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Chief Review Services Chef - Service d'examen

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Internal Audit:
Contract Terms of Payment

March 2011

7050-52 (CRS)



Canada 

Caveat

The audit focus is on Department of National Defence (DND) contract management. Therefore, contractors were neither consulted nor included in the scope of the audit.



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Acronyms and Abbreviations

ADM(Mat)	Assistant Deputy Minister (Materiel)
BoP	Basis of Payment
CA	Contracting Authority
CMS	Communications Management System (for CP140 Aurora)
COTS	Commercial Off-the-Shelf
CRS	Chief Review Services
CSI	Combat Systems Integration
Dev	Development
DGMSSC	Director General Materiel Systems and Supply Chain
DMPP	Director Materiel Policy and Procedures
DMS	Data Management System (for CP140 Aurora)
DND	Department of National Defence
EPA	Effective Project Approval
FTR	Fixed-Time Rate
FX	Foreign Exchange
HCM/FELEX	Halifax-Class Modernization/Frigate Life Extension
ISS	In-Service Support
LOE	Level of Effort
MCP	Major Crown Project
MERX	Government of Canada's Electronic Tendering Service
MHLH	Medium-Heavy Lift Helicopter
MHP	Maritime Helicopter Project
Mod MOTS	Modified Military Off-the-Shelf
Mod	Modified
NATO	North Atlantic Treaty Organisation
OPI	Office of Primary Interest
PA	Procurement Authority
PAM	Procurement Administration Manual
PWGSC	Public Works and Government Services Canada
R&O	Repair and Overhaul
RFP	Request for Proposal



SACC	Standard Acquisition Clauses and Conditions
T&C	Terms and Conditions
TA	Task Authorization
TB	Treasury Board
VE	Value Engineering
WES	Weapon Effects Simulation



Results in Brief

Since 2005, several Chief Review Services (CRS) contract management audits have identified issues regarding contract terms of payment that do not optimize value for money. In October 2009, CRS conducted an analysis of active contracts tendered by Public Works and Government Services Canada (PWGSC) to enable DND to identify contracts with higher-risk terms of payment.¹

Forty-seven contracts worth approximately \$26 billion were identified, representing 95 percent of the Department's contract obligations. These contracts ranged in value from \$6.2 million to \$4.2 billion and contained 140 bases of payment.²

The audit objective was to assess whether the terms of payment used within these contracts optimized value for money.

Findings and Recommendations

Procurement Policy for Terms of Payment

For some procurement processes, government contracting policy requires DND's input into PWGSC-tendered contracts which impact the contract terms of payment. The current DND/PWGSC Division of Responsibility Agreement places some limitation on DND's involvement in the areas of earned value reporting, review of solicitations prior to promulgation, and participation in contract negotiations.³

DND procurement staff noted that the level of DND participation is often dependent on the level of experience of the DND Procurement Authorities (PA) along with their relationship with the PWGSC Contract Authority (CA). As a result, the level of DND participation in these areas will vary from contract to contract. The Responsibility Agreement should reflect actual business practice.

It is recommended that the "DND/PWGSC Division of Responsibility Agreement" be revised to remove some DND limitations and reflect actual business practice.

Overall Assessment

Improvements in the contracting policy relating to terms of payment, along with the use of mandatory and optional contract control clauses, will help the Department achieve greater value for money in its contracts.

¹ CRS Analysis of Contracts, 2009 (<http://www.crs-csex.forces.gc.ca/reports-rapports/2009/129P0875-eng.aspx>).

² A single contract will often have multiple bases of payment (fixed price, cost reimbursable, etc.) for work that will be performed. The 47 contracts reviewed in this audit contained a total of 140 bases of payments.

³ DND/PWGSC Responsibility Agreement, Version 10-2 (2010-08-16)—client-specific agreement with DND.



Required Clauses

Procurement staff did not ensure that required PWGSC Standard Acquisition Clauses and Conditions (SACC) were included in contracts. |||
and 30 contracts with progress payments of approximately \$11 billion did not use compulsory holdback clauses. Including these clauses would increase the likelihood of the Department receiving optimal value for money.

It is recommended that DND amend the Procurement Administration Manual (PAM) to include seven key terms of payment clauses in the PWGSC 9200 requisition for goods and services form.

Contract Cash Flow

Seven of 47 contracts worth \$6.68 billion were identified as having |||
||| The proportion of the cash flow |||
||| ranged from ||| of the total contract cash flow.
The audit found instances where the |||
and/or the |||
||| In these cases, the Department has |||
|||

It is recommended that |||
|||

Warranty

|||
|||
Even though 2 to 3 percent of a contract value may be the price of a warranty, |||
|||

It is recommended that a more |||
||| In future contracts, where appropriate, vendors should be obliged to report on progress of warranty work/claims.

Note: For a more detailed list of CRS recommendations and management response, please refer to [Annex A](#)—Management Action Plan.



Introduction

Background

In June 2009, CRS completed an analysis of DND contracts tendered by PWGSC. Using five specific criteria,⁴ 51 contracts with higher-risk terms of payment were identified⁵ (of the 51 contracts, five were removed (worth approximately \$67 million) from the audit sample due to low-dollar value and Automated Buyer Environment database errors). At the time of the audit the remaining 47⁶ contracts represented 95 percent of all DND/PWGSC contract obligations.

DND Contract Population

At the time of the audit there were 5,022 DND contracts worth \$27.3 billion tendered by PWGSC.

Objectives

To assess whether the terms of payment used in DND contracts tendered by PWGSC optimize value for money.

Scope

Forty-seven DND contracts tendered by PWGSC worth \$26 billion identified in the CRS “Analysis of Contract” report (October 2009).

The audit excluded DND construction projects tendered by Defence Construction Canada (7,982 contracts worth \$2.0 billion). As well, contracts tendered by DND (3,145 contracts worth \$210.2 million) were excluded due to the relatively immaterial value of the contracts.

Methodology

- Review of PWGSC Supply Manual and DND PAM;
- CRS questionnaire to 47 contract DND PAs;
- Review of 47 contracts and amendments—including associated DND 9200 requisitions, DND/PWGSC Procurement Plans, Requests for Proposals (RFP), progress claims, and supporting documentation; and
- Consultation with DND PAs/PWGSC CAs.

Criteria

The audit criteria are outlined in [Annex B](#).

⁴ Materiality, type of payment, basis of payment, procurement expertise and contract duration.

⁵ The criteria are explained in the CRS Analysis of Contracts, 2009 (<http://www.crs-csex.forces.gc.ca/reports-rapports/2009/129P0875-eng.aspx>).

⁶ 46 contracts remained; however, the C130J contract, representing both acquisition and in-service support (ISS) components, was analyzed as two separate contracts—thus a count of 47.



Request for Proposal. To ensure that required contract terms of payment in DND’s submission of the PWGSC 9200 have been included in the RFP, DND PAs should have an opportunity to review the final RFP. The PAM requires DND PAs to make a request to review the draft RFP before it is sent to Government Electronic Tendering Service/MERX.¹¹ However, the DND/PWGSC Responsibility Agreement only requires PWGSC to send a final copy of the RFP to DND at the same time that it is sent to industry. To ensure consistency between the Responsibility Agreement and the PAM, and that all DND required terms of payment have been included in the RFP, the Responsibility Agreement should be amended accordingly.

Negotiate Sole-Source Contracts. Both the PAM and the DND/PWGSC Responsibility Agreement only require that ||| With respect to the audit sample, there were |||¹² |||¹³

Review of Draft Contract. Although the DND/PWGSC Responsibility Agreement indicates that the DND PA is the lead in reviewing the draft contract,¹⁴ the PAM states that the DND PA will only review the draft contract at the request of the PWGSC CA.¹⁵ Some audit clients indicated that there are instances where ||| It is suggested that the DND PAM be amended to align with the more authoritative policy, the DND/PWGSC Responsibility Agreement.

Interdepartmental Co-operation. Effective communication between DND and PWGSC is worked out on a project-by-project basis depending on the complexity of the contract.¹⁶ The level of DND participation is often dependent on the level of experience of the DND PA and PWGSC CA and their relationship. Experienced DND PAs are more likely to participate in the development/evaluation of bid criteria, and also review the RFP and draft contracts in spite of policy limitations. The Responsibility Agreement does not reflect actual business practices.

¹¹ PAM, October 2010, Section 3.6.3.3.

¹² PWGSC Supply Manual, Version 10-2 (August 16, 2010), Section 5.85.

¹³ CRS Audit of CF188 Hornet Maintenance Contract, 2002; CRS Audit of Chemical, Biological, Radiological and Nuclear (CBRN) Defence Omnibus Project, 2008 (<http://www.crs-csex.forces.gc.ca/reports-rapports/2008/141P0809-eng.asp>).

¹⁴ PWGSC Supply Manual, Version 10-2 (August 16, 2010), Section 4.8.

¹⁵ PAM, October 2010, Section 4.2.3.2.2.2, Point C.

¹⁶ PWGSC Supply Manual, Version 10-2 (August 16, 2010), Annex 1.2 (Section A).



Recommendation

ADM(Mat) request that the “DND/PWGSC Division of Responsibility Agreement” be revised to remove some DND limitations and to reflect actual business practice.

OPI: ADM(Mat)/DGMSSC/DMPP



Required Clauses

Required standard acquisition clauses as prescribed in PWGSC procurement policy to control costs were not consistently used.

To ensure value for money is achieved for Canada, the PWGSC Supply Manual provides PWGSC CAs specific contract T&Cs that must be in place given the nature and selected bases and method of payment utilized within the contract. The DND PAM also directs DND PAs to include appropriate contract clauses as part of the contract requisition (PWGSC 9200) to PWGSC. Although the PWGSC SACC manual provides approximately 700 different contract clauses, a checklist of the seven key clauses that relate to the selected BoP should always be considered (as shown in [Annex C](#)). As portrayed in Table 1, a number of contracts were found to be missing the appropriate clauses.

Serial	Missing Clauses	No. of Contracts	Value of Payments (\$M)
1.			
2.			
3.			
4.			
5.			

Table 1. Missing Contract Clauses. Only the value of the FTR and progress payments are reflected in this table—not the total contract value. The highlighted rows (1, 2 and 3) show || contracts that did not have the required |||

Provision of Holdbacks. To ensure vendor performance and to help avoid overpayment in relation to the progress of work, contracts that use progress payments are required to contain a holdback provision.¹⁷ Of the || contracts worth ||| within the audit sample that |||

Impact of Holdbacks

A monthly holdback of 10 percent represents |||

¹⁷ PWGSC Supply Manual Version 10-2 (August 16, 2010), Section 4.70.30.25 (Note: For progress payments that include milestones, holdbacks are optional. The finding did not include milestone payments).

Contract Cash Flow

Certain terms of payment allow for the cash flow at the time of first delivery to range from ||| of the contract value.

To procure state-of-the-art combat systems in a timely manner, some contracts involve modified military, or commercial-off-the-shelf (COTS) products while others require more development. Accordingly, first deliveries for major capital acquisitions are pivotal to ensure the combat system complies with the DND performance specification. As expected, schedules and costs for developmental systems are more difficult to predict. In addition, there are no DND or PWGSC guidelines to help determine what proportion of the total contract cash flow the first delivery should represent.

The audit examined all contracts in the sample with provisions for first delivery to determine if there was any correlation between project schedule planning and cash flow.

²³						

Table 2. |||

|||||

²³ For the WES contract, the “Percentage Contract Duration for First Delivery” and “Percentage Contract Value for First Delivery” were calculated from the acquisition value of \$91 million.

Although most major capital acquisition contracts are with well-established defence contractors with proven products, |||||
				This situation developed in				
				²⁴				

Recommendation

ADM(Mat) should ensure that |||||
|||||
OPI: ADM(Mat)/DGMSSC/DMPP

²⁴ |||||

Warranty

|||||

The inclusion of a warranty provision within contracts provides DND with the opportunity to ensure that defective work or material will be fixed or replaced at the contractor's expense.²⁵ DND's Material Management Instruction 1020 states that warranty provisions should be in place for all items with a unit cost in excess of \$100,000. As well, it is the responsibility of the DND PA to administer aspects of the warranty provision and implement a respective tracking mechanism.²⁶ Furthermore, in some contracts, CRS has observed an obligation for the vendor to track and report on warranty work.²⁷

Forty-five contracts in the audit sample included a warranty provision. This provision provided 12 months of warranty coverage for both goods and services. Through a questionnaire administered during the audit, the DND PAs of the audit contract sample were required to provide copies of warranty claims that had been made against the contracts.

While contract warranty clauses are in place, ||||| Vendors include warranty work in their bid price, ranging from 2 to 3 percent of the contract value. ||||| warranty work worth \$494 million |||||²⁸ |||||²⁹

Recommendation

ADM(Mat) should |||||
|||
|||
OPI: ADM(Mat)/DGMSSC/DMPP

²⁵ PWGSC SACC Clause 9601/2030–General Conditions–Long Form Section 20.
²⁶ DND Material Management Instruction (1999), Section 1020.
²⁷ CRS Internal Audit: Airbus Maintenance Contract, 2007.
²⁸ Normally the warranty value is based on 2.0 percent of the contract value. Therefore, 47 contracts worth \$24.7 billion would amount to \$494 million.
²⁹ |||||

Value-Added Contract Clauses

Contract terms of payment did not always include clauses to optimize value for money.

The PWGSC Supply Manual and SACCs require that certain contract clauses be included to mitigate risks to the Crown. These risks are generally inherent to particular goods/ services, commodity groupings, sourcing strategies and BoPs that require particular attention. However, based on the audit sample there are opportunities for DND PAs to recommend additional terms of payment clauses to the PWGSC CA to help optimize value for money, as outlined in Table 3.

Serial	Type of Clause	No. of Potential Contracts	Contract Value (\$B)	Contract Prerequisite
1	Value Engineering	13	\$5.2	Recurring work with cost baseline
2	Firm Price/Bulk Purchases	10	\$2.5	Repetitive services and goods
3	Learning Curve Efficiencies	8	\$3.7	New work with production increase
4	Incentive Fee	6	\$1.1	Need to increase vendor performance

Table 3. Value Added Contract Clauses. Contract clauses in serial 1 and 4 would benefit both the vendor and the Department.

Value Engineering (VE). The VE clause encourages the vendor to suggest cost saving measures for recurring work with a known cost baseline. These savings are shared between the Crown and the contractor. This clause has been exercised in the CF188 Hornet aircraft avionics contracts. Of the 47 contracts examined in the audit sample, nine contracts contained a VE clause. Thirteen other R&O/ISS contracts in the sample, worth \$5.2 billion, may have also benefited from a VE clause. This clause poses no additional risk to the Crown or the contractor and does not need to be exercised if savings cannot be realized.

Firm Price. In other CRS contract audits, opportunities were observed for recurring cost reimbursable work to become fixed price. This strategy, for example, resulted in annual savings of \$2.7 million as a result of the CF188 Hornet Maintenance contract audit.³⁰ In this audit, 10 of 47 contracts were considered as having activities that were repetitive in nature with a cost reimbursable basis of payment.

³⁰ CRS Follow-up on Internal Audit: CF188 Hornet System Engineering Support Contract (SESC), 2009 (<http://www.crs-csex.forces.gc.ca/reports-rapports/2009/136P0902-eng.aspx>).



Bulk Purchases. It was identified that costs could be reduced for some contracts in the audit sample through a bulk purchase of material. Such a purchase resulted in a savings of \$2.2 million as the result of a CRS aircraft maintenance contract audit.³¹

Learning Curve Efficiencies. As vendors get more experienced at a new task, they usually become more efficient at them. As such, a learning curve efficiency of up to 20 percent is possible each time production doubles.³² While no contracts within the audit sample expressly contained learning curve provisions, such efficiencies should be part of the tender evaluation process to ensure value for money. These opportunities may arise in R&O (time and material) contracts when repetitive overhauls or modifications are required. One such navy contract audited by CRS had the opportunity for learning curve efficiency savings of \$2.8 million.³³ There were eight R&O contracts in the audit sample worth \$3.7 billion where learning curve opportunities may exist.

Cost Reimbursable with Incentive Fee. This BoP reimburses the contractor for costs incurred and adjusts the profit level depending on whether actual costs are above or below a targeted price.³⁴ Performance-based contracts that link incentives to performance targets are relatively new to DND and there is little PWGSC guidance. Therefore, the audit found that only 14 of 47 contracts included an incentive fee basis of payment. The total value of the incentive fees for the contracts amounted to \$165 million—a relatively small portion of the audit sample value (0.65 percent). There were six other contracts in the audit sample worth \$1.1 billion that could have benefited from an incentive fee.

Although incentive fees may be appropriate for more contracts, some DND PAs expressed reservations of increasing vendor profit to obtain an acceptable level of performance. It was observed that a fixed award fee, which diminishes the profit of a vendor in a cost over-run situation, was only used twice in the audit sample—a total amount of \$6.2 million.

Recommendation

For future contract requisitions, ADM(Mat) should develop a value-added clause checklist to help procurement staff improve value for money.

OPI: ADM(Mat)

³¹ CRS Internal Audit: Airbus Maintenance Contract, 2007.

³² Sawyer's Internal Auditing (5th Edition), 2005, page 520.

³³ CRS Internal Audit of the Close-In Weapon System (CIWS) Support Contracts, 2008 (<http://www.crs-csex.forces.gc.ca/reports-rapports/2008/115P0836-eng.aspx>).

³⁴ PWGSC Supply Manual, Version 10-2 (August 16, 2010), Section 4.70.20.15.



Task Authorization

Approximately 19 percent of the audit sample value are task authorizations (TA) that relate to future work with no specified basis of payment.

A TA enables DND to authorize work by a contractor on an “as and when requested” basis in accordance with the conditions of an existing contract. Contracts that provide for the use of TAs are normally R&O or ISS contracts where a definite need for a service exists, but the precise nature and timing of the work cannot be set out in advance. When DND requires these services, a TA is issued to instruct the contractor to carry out the specified work.³⁵

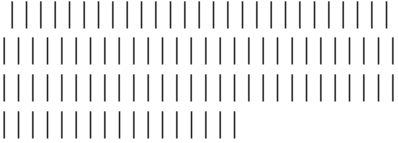
The audit identified 40 of 47 contracts that contained provisions for TA work with an estimated value of \$4.3 billion. Within this sample of TAs, two types of contracts were noted:

- Type 1 TA, with a large portion of predefined work such as the acquisition of an asset, or ongoing service, with a provision for additional TA work.
- Type 2 TA, where all work is assigned using TAs.

TA Pricing. The most significant risk associated with TAs is that the BoP is not specified until the TA is assigned to the vendor. There are usually three BoP options for a TA:

- A firm-price task.
- A ceiling-price task that a vendor may not exceed, but the final price could be lower.
- A level of effort (LOE) that may be adjusted before the vendor reaches 75 percent of the original price estimate.

Task Cost Escalation



|||||
|||||³⁶

³⁵ PWGSC Supply Manual, Version 10-2 (August 16, 2010), Section 3.35.1.1 (a).

³⁶ PWGSC Supply Manual, Version 10-2 (August 16, 2010), Annex 3.4: Task Authorization Contracts (5h).

Fixed-Time Rate Provisions. The audit identified four Type 1 TA contracts with approximately \$614 million in work that did not have sufficient basis of payment control clauses for fixed-time rates where the BoP of the TA would be a LOE. Although the Supply Manual states that “any audit requirements should be clearly detailed in the contract,”³⁷ there were no provisions for required time verification or discretionary audits³⁸ in these four contracts.

Recommendation

For LOE TAs, ensure that fixed award fees have been considered as an incentive to control costs.

OPI: ADM(Mat)/DGMSSC/DMPP

³⁷ PWGSC Supply Manual, Version 10-2 (Aug 16, 2010), Annex 3.4: Task Authorization Contracts (5h).

³⁸ PWGSC SACC, Clause C0711C (Fixed Time Rate), C0705C (Discretionary Audit Requirement).



Annex A—Management Action Plan

Procurement Policy for Terms of Payment

CRS Recommendation

1. ADM(Mat) request that the “DND/PWGSC Division of Responsibility Agreement” be revised to remove some DND limitations and to reflect actual business practice.

Management Action

The issues pointed to in the audit reflect weaknesses in the strategic management of the machinery of the Government of Canada in the business of defence procurement. DND is seeking a strategic engagement with PWGSC and TBS to find appropriate long-term strategic remedies. The specific proposals in the audit represent potential quick hits and DND is consulting with PWGSC on their possible adoption.

OPI: ADM(Mat)/DGMSSC/DMPP

Target Date: Ongoing

Required Clauses

CRS Recommendation

2. ADM(Mat) should amend the PAM to ensure that the seven key terms of payment clauses are considered when completing the PWGSC 9200 requisition for goods and services.

Management Action

As DND has a participatory role in contract terms of payment and PWGSC the lead responsibility, the PAM will be amended to provide further guidance and emphasis with regards to selecting appropriate terms of payment, and link to the PWGSC payment clauses accordingly.

OPI: ADM(Mat)/DGMSSC/DMPP 4

Target Date: September 2011



Contract Cash Flow

CRS Recommendation

3. ADM(Mat) should ensure that |||

Management Action

Director Materiel Policy and Procedures (DMPP) will develop guidelines for the development of a cash flow plan for incorporation into the PAM and the Project Management Manual and training.

OPI: ADM(Mat)/DGMSSC/DMPP3 and DMPP 4

Target Date: March 2012

Warranty

CRS Recommendation

4. ADM(Mat) should |||

Management Action

The PAM will be reviewed and revised where necessary to strengthen the area of warranty claims.

OPI: ADM(Mat)/DGMSSC/DMPP 4

Target Date: March 2012



Value-Added Contract Clauses

CRS Recommendation

5. For future contract requisitions, ADM(Mat) should develop a value-added clause checklist to help procurement staff improve value.

Management Action

DMPP will develop a value-added clause checklist progressively and on a basis of continuous improvement for validation by functional authorities, and incorporation into guidelines, training and/or toolkits as appropriate.

OPI: ADM(Mat)/DGMSSC/DMPP 4

Target Date: March 2012

Task Authorization

CRS Recommendation

6. For LOE TAs, ensure that fixed award fees have been considered as an incentive to control costs.

Management Action

The PAM will be reviewed and updated where necessary to address this issue.

OPI: ADM(Mat)/DGMSSC/DMPP 4

Target Date: March 2012

Annex B—Audit Criteria

Objective

To assess whether terms of payment used within the audit sample of contracts optimized value for money.

Criteria Assessment

Level 1 (Satisfactory); Level 2 (Needs Minor Improvement); Level 3 (Needs Moderate Improvement); Level 4 (Needs Significant Improvement); Level 5 (Unsatisfactory)

Governance

1. **Criteria.** Governance frameworks in determining contract terms of payment are articulated in policy and followed.

Assessment. Level 4—Government contracting policy places some limitations on DND to have sufficient input into PWGSC-tendered contracts. The DND PAM does not consistently reflect PWGSC procurement policy.

Value for Money

2. **Criteria.** Appropriate and effective methods and basis of payment are utilized in DND contracts tendered by PWGSC to maximize value for money.

Assessment. Level 3—Optimal terms of payment clauses that help optimize value for money were not always considered in DND contracts tendered by PWGSC.

Control

3. **Criteria.** Appropriate controls are in place to minimize risk to the Crown associated with various contract terms and bases of payment.
4. **Criteria.** Contract incentives have been appropriately used and have added value to contract methods and bases of payments.

Assessment. Level 3—The absence of required clauses and incentives did not provide the Department with the opportunity to ensure that optimal value for money is achieved through the contract's terms of payments.



Annex C—Basis of Payment Control Mechanisms

Control Mechanism	Basis of Payment						
	Firm Price	Firm Price Subject to EPA and FX	Cost Reimbursable FTR	Cost Reimbursable with Incentive Fee	Cost Reimbursable with Fixed Fee	Cost Reimbursable with Fee based on Actual Cost	Cost Reimbursable with no Fee
	A – Sole Source	A – Sole Source	A	A	A	A	A
	A – Sole Source, Single Bid	A – Sole Source, Single Bid	N/A	A	N/A	N/A	N/A
	N/A	N/A	A	N/A	N/A	N/A	N/A
	N/A	N/A	A	N/A	N/A	N/A	N/A
	N/A	N/A	A	A (except for R&O)	A	A	A
	N/A	N/A	A	A	A	N/A	A
	N/A	N/A	A	A	A	A	A

Legend:
 A – Applicable
 N/A – Not Applicable

Table 4. Basis of Payment Control Mechanisms. This table shows the appropriate control mechanisms that must be included as part of the contract’s T&Cs, given the selected basis or bases of payment.

