and acquisition of capital assets. They are also critical in developing accurate Federal Government requirements, defining measurable performance standards, and managing contractor activities to ensure that intended outcomes are achieved. Because the selection of the most appropriate contract type requires the combined expertise of Contracting Officers and the program offices, it is critical that program and project managers consult with the Contracting Officers and discuss available contract types so that an SOW can be written for the contract type that would best suit their needs at the most advantageous cost to the Federal Government.

Recommendation

Recommendation 2: The Deputy Commissioner for Operations Support and the Chief, Agency-Wide Shared Services, should establish and implement guidance that requires members of the acquisition team, including Office of Procurement and program office personnel, to meet and coordinate prior to writing the SOW to ensure that the best value contract type can be negotiated for the goods and services needed.



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Management's Response: The IRS agreed with this recommendation. The Office of Procurement will continue to emphasize the requirements of acquisition planning as prescribed by the FAR and will include a module entitled "Types of Work Statements, Appropriate Contract Types and Risk" at their annual Advance Acquisition Planning conference to be held in March 2009. In addition, the Deputy Commissioner for Operations Support and the Chief, Agency-Wide Shared Services, have issued a memorandum emphasizing the use of the "7 steps to Performance-Based Acquisition."

Cost-Reimbursement Contracts Are Used Routinely, and Little Effort Is Made to Convert Follow-On Work to Less Risky Contract Types

Our interviews with procurement and program office personnel and review of the 40 contract files indicated that cost-reimbursement contracts were used routinely because that was the contract type originally awarded or used on the prior procurement request. Office of Procurement personnel stated that the program offices often chose cost-reimbursement contracts because they had used a particular contractor before and/or had developed a good working relationship with the contractor and wished to maintain that continuity. Using cost-type contracts also afforded the program offices flexibility in preparing the SOWs because in this type of contract, technical specifications and requirements can be very broadly defined. Office of Procurement personnel often do not have the technical expertise to add all necessary requirements and rewrite an SOW for a different contract type if they have not been involved in acquisition planning prior to receipt of the SOW. For example, if the program office needs contractor support for software development and maintenance services for new and existing systems, Office of Procurement personnel would not know the technical requirements needed to develop the software or the degree of maintenance services needed. They would not be familiar enough with the technical aspects of the existing systems to know what specific services are needed. When requests from program offices lack definitive scope, complete plans, and specifications, Contracting Officers often use riskier contract types, such as cost-reimbursement or time and materials.

Office of Procurement officials advised us they believe that decisions by program offices to concurrently implement a number of projects often negatively affects the Contracting Officers' ability to select firm fixed-price contract types. Firm fixed-price contracts may be entered into by the Federal Government only when all funding for the contracted good or service is currently available. This rarely is the case if the contract is for multiple years because the IRS budget is approved annually. Consequently, the IRS' decision to implement many projects at once instead of concentrating fully on a small number of projects often results in each project being funded incrementally, or partially, on a year-to-year basis. Thus, many IRS contracts are not eligible for firm fixed-price awards. Further, if Congress and the President do not agree and approve the IRS' budget by October 1 of each year, the IRS often operates under Continuing Resolution Authority during the first part of the fiscal year. This typically means that the IRS must operate



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at the prior year budget levels. New contract requests that could use a less risky contract type might not be approved in these funding circumstances.

In January 2008, the Office of Procurement established a CRB to review modernization and information technology requisitions that meet certain criteria prior to award of a contract. All modernization and information technology requisitions that are proposed as cost-reimbursement for more than \$1 million must obtain approval from the CRB to move forward. Also, the CRB must approve all modernization and information technology requisitions that are not going to use PBA methods. In April 2008, the Office of Procurement issued a Policy and Procedure Memorandum, which states that the Office Director or Branch Chief must initiate through the Chief, Quality Assurance Branch, an acquisition planning meeting with the Director, Procurement, and appropriate program personnel for any actions that exceed \$10 million and are other than firm fixed-price. The acquisition planning meeting must occur at a point when acquisition strategy is being developed. Because the CRB and the new policy were implemented after the period of our audit, we did not review any actions that might have gone through these new processes. However, we believe that the CRB and the new policy are good steps toward reversing the trend of routinely using cost-type contracts and mitigating risks to the Federal Government.

Office of Procurement personnel stated that they are now using more hybrid contracts, in which some elements of the contract are firm fixed-price while other elements that do not contain well-defined specifications are negotiated using time and materials or cost-reimbursement payment methods. The FAR states that cost-reimbursement contracts should be used only when uncertainties involved in contractor performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract. However, for longer term contracts, there is an opportunity for the IRS to learn from the early contracts what the actual costs and requirements are to better gauge future contract needs. For example, the longer a contract for maintenance services goes on, the better the agency is able to estimate the monthly costs, such as those associated with routine operations and/or maintenance. This might enable the Contracting Officer to negotiate subsequent procurement actions as fixed-price. As experience in the course of a series of contracts or a single long-term contract provides a basis for firmer pricing, Contracting Officers should avoid extended use of a cost-reimbursement or time and materials contract.

Eighteen of the 40 contract actions we reviewed contained operations and/or maintenance as part of the contract. However, the operations and/or maintenance elements of the contract were fixed-price in only 4 (22 percent) of the 18 contracts. We believe that as work continues on various systems, projects, and programs, these acquisitions should be routinely reviewed to determine whether there are elements (e.g., operations and maintenance) that can be awarded on a fixed-priced basis when a contract for follow-on work is awarded. Hybrid contracts can be a useful tool to assist the IRS in transitioning contracts that were initially negotiated as cost-reimbursement into firm fixed-price contracts, thereby reducing the monetary risk to the Federal Government.



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Recommendation

Recommendation 3: The Deputy Commissioner for Operations Support should require the program offices to routinely review contracts prior to exercising option years or recompeting the contracts for follow-on work, for the possibility of converting all or portions of the contracts to less risky contract types with an eventual goal of using a firm fixed-price basis.

Management's Response: The IRS agreed in part with this recommendation. The IRS agrees that the program offices should routinely review contracts when recompeting for follow-on work for potential changes to less risky contract types. However, the IRS disagreed with changing the contract type at the time of exercising an option because a material contract change could result in possible violation of the Competition in Contracting Act. The IRS will look for opportunities to use firm-fixed price contracts on an ongoing basis.

Office of Audit Comment: We would like to clarify our third recommendation. If the existing contract type is no longer in the best interest of the Government, the option should not be exercised and the contract should be recompeted. We are not suggesting that the IRS unilaterally change contract type before exercising option years.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether the IRS is using appropriate contract types, as presented in and directed by the FAR,¹ to accomplish its mission of tax administration. To accomplish the objective, we:

- I. Obtained an understanding of the process the IRS uses to select contract types and identified controls and potential risks.
 - A. Researched the FAR (Chapter 1 – General and Chapter 10 – Treasury) and IRS policies and procedures regarding the selection of contract types to gain an understanding of the selection process.
 - B. Interviewed procurement and program office personnel to confirm the process of selecting contract types.
 - C. Identified risks in the process of contract type selection and controls in place to minimize those risks.
 - D. Determined whether the IRS’ contract selection process is designed to achieve the most appropriate contracting method.
- II. Determined whether the Office of Procurement completely and accurately documented the processes used and decisions made in selecting contract types.
 - A. Identified a universe of 16,374 active procurement actions taken from February 2007 to January 2008 from the Federal Procurement Data System.² We then divided the actions by contract type (firm fixed-price, cost-reimbursement, labor hour, time and materials, cost sharing). To conduct our preliminary analysis, we judgmentally selected nine of these actions from the different contract types. We used a judgmental sample because we did not plan to project our results to the universe. We did not assess the reliability of the data contained in the Federal Procurement Data System. The data were used for sampling purposes only and did not have any effect on accomplishing the objective.

¹ 48 C.F.R. ch. 1 (2006).

² A system which collects, processes, and disseminates official statistical data on Federal contracting. All Federal agencies report directly to this system.



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- B. From contract files, identified whether documentation was present that would completely and accurately support the contract type selection, using established selection criteria.
 - C. Interviewed procurement and program office personnel to determine the extent of their involvement in the decisions regarding contract type selection.
- III. Determined whether the Office of Procurement is selecting the most appropriate contract types to obtain goods and services.
- A. From the 16,374 procurement actions identified, selected 31 additional procurement actions using random sampling. From our preliminary review of the contract files, we determined that the cost-reimbursement, labor hour, and time and materials contract types were the most risky. Therefore, we randomly selected the 31 actions from those contract types.
 - B. From all 40 contract files (9 from the first sample and 31 from the second), including the SOW,³ acquisition plan, and pre-award documentation, documented the following:
 - 1. Contract type (firm fixed-price, cost-reimbursement).
 - 2. Deliverables expected from the contractor.
 - 3. Cost arrangements.
 - C. Interviewed procurement and program office personnel to document the purpose of the contract and what was expected from the contract (e.g., what work was to be accomplished, deliverables).
 - D. Compared the type of contract selected with the intent of the contract as established in the SOW by reviewing the contract files and through discussions with procurement and program office personnel. We documented and discussed any discrepancies based on established selection criteria.

³ The portion of a contract that describes the actual work to be done by the contractor by means of 1) specifications or other minimum requirements, 2) quantities, 3) performance dates, 4) time and place of performance of services, and 5) quality requirements. The SOW is the key element in deciding the selection of a contract type. The level of detail, clarity, and identification of performance objectives and expectations in the SOW drive all other conditions of the contract, including pricing structure, contractor's entitlement to payment, and level of contract administration.



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Appendix II

Major Contributors to This Report

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Appendix III

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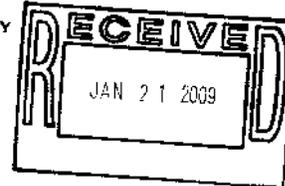
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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224



January 16, 2009

MEMORANDUM FOR MICHAEL R. PHILLIPS
DEPUTY INSPECTOR GENERAL FOR AUDIT

From: James P. Falcone *James P. Falcone*
Chief, Agency-Wide Shared Services

Subject: Draft Audit Report – Current Practices Might Be Preventing Use
of Most Advantageous Contractual Methods to Acquire Goods
and Services (Audit # 200810012)

Thank you for the opportunity to respond to the subject audit report. The audit was conducted to determine whether we are using appropriate contract types, as presented in and directed by the Federal Acquisition Regulation (FAR), to accomplish the mission of tax administration. Our response, including closure of one recommendation, is attached.

The audit reviewed 40 contracts representing \$339 million which were negotiated and awarded to private vendors between February 2007 and January 2008. Thirty-three of the contracts utilized cost reimbursement methods and five contained fixed-price elements in addition to cost reimbursement. The report states that these types of contracts present a greater risk of paying more funds than necessary but also states that the contract types were not improper based on their associated statements of work. The report cites little coordination between program offices and the Office of Procurement regarding selection of the most advantageous contract type prior to the program offices submitting their requirements.

We agree that strong coordination is needed between program offices and Procurement during the acquisition planning stages and throughout the procurement process to ensure appropriate types of contracts are chosen and adequate documentation is included in contract files regarding contract type and use of performance-based acquisition (PBA). Since the timeframe reviewed by this audit, we have made efforts to improve existing processes including the implementation of the Contract Review Board (CRB) which has resulted in numerous acquisitions being returned to the Contracting Officer to determine a more appropriate contract type. Also, we believe the training modules being offered in contract types, along with continued emphasis on PBA at our annual Advance Acquisition Planning conference in March 2009, will lead to more firm-fixed price contracts.



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With regard to Recommendation 3, we would like to note that only Contracting Officers, not program personnel, have authority to exercise options. While we agree a review of contract type should be done prior to re-competing requirements, it may not be feasible to change contract type at the time of exercising an option as that could result in a material contract change and a possible violation of the Competition in Contracting Act (CICA).

We appreciate your continued support and the valuable assistance and guidance that your team provides. If you have any questions, please contact me or a member of your staff may contact Tim Shaughnessy, Director, Office of Procurement Policy, at (202) 283-1310.

Attachment



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RECOMMENDATION #1: The Director, Procurement, should ensure that the Contracting Officers document their decisions for awarding a cost-reimbursement contract and/or a contract that does not use PBA methods with complete, detailed justifications in the contract file.

CORRECTIVE ACTION TO RECOMMENDATION: We agree with this recommendation. The Office of Procurement Policy is developing templates for documenting contract type decisions and rationale when PBA methods are not used. The templates will be incorporated into the Guidebook for Acquisition Practices (GAP) which is an electronic tool that guides the user through the Acquisition Life Cycle (ACL). It will provide examples of best acquisition practices, support systems tutorials, and links to associated statutory and regulatory requirements. The GAP is currently under revision and is expected to be released in late January 2009, with the templates being incorporated by March 31, 2009.

In accordance with the Office of Procurement Policy's "Policy and Procedures Memorandum No. 4.1(B) – Procurement Reviews", each of Procurement's operating divisions has implemented an Office Instruction (OI) establishing a quality review program and internal review system procedures. The reviews required under these OIs will ensure that required documentation is contained in contract files.

In addition, in Fiscal Year 2008, IRS Procurement established a Contract Review Board (CRB) in the Office of Information Technology Acquisition that reviews all acquisitions meeting established dollar thresholds. Included in the CRB is the review of the rationale for contract type and any justification for not using PBA methods. In addition, the Quality Assurance Branch within the Office of Procurement Policy and General Legal Services review all actions estimated to exceed established thresholds.

IMPLEMENTATION DATE: May 1, 2009

RESPONSIBLE OFFICIAL: Director, Procurement, OS:A:P

CORRECTIVE ACTION MONITORING PLAN: The Office of Procurement Policy, Quality Assurance Branch, will conduct periodic audits to ensure contract files contain appropriate documentation and OIs are being followed.



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RECOMMENDATION #2: The Deputy Commissioner for Operations Support and the Chief, Agency-Wide Shared Services should establish and implement guidance that requires members of the acquisition team, including Office of Procurement and program office personnel, to meet and coordinate prior to writing the SOW to ensure that the best value contract type can be negotiated for the goods and services needed.

CORRECTIVE ACTION TO RECOMMENDATION: We agree with this recommendation. The Office of Procurement will continue to emphasize the requirements of acquisition planning as prescribed by FAR Part 7, Acquisition Planning, and FAR Part 10, Market Research. On March 7, 2008, the Deputy Commissioner for Operations Support signed a memorandum emphasizing the use of the "7 Steps to Performance-Based Acquisition". Step 1 requires the establishment of an integrated project team which is the basis for ensuring the best contract type is chosen. Also included as an attachment to that memorandum was the Business Systems Modernization Guidance, "Selection of Appropriate Contract Types for BSM Task Orders". Finally, as part of the CRB established in early 2008, the Office of Information Technology Acquisition has conducted 34 CRBs. Sixteen of the projects presented were either conditionally approved or disapproved, including six projects which were returned to the Contracting Officer to work with program personnel to change contract type.

The Office of Procurement will host its annual Advance Acquisition Planning conference in March 2009, where a module entitled "Types of Work Statements, Appropriate Contract Types and Risk" will be offered. The session will discuss the importance of the acquisition team choosing the appropriate type of contract.

IMPLEMENTATION DATE: May 1, 2009

RESPONSIBLE OFFICIAL: Director, Procurement, OS:A:P

CORRECTIVE ACTION MONITORING PLAN: Procurement will enter accepted corrective actions into the Joint Audit Management enterprise System (JAMES). These corrective actions are monitored on a monthly basis until completion.



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RECOMMENDATION #3: The Deputy Commissioner for Operations Support should require the program offices to routinely review contracts prior to exercising option years or re-competing the contracts for follow-on work, for the possibility of converting all or portions of the contracts to less risky contract types with an eventual goal of using a firm-fixed price basis.

CORRECTIVE ACTION TO RECOMMENDATION: We agree in part with this recommendation. Program offices should routinely review contracts when re-competing for follow-on work for potential changes to less risky contract types. However, we disagree with changing contract types at the time of exercising an option. While the program office does need to establish a continuing need for the service being provided prior to exercising an option, it is the responsibility of the Contracting Officer to initiate that process. By converting the contract type at this stage, a material contract change could occur resulting in a possible violation of the Competition in Contracting Act (CICA).

We agree that barriers to firm-fixed price contracts should be eliminated where possible. We continue to evaluate the use of firm-fixed price contracts as required by the FAR and in accordance with IRS guidelines and continue to look for opportunities to employ firm-fixed price contracts on an on-going basis.

To enhance existing processes, the CRB was established to further ensure selection of appropriate contract type. In addition, offered training will encourage the use of firm-fixed price contracts when re-competitions are conducted.

IMPLEMENTATION DATE: January 14, 2008 Completed. These are on-going activities.

RESPONSIBLE OFFICIAL: Director, Procurement OS:A:P

CORRECTIVE ACTION MONITORING PLAN: N/A