

## **Teaching Note**

### **Service Unbounded: A Contract Management Dilemma**

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### **Critical Incident Overview**

Nathan O'Rourke's simple service contract became complicated when the contractor he was responsible for chose to work beyond the scope of the contract. Although he knew the contractor worked at risk with the best of intentions, there was a mess to clean up because the contractor continued to perform contractual duties beyond the period of performance outlined in the contract. O'Rourke had to decide the best course of action to take with his superior and with the contractor under his supervision.

This decision critical incident (CI) has ethical and legal implications, considers the situation from both sides of the contract, and offers a glimpse of how challenging contract management can be. It also explores the concept of outsourcing, types of outsourcing relationships, when outsourcing is most appropriate, and procurement ethics. The CI is easy for learners to relate to, yet provides a platform for students to explore several different project management-related topics. It takes approximately 60 minutes of class time to complete.

This decision-making CI is intended for graduate-level courses focused on project management or contract management. It could also be used in more general courses relating to business ethics.

### **Research Methods**

This decision critical incident was developed based on the experiences of one of the authors, who experienced the situation described. The co-authors have experience from both the government and contractor side in similar circumstances. The names of the government agency, contractor, and individuals involved have been disguised to protect anonymity.

### **Learning Outcomes**

In completing this assignment, students should be able to:

1. Examine ethical issues associated with contract management.
2. Predict how customer/contractor relationships may change over time.

3. Distinguish when outsourcing may or may not be appropriate.
4. Assemble best practices for project outsourcing.

### **Discussion Questions**

1. What are the ethical and practical pros and cons of notifying the contracting officer that unauthorized work had been performed? (LO 1)
2. This incident occurs three months into a 2-year contract. How might the relationship between Engineering Associates and Scientific Research Agency change as they continue to collaborate over several years? (LO 2)
3. The functions being performed by Engineering Associates had been performed by government employees in the past. Why might the government have chosen to outsource these functions? Consider whether it would have been better to keep these functions in-house. (LO 3)
4. The Government awarded a Cost Plus Fixed Fee (CPFF) contract to Engineering Associates, Inc. Describe and compare different contract types. Was the CPFF the best choice? (LO 4)
5. What are some outsourcing best practices that could have helped to avoid the described situation? (LO 4)

### **Answers to Discussion Questions**

- 1. What are the ethical and practical pros and cons of notifying the contracting officer that unauthorized work had been performed? (LO 1)**

Ethics is a significant issue for procurement professionals. This is particularly true for procurement professionals in the public sector because they are entrusted with taxpayer dollars (Hunsaker, 2009). Procurement professionals must adhere to the laws and regulations that apply to them. Public procurement professionals are generally bound by a code of ethics to be fair and prudent with the people's money and to otherwise act in an ethical manner. The Department of Defense (DoD), for example, has the Joint Ethics Regulation (U.S. Department of Defense, 1993). This document provides the military and civilian members of DoD with clear standards of ethical conduct. The regulation highlights the importance of honesty, integrity, loyalty, accountability, fairness, caring, respect, promise-keeping, and the pursuit of excellence. Among other things, the regulation states that government employees are not to accept gifts or payment from contractors and shall not consume government resources for personal use.

The answer to the critical incident's ethical question is clear. The contracting officer's representative must be open with the contracting officer about the situation, help to restore the contract, and put in place procedures so the contractor does not work at risk again. Nathan O'Rourke may be reprimanded and the contractor's relationship with Scientific Research Agency might be stressed, but the Joint Ethics Regulation compels the contracting officer's representative to be honest and report the situation. The size of the contract violation in this critical incident is relatively small and O'Rourke's inattention was not intentional or representative of his normal work performance, so it is unlikely that serious punishment such as demotion or termination of employment would result from these actions. However, in situations

where gross negligence on the part of the contracting officer's representative leads to major problems, the employee might be fired. If government representatives use their relationships with contractors for personal gain and commit fraud, the punishment could be major fines and/or incarceration.

Nathan O'Rourke needed to figure out how to put things right. The problem with ethical dilemmas is there are usually multiple answers depending on a person's perspective.

- a. Approach #1, a stern warning, but payment is made. A face-to-face meeting is convened at the government site between the contracting officer's representative, the contracting officer, and the supplier project manager. The contracting officer's representative establishes her or his authority by clearly explaining the predicament the supplier created. The contracting officer's representative informs the supplier that even though the intentions were good, the actions were in direct violation of the contract and government procurement policies. Payment will be issued, but in the future, the supplier should expect not to be reimbursed.
- b. Approach #2, same as above, but with no payment to the supplier. Some students may have a moral hazard philosophy whereby they believe the government is not obligated to the supplier. They might believe the government is obligated to teach the supplier a lesson. By not paying them this time, when the stakes are low, the contracting officer's representative will have a higher degree of confidence that this particular supplier will not work outside the contract in the future.

With approach #1, students could be encouraged to explain how the contracting officer's representative could provide clear instructions and procedures to help the new supplier identify and avoid performing unapproved, out of scope work. This would lower the probability of this occurring in the future and improve her/his relationship with both the supplier and contracting officer.

The best approach will depend on the unique factors of a given situation. In most cases, if the Government receives a benefit from the contractor's work they are obligated to pay the contractor. The contracting officer's representative could also consider consulting with an Ethics Counselor if needed.

**2. This incident occurs three months into a 2-year contract. How might the relationship between Engineering Associates and Scientific Research Agency change as they continue to collaborate over several years? (LO 2)**

The working relationship between the customer and contractor tends to improve over time as the two organizations become partners with a common goal of success. Unfortunately, most government contracts are limited to a period of performance of two to three years. This is enough time, however, to reap some of the benefits of long-term relationships. Some of the advantages of long-term relationships include reduced administrative costs, more efficient utilization of resources, improved communication, improved innovation, and improved performance (Larson & Gray, 2009). It is generally the flexibility that comes from long-term communication that

leads to improved innovation and performance (Cruz & Marques, 2013). It is also important to note that long-term relationships between government and contractors can become incestuous and, in some cases, the benefits of a new contract may outweigh the benefits of the long-term relationship.

The contract with Engineering Associates, Inc. is the first contract Scientific Research Agency has had with the young, small-business firm. The situation described in the CI is not unusual for a smaller services contractor that is new to the government. The contractor knew what the customer needed so they kept doing the work after that portion of the contract ended. As the relationship between Engineering Associates, Scientific Research Agency, and the agency's contracting community grows we can expect to see these types of instances diminish greatly. The problem might get worse when the relationship between the supplier and the government agency is so close the supplier can be tempted to perform additional work knowing its buddy in the agency will make sure it gets reimbursed.

**3. The functions being performed by Engineering Associates had been performed by government employees in the past. Why might the government have chosen to outsource these functions? Consider whether it would have been better to keep these functions in-house. (LO 3)**

Outsourcing is a term used to describe situations where an organization transfers some of its business functions to other companies (Larson & Gray, 2009). These functions might include customer support, information technology support, accounting, marketing, or other areas. The reasons for outsourcing vary by situation and by business. Outsourcing functions to companies overseas can reduce costs and free up scarce resources to perform critical activities within the core competencies of the business. A firm with limited staff can outsource for technical expertise that they does not have internally, or can bring on additional resources quickly to handle surge requirements. Basically, outsourcing offers flexibility. Outsourcing is not always the answer, however. It can result in fragmentation among the team and can lead to poor communication, unclear lines of authority, and interpersonal conflict. Contracting out can also lead to security issues, and the primary organization may lose control of its intellectual property.

With the U.S. military at war for more than a decade, civilians have played an increasingly important role in the Army (Ritter, 2010). Due to federal hiring restrictions, many of these civilians are providing their support as contractors. As the DoD reduces its footprint in the Middle East, the military is looking at its civilian workforce and considering whether its current balance between insourcing and outsourcing is appropriate. As of the writing of Ritter's article, the Army leadership felt that too much had been contracted out and contractors were performing duties that were inherently governmental.

The functions being performed in the CI by Engineering Associates, Inc. involved working on DoD properties, in DoD testing facilities, and alongside DoD soldiers and civilian employees. The duties outlined in the contract were routine tasks were required to run the labs. These duties were not sensitive in nature and were not related to any surge requirements. Scientific Research Agency, unlike most government organizations, was reimbursable funded. This meant that Scientific Research Agency was paid by other agencies to do work instead of being funded

directly by Congress. Being funded in this way, Scientific Research Agency's budget varied year to year, so having some of its workforce as onsite contractors offered added flexibility in terms of fixed costs because in lean times the contracts can be cancelled.

Scientific Research Agency likely chose to outsource this task because it involved specialized expertise in the areas of software management and quality assurance management that Scientific Research Agency did not have in-house. Because these functions were required regardless of the lab's workload, it may have been better to insource these duties—assuming that Scientific Research Agency was authorized to hire new employees.

**4. The Government awarded a Cost Plus Fixed Fee (CPFF) contract to Engineering Associates, Inc. Describe and compare different contract types. Was the CPFF the best choice? (LO 4)**

In most cases, the organization responsible for the execution of a project does not have all of the necessary resources in-house to perform all of the duties related to the project. There are several types of contracts used in outsourcing, but they generally fall within two groups; Fixed Price and Cost Reimbursable. Fixed Price puts more risk on the seller and Cost Reimbursable puts more risk on the buyer. "The choice of appropriate contract types is situationally dependent and a number of factors must be taken into account to determine the best contract type to use" (Kendall, 2013, p. 2). Market research and past experience are used to determine which contract type is most suitable.

Under fixed price contracts, a fixed total price is set for a defined product, service, or result. Incentives can be added for achieving or exceeding certain project objectives. Damages can also be sought if certain objectives are missed. Because a fixed price is set up front, a clear and detailed requirements document is needed at the start of the contract so the seller has a clear understanding of what they are to provide for the fixed price. Since the contractor gets a flat fee for its service, regardless of how much it costs the contractor to complete, it is strongly incentivized to stay on schedule and budget. This type of contract is appropriate for contracts with clear deliverables including construction contracts or the purchasing of commercial goods. It is not appropriate when the full scope of the requirement is unclear at the start of the contract.

Under cost reimbursable contracts the seller is reimbursed for "actual costs incurred for completed work, plus a fee representing seller profit" (Project Management Institute [PMI], 2013, p. 363). As with fixed price, cost reimbursable contracts can include incentives. A cost reimbursable contract increases the risk on the customer and reduces the risk on the contractor (Sadeh, Dvir, & Shenhar, 2000). Also, cost reimbursable contracts may motivate the contractor to be less efficient with resources. A cost reimbursable contract offers some flexibility to the buyer to adjust the scope of the contract without increasing the risk to the seller. This type of contract is most appropriate for initiatives where the level of effort is hard to define up front, such as research and development. Examples of cost reimbursable contracts include Cost Plus Incentive Fee (CPIF) and Cost Plus Fixed Fee (CPFF).

Time and materials contracts are a third contract type that has aspects of both the fixed price and cost reimbursable contract types (PMI, 2013). The federal government has long relied on this

contract type due to the flexibility it offers, but in recent years there has been more scrutiny of its use because Time and Materials contracts can end up being very costly for the buyer (U.S. Government Accountability Office, 2007).

Before soliciting the requirement, the contracting officer's representative and the contracting officer should consider the available contract types and select the most appropriate contract type for the work being performed. The contract with Engineering Associates, Inc. was a cost reimbursable type contract. This is an appropriate contract type for work being performed in a dynamic laboratory setting, where a detailed scope cannot be defined at the start of the contract.

**5. What are some outsourcing best practices that could have helped to avoid the described situation? (LO 4)**

The contract with Engineering Associates, Inc. mentioned that it was to handle the management of laboratory consumables, but was not particularly clear about the management of the gas cylinder rentals. This lack of clarity was partially responsible for the need for a contract modification and the miscommunication that led to the contractor working at risk. There are several best practices that could have been applied during the development and execution of this task that may have minimized or eliminated the possibility of the contractor working at risk.

- a. **Better Defined Requirements**— Ensuring project success requires investing the time and energy to develop comprehensive project communication systems and to spell out the work requirements and deliverables (Larson & Gray, 2009). For services procurements, it is often best to use performance-based strategies to develop clear requirements and communicate how success will be measured. Used in industry for decades, performance-based acquisition principles were adopted by the federal government in 2001 (Gansler, 2001). In traditional contracting, the scope of work document defines—in a prescriptive way—the steps for reaching project objectives. This restricts the flexibility of the contractor and the customer after the contract is awarded and frequently does a poor job of communicating the key drivers for the contract. This approach can also lead to more costly contracts because the contractor is not incentivized to develop innovative approaches to the effort. The main concept for performance-based acquisition is to create a description of the requirements that focuses on the outcome, not the methods to produce them. Another part of performance-based acquisition is preparing and communicating at the outset how success will be measured. Developing requirement documents in this format can be challenging for the requiring activity, but is well worth the effort.
- b. **More Frequent Status Updates**— Engineering Associates, Inc. provided monthly status reports to the contracting officer's representative and the contracting officer. This level of communication proved to be insufficient to deal with the issues that arose related to gas cylinder management. It is important for project managers and other key personnel to meet regularly to assess project performance (Larson & Gray, 2009). These regular meetings, while time-consuming, foster teamwork, communication, and timely problem solving. The meetings also help to create a strong partnership between the stakeholders. Had the stakeholders associated with the Engineering Associates contract met on a weekly or bi-weekly basis, the issues discussed in the CI could have been identified and

resolved more promptly. It should also be stressed that one solution does not fit all projects, as projects are unique by definition. The contracting officer's representative may have been complacent because he always ran larger projects where monthly reporting was sufficient. Clearly on a short project (a three-month base period of performance in this case), monthly reporting was inadequate. As with any new contractor (or new employee), the best practice is to spend up-front time to establish the relationship and trust by setting expectations early, and ensuring both parties deliver on their promises no matter how insignificant those promises might seem.

- c. **Strategic Sourcing**—Strategic sourcing is an initiative of the federal government, started in 2005, where organizations are asked to examine the way they buy things and consider how to procure them more smartly. The goal is to get the best products and services at the best value by looking at all of the costs associated with an organization's acquisitions and considering whether certain requirements can be combined to achieve economies of scale (Chaplain, 2012). For the CI, it may have been more efficient and more effective to combine Scientific Research Agency's requirement for testing support with testing support requirements from other, similar, agencies. Strategic sourcing also creates healthy competition among suppliers seeking to do business with the government. Controlling the bargaining power of suppliers benefits the government by reducing its dependence on one particular supplier (Porter, 1998). In this case, the supplier could have simply decided that working at risk increased its stock with the government; whereas, an incumbent supplier would have been comfortable letting the gas cylinders run out, essentially transferring blame to the government procurement office. The supplier might have performed a cost/benefit analysis and decided the loss of reimbursement costs for the gas cylinders was much less than the loss of a long-term follow-on contract.

Scientific Research Agency would have been well served by some or all of the best practices mentioned above when developing its support requirements.

## **General Discussion**

A variety of classroom discussion topics are covered in the learning objectives including various approaches to the dilemma in Question 1 and the pros and cons of outsourcing in Question 3. In addition to the topics covered in the Learning Objectives, the class could discuss the differences between public and private procurement. Private companies are generally free to award to whomever they want. Private companies are not required to go out for competitive bids. If a private company likes a particular contractor, they are free to award a contract directly to them without competition. This might not, however, make good business sense because it decreases the companies' bargaining power. Alternatively, procurement in the public sector is governed by regulations and policies that help to ensure contract awards represent the best value to the government and promote fair and open competition between interested vendors. The Federal Acquisition Regulation (FAR) is the key acquisition regulation for the United States government and is supplemented by countless agency-specific regulations.

## Epilogue

This critical incident is based on a real-world occurrence. In the actual event, the contracting officer eventually modified the contract to include management of the gas cylinders through the first option period and the contractor was reimbursed for the work they performed *at risk*. The contracting officer's representative initiated more frequent meetings with the contractor and the contractor was informed about the dangers of working outside the scope of the contract.

## Additional Pedagogical Materials

For additional information on long-term contractor relations, consider using Rogers, Stephen C. (2009). *The Supply-based advantage*. New York, NY: AMACOM.

For additional information on ethical dilemmas in business, consider using Trevino, L. K. and Nelson, K. A. (2014). *Managing business ethics: Straight talk about how to do it right* (6<sup>th</sup> ed.). Hoboken, NJ: Wiley.

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