



FEDERAL CONTRACTS



REPORT

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DOD

Rules Without Reason: The Proposed Defense Business Systems Regulations

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The Defense Department has proposed to amend the Defense Federal Acquisition Regulation Supplement (DFARS) to significantly enhance the withholding authority of its administrative contracting officers (ACOs). The stated purpose of the proposed rules is “to improve the effectiveness of Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) oversight of contractor business systems.” As shown below, however, none of the covered business systems is lacking in regulatory oversight, so additional rules appear unnecessary.

Regulatory Intent. The supplementary information to the proposed DFARS business systems rules states:¹

Contractor business systems and internal controls are the *first line of defense against waste, fraud, and abuse*. Weak control systems *increase the risk of unallowable and unreasonable costs on government contracts*. To improve the effectiveness of Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) oversight of contractor business, DOD is considering a rule to

clarify the definition and administration of contractor business systems as follows:

1. DOD is proposing to define contractor business systems as accounting systems, estimating systems, purchasing systems, earned value management systems (EVMS), material management and accounting systems (MMAS), and property management systems.

2. DOD is proposing to implement compliance enforcement mechanisms in the form of a business systems clause which includes payment withholding that allows administrative contracting officers to withhold a percentage of payments, under certain conditions, when a contractor’s business system contains deficiencies. Under such circumstances, payments could be withheld on: (a) interim payments under cost-reimbursement contracts, incentive-type contracts, time-and-materials contracts, and labor-hour contracts; (b) progress payments; and performance-based payments. (Emphasis supplied.)

Each of the business systems covered by the proposed rules is discussed below.

Impact. A. Accounting Systems

The evaluation of a contractor’s accounting system is only done for flexibly priced contracts. Accordingly, a contractor does not have to have an acceptable accounting system for firm-fixed price contracts. On the other hand, cost-reimbursement contracts require a contractor to have an approved accounting system.² The acceptability of a contractor’s accounting system nor-

¹ - DFARS Case 2009-D038, 75 F.R. 2,457, January 15, 2010.

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² Federal Acquisition Regulation 16.104(h) and 16.301(a)(1).

mally is determined in a review done by an auditor with the Defense Contract Audit Agency (DCAA). In their review, DCAA auditors apply the standards found in agency audit guidance.³ Among the many items covered in an accounting system review is the following:

7. Verify that the system can identify and segregate unallowable costs as defined by FAR Part 31 and any applicable contract terms.

Note that approval of the accounting system is required *before* performance of the contract. Accordingly, the stated goals of the proposed business systems rules (to protect the government from fraud, waste, and abuse, as well as the “the risk of unallowable and unreasonable costs on government contracts”) would be inapplicable to contracts that have not been performed. More importantly, in this manner the government already protects itself through the evaluation of a contractor’s accounting system.

Finally, it is unreasonable to expect the proposed business systems rules to completely protect the government from fraud, waste, and abuse, or the risk of unallowable costs. This is because those risks arise from an accounting system’s human operators, not the accounting system itself.

B. Estimating Systems

DCAA also performs contractor estimating system reviews.⁴ Such reviews are covered in DFARS 215.407-5 and 252.215-7002. It is DOD policy that all contractors have an adequate estimating system. However, under DFARS 215.407-5 only certain large businesses are required to disclose their estimating system.

A contractor that has an adequate estimating system produces acceptable proposals on which fair and reasonable prices can be negotiated. Such a system should assure both the contractor and the government that cost estimates provided to the government for future work are reliable and consistently applied, and that the resulting projections are verifiable, supportable, and sufficiently documented. For those needing more information in this area, DFARS 215.407-5-70(d) comprehensively lists fifteen characteristics of an adequate estimating system.

The objectives of the proposed business systems rules, to protect the government from fraud, waste, and abuse, and the risk of unallowable costs, are at best duplicative as applied to estimating systems. DOD’s oversight activities in this area have not spawned any contract disputes, as there are no reported cases concerning estimating systems. This indicates that DOD already exercises adequate regulatory oversight through its estimating system reviews.

C. Purchasing Systems

Oversight of a contractor’s purchasing system is accomplished through a contractor purchasing system review (CPSR). The regulatory scheme for a CPSR is found in FAR Subpart 44.3. In general, a CPSR is performed where a contractor’s government contracts are expected to exceed \$25 million in the next year.⁵ Sub-

sequently, the ACO makes a determination every three years whether another CPSR is needed.

Where a CPSR finds major weaknesses, the ACO may withhold approval of a contractor’s purchasing system.⁶ This essentially means the contractor’s costs related to its supplier and/or subcontractor purchases are unallowable. When a contractor’s purchasing system is disapproved, the ACO notifies the contractor in writing of the particular deficiencies, and the contractor has 15 days to submit a corrective action plan. Even after the contractor’s plan is approved, the ACO conducts a review to ensure that the deficiencies have been corrected.

The application of the proposed business systems rules in this area would appear to transgress the provisions of FAR 44.304, “Surveillance,” which states:

(a) The ACO shall maintain a sufficient level of surveillance to ensure that the contractor is effectively managing its purchasing program.

(b) Surveillance shall be accomplished in accordance with a plan developed by the ACO with the assistance of subcontracting, audit, pricing, technical, or other specialists as necessary. The plan should cover pertinent phases of a contractor’s purchasing system (pre-award, postaward, performance, and contract completion) and pertinent operations that affect the contractor’s purchasing and subcontracting. The plan should also provide for reviewing the effectiveness of the contractor’s corrective actions taken as a result of previous government recommendations. *Duplicative reviews of the same areas by CPSR and other surveillance monitors should be avoided.* (Emphasis supplied.)

The new business systems rules may constitute “other surveillance monitors,” within the meaning of FAR 44.304. Nonetheless, recall DOD’s primary concern: “Weak control systems increase the risk of unallowable and unreasonable costs on government contracts.” Regarding same, the incurrence of unallowable and/or unreasonable costs through purchasing systems has apparently not yet triggered any disputes, as there are no reported government contract cases involving CPSRs. It follows that DOD appears to be responding to risks that are non-existent, insofar as purchasing systems are concerned.

D. Earned Value Management Systems (EVMS)

The FAR covers EVMS in FAR Subpart 34.201, which states that an EVMS is only required in major acquisitions for development under OMB Circular A-11. This explains why an EVMS is so rarely encountered in government contracts. If a contractor does not already have an approved EVMS, its system must comport with the American National Standards Institute/Electronic Industries Alliance (ANSI/EIA) Standard 748.

FAR clause 52.234-2 (Notice of Earned Value Management System—Pre-award Integrated Baseline Review) is required in any solicitation where a contractor will be required to use an EVMS. Of significance to the proposed business systems rules, Subparagraph b(3) of that clause states:

(3) The government will review and approve the offeror’s plan for an EVMS *before contract award.* (Emphasis supplied.)

⁶ - FAR 44.305-3.

³ - “Pre-award Survey of Prospective Contractor Accounting System,” April 2004.

⁴ - DCAA Contract Audit Manual, § 5-1200. See also PGI 215.407-5-70(f).

⁵ - FAR 44.302(a). More detailed information concerning CPSRs may be found at <http://www.acq.osd.mil/dpap/dars/pgi>.

Hence, an EVMS is reviewed and approved *before* a contract is even awarded.⁷ Accordingly, it is difficult to understand how an EVMS could “increase the risk of unallowable and unreasonable costs on government contracts,” which is the stated basis for the proposed business systems rules. Here too, there are no reported cases involving an EVMS, so one may wonder what risks an EVMS presents that DOD believed it needs protection from.

E. *Material Management and Accounting System (MMAS)*

A material management and accounting system (MMAS) covers the costs associated with transactions for materials. The scope and operation of an MMAS is defined in DFARS 252.242-7004 (Material Management and Accounting System, JUL 2009):

(1) “Material management and accounting system (MMAS)” means the contractor’s system or systems for planning, controlling, and accounting for the acquisition, use, issuing, and disposition of material. Material management and accounting systems may be manual or automated. They may be standalone systems or they may be integrated with planning, engineering, estimating, purchasing, inventory, accounting, or other systems.

The regulatory requirements applicable to a MMAS are found in DFARS 252.242.7200, which excludes small businesses, non-profits and educational institutions from its coverage. However, a MMAS is required where a contractor received more than \$70 million in contracts during the preceding fiscal year for which cost and pricing data were required.⁸ In circumstances where a MMAS is required, the administrative contracting officer (ACO) reviews and evaluates the contractor’s submission. Should the ACO’s review note any deficiencies in the MMAS, the corrective action is indicated. Thereafter, the ACO is authorized to reduce progress payments and/or disallow costs where a contractor fails to take suitable corrective action on deficiencies noted in its MMAS.⁹ The amount of the withholding is to be an “appropriate percentage” commensurate with the impact on the government’s costs. The withholding continues until the deficiencies are corrected.

All MMAS matters are routinely handled and resolved at the ACO level, which can be seen in the fact that there are no reported cases concerning MMAS disputes (are you seeing a pattern here?).

Given the comprehensive oversight regime already in this area, the proposed business systems rules appear to be unnecessary.

F. *Property Management*

A contractor’s management of government-furnished property (GFP) is covered by FAR Part 45. In most instances involving GFP, the Defense Contract Management Agency (DCMA) reviews and approves a contractor’s property management policies, procedures, and practices.¹⁰ When a contractor’s property management

system fails to address a particular regulatory or contractual requirement, the government’s property administrator notifies the contractor in writing of that deficiency. Should the contractor fail to correct such a deficiency, then the contracting officer may take either of the following actions: (1) Revocation of the government’s assumption of the risk for loss, damage, destruction, or theft; and/or (2) The exercise of other rights or remedies available to the contracting officer.¹¹

Matters concerning property management are generally raised and resolved as an integral part of contract administration. Nonetheless, there have been disputes between contractors and agencies involving GFP, and there is a body of case law in this area. Indeed, property administration is a specialized province in the realm of contract administration. However, there are virtually no authoritative pronouncements from any agency citing a need for additional regulatory powers in this area – not even DOD.

Analysis. A. *American Bar Association Section Comments*

The Cost, Pricing, and Accounting Committee of the ABA’s Public Contract Law Section submitted comments regarding the proposed rules. The ABA concerns were primarily in the following areas:

- the proposed rules would establish a punitive withholding system;
- the Allowable Cost and Payment clause¹² and similar FAR provisions already protect the government’s interests;
- the term, “unacceptable business systems,” is not adequately defined;
- the proposed rules would likely increase the number of contract appeals; and
- the proposed rules would be burdensome to small and medium-sized businesses.¹³

It remains to be seen whether DOD accords any weight to these (or any other) criticisms.

B. *Commentary*

As shown above, virtually every business system covered by the proposed new rules is already covered by other FAR and/or DFAR provisions. Indeed, half of the business systems covered by the proposed rules are evaluated and approved before contract performance even begins (e.g., accounting system, estimating system, and EVMS). These systems, therefore, pose *no* risk to DOD of fraud, waste, and abuse, or exposure to unallowable costs. Moreover, the complete absence of litigation involving all but one of the business systems covered by the proposed rules indicates that the government’s fears are imaginary. It follows that there is no support for the underlying rationale of the proposed business system rules. If finalized, these rules will just be another regulatory layer in the DOD’s contract compliance blanket.

Conclusion. The proposed DFARS business systems rules have already been the subject of numerous criticisms, and the consensus of the government contract

⁷ - DCAA Contract Audit Manual § 11.202.2. See also “Audit Guidance on Performance of Earned Value Management Systems (EVMS) Audits,” 09-PPD-002(R), January 22, 2009.

⁸ - DFAR 252.242-7203. An ACO may require a large business that receives \$30 million in DOD contracts to have an acceptable MMAS, if necessary for “the best interests of the government.”

⁹ - DFAR 252.242-7204(d)(4).

¹⁰ - FAR 45.105(a).

¹¹ - FAR 45.105(b).

¹² - FAR 52.216-7. See also FAR 42.704 regarding indirect rates.

¹³ - The complete ABA comments may be found at <http://www.abanet.org/contract/regscmm/home.html>, see “Emerging Areas.”

community is that the rules will not be an improvement to contract administration.

There is another aspect to the proposed rules, though, that has not been previously mentioned by commentators. By authorizing elevated withholding powers, the proposed DFARS rules will significantly enhance the ability of an ACO to interrupt a contractor's cash flow. For many (if not most) government contractors, cash flow is directly related to a contractor's ability to make payroll. By impeding cash flow, ACOs will be able to inflict considerable immediate harm on con-

tractors, especially where the withholding amount is significantly disproportionate to the government's risks. Perhaps this is the unstated intent of the proposed rules.

Finally, this article presented a comprehensive review of each business system listed in the proposed rules. As shown, virtually none of the business systems expose DOD to any risks of waste, fraud, and abuse, or unallowable costs. Because DOD already exercises adequate regulatory oversight in all the covered areas, the proposed regulations are rules without reason.