

## **Contractor Business Systems and Internal Controls, By D. Walker**

As we briefly noted in our January 2010 newsletter, DPAP (Defense Procurement and Acquisition Policy) has proposed a rule to address contractor business systems. The Federal Register (Vol. 75, No. 10, January 15, 2010) issued a proposed amendment to DFARS to improve the effectiveness of DoD oversight of contractor business systems (internal controls). The proposed rule defines contractor business systems and will implement compliance enforcement mechanisms which include withholding payments for business systems which contain deficiencies. Of particular note, interested parties should submit comments in writing on or before March 16, 2010.

In terms of the impetus for this proposed rule, it is clearly aimed at resolving the alleged dysfunctional relationship between DCAA and DCMA as reported by the Commission on Wartime Contracting (CWC). Most recently, the CWC Special Report on Contractor Business Systems, dated September 21, 2009 (available at [www.wartimecontracting.gov](http://www.wartimecontracting.gov)) reported five systemic problems, and number one is the —divergent and often contradictory behaviors (DCAA and DCMA) sending mixed messages to contractors . This is an obvious embarrassment to the DoD and by all indications the reason for the petulant response in the form of the proposed DFARS rule.

Regardless of the fact that the proposed rule is attributable to the issues solely attributed to wartime contracting, it is a much broader proposed rule and it will likely result in changes to the regulatory requirements relative to all DoD contractor internal controls or as coined by the CWC, —business systems . In addition to the definition of six business systems (estimating, purchasing, property management, earned value management systems, material management and accounting systems) , the proposed rule includes enforcement provisions which range from 5% to 100% withholdings applied to contractor invoices (public vouchers and progress payments).

On a positive note, the rule clearly assigns the decision making authority to the contracting officer who would rely on DCAA audits to make a decision as to the adequacy of a business system. Applied to the overall accounting system the expectation is stated in terms of the system providing reasonable assurance that laws and regulations will be complied with, data is reliable, and risk of misallocations and mischarges are minimized (other systems have system specific criteria delineated in the proposed rule). However, the rule fails to define any measurable objective standards unless such standards already exist (e.g. MMAS or Material Management and Accounting Systems which does have for example a specific —desirable level of inventory accuracy of 95%).

The DPAP website has also publicized its creation of a subcommittee on —Contractor Business Systems Issues whose focus areas include the assessment of the need for standards (such as those published for Earned Value Management Systems (EVMS)) for the various business systems. Unfortunately and inexplicably DPAP has disconnected the critical issue of defining the standards for measuring business systems from the DFARS rule making process on business systems. The DFARS proposed rule appears to have a placeholder for the outcome of the subcommittee with respect to standards for business systems; hence, public comments on the DFARS proposed rule are in something of a vacuum with respect to the full, ultimate context of the DFARS rule. We are left to comment on a proposed rule

arguably missing its most critical component; analogous to voting on a government referendum and only knowing part of the referendum while deferring to a government subcommittee to —fill in the blank at a later date.

As it relates to standards which would otherwise define business systems requirements for an accounting system, the proposed rule essentially incorporates the SF1408 criteria (Standard Form 1408 which is currently used to document a government/DCAA assessment of a contractor's accounting system before awarding a contract to a contractor). Before listing the 17 requirements, the proposed rule includes the statement, —including but not limited to, as applicable (with respect to the list of 17 criteria). Open-ended regulations simply cannot result in consistent interpretations, particularly when the government audit agency (DCAA) freely interprets and applies requirements over and above any stated requirements (see related discussion in the article on Bid Protest).

In many cases, the first obstacle or issue will continue to be the question of —as applicable because most DCAA auditors view applicability in the broad context of government contracting and not in the narrow context of the specific contract or solicitation to which the instant SF 1408 evaluation applies. Ultimately, government contractors will continue to face DCAA's free-wheeling interpretations of requirements over and above the stated requirements because the wording of the proposed rule simply opens the door to a much more expansive definition of accounting system requirements.

As it pertains to the ominous withhold (enforcement) provisions, these are viewed by DPAP as necessary presumably because DCMA has asserted that current regulations do not provide for administrative withholds in contrast to interpretations by DCAA (another DCAA interpretation which appears to be inconsistent with and more unfavorable to contractors than the actual regulation; imagine that). The proposed withholds are 10% for a business system (with one or more deficiency) up to 50% for more than one business system (i.e. five or six business systems, each with one or more uncorrected deficiency would result in a mandatory withhold of 50% of all government public voucher or progress payments). And of course, the ultimate withhold of 100% of contractor payments for deficiencies —highly likely to lead to improper contract payments. As proposed a contractor could find itself without any government payments (100% withholds) based upon no actual mischarges or overbillings, but merely a deficiency which is —highly likely to lead to improper contract payments. If a system deficiency is —highly likely to lead to improper contract payments, even a moderately skilled auditor should be able to uncover the actual overpayments as opposed to effecting a rule which imposed an arbitrary 100% withhold.

There are provisions to reduce withholds to 5% wherein a contractor has prepared an acceptable corrective action plan, but not fully implemented that plan. Of course the corrective action plan must be acceptable which is defined nowhere within the proposed rule.

Unless we've missed the exemption, the DFARS proposed rule will be applicable to all DoD contracts (large business or small business) although the proposed rule specifically asks for comments from small entities as to the expected impact on those small entities (we are not sure why DPAP introduced the otherwise undefined terminology of small entities instead of using the more tradition reference to small

business). No doubt, small entities will be receptive to the proposed rule and the idea of investing hundreds of thousands for business systems solely to be able to obtain DOD contracts; well maybe not so receptive.

Of passing note, FAR 52.203-13 imposed internal controls requirements, but only on contracts in excess of \$5 million and not applicable to small businesses. By implication and by no means unique to this particular DFARS proposed rule, DOD contractors are once again going to be held to a higher standard than are government contractors in general.

There is significantly more to the proposed rule which can be accessed by going to the Federal Register [regulations.gov](http://www.regulations.gov) and search for DARS-2010-0001-0001. All DoD contractors are encouraged to read the proposed rule and to comment on the proposed rule. Certainly Beason & Nalley will be submitting comments with respect to the DFARS proposed rule.