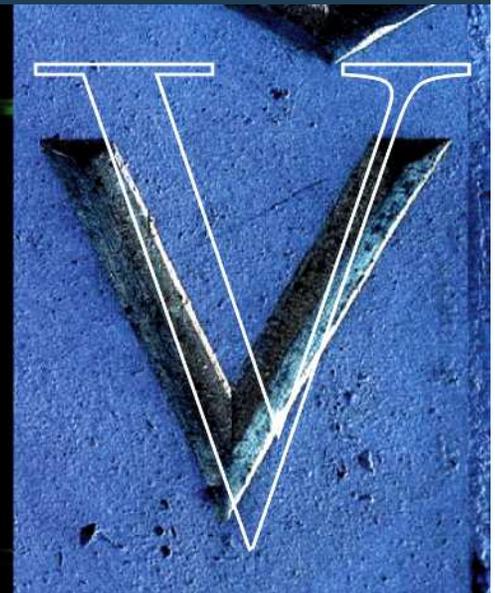
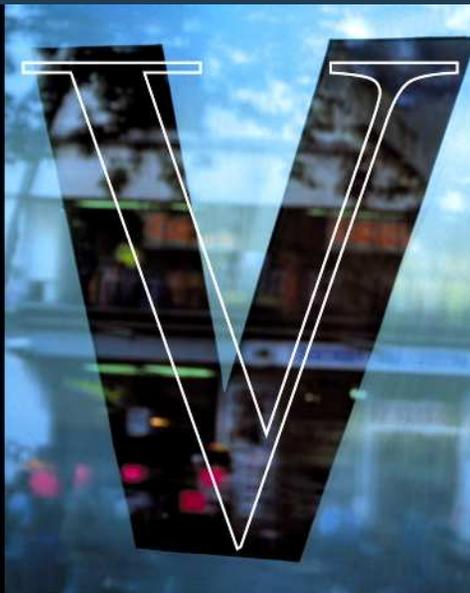
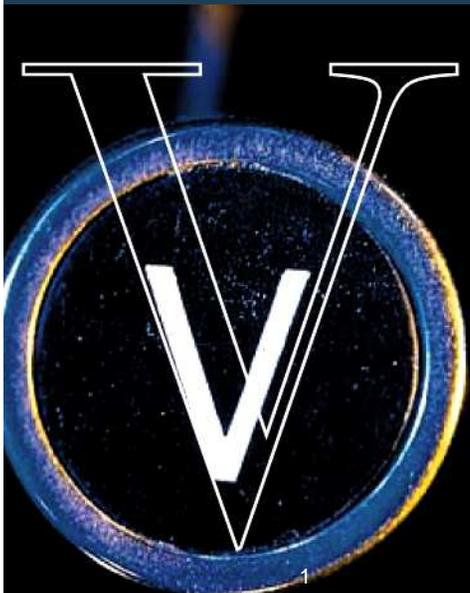


Strategic Implications of the New  
DFARS Business System Rule  
*Co-presented by Venable LLP and Argy,  
Wiltse & Robinson*

June 12, 2012



## Panelists



**Robert A. ("Rob") Burton, Partner, Venable LLP**

- A 30-year veteran of procurement law and policy.
- Former Deputy Administrator of the Office of Federal Procurement Policy (OFPP), the nation's top career federal procurement official, including 2 years as Acting Administrator.



**Rebecca E. ("Becky") Pearson, Partner, Venable LLP**

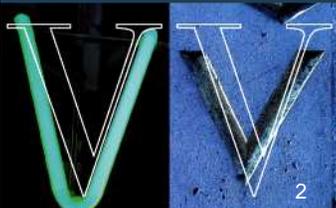
- Partner in the Government Contracts practice at Venable LLP, who assists clients in government contract litigation and counsels clients on matters involving contracts including defective pricing and cost allowance questions.



**Eric Sobota, Principal, Argy**

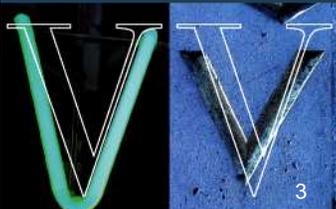
- Principal at Argy, Wiltse & Robinson. He regularly consults government contractors on a wide variety of compliance issues ranging from proposals through termination claims. Eric has also been admitted to the GAO on many bid protest matters as a cost expert.

*Thanks to Venable Partner John Farenish, former General Counsel of DCAA, for his contributions to the slides.*



## Agenda

- Introduction
- Overview of Business Systems Rule
- Implications for Large Contractors
- Implications for Contractors with Only a Few CAS Covered Contracts
- DCMA v. DCAA Roles
- Experiences with Business Systems Rule
- Prime v. Subcontractor Issues
- Disputes
- Pre- Award Issues
- Responsibility and Suspension and Debarment Issues



## DFARS Business Systems: Final Rule

On February 24, 2012 the DoD DAR Council adopted as final, with changes, the interim rule regarding improved effectiveness and oversight of contractor business systems. (DFARS Case 2009-D038)

### Background:

- June 2009, CWC interim report recommended increased oversight and improved effectiveness of contractor business systems
- Initial proposed rule published on January 15, 2010 (75 FR 2457)
- Second proposed rule issued on December 3, 2010 (75 FR 75550)
- 2011 National Defense Authorization Act (NDA) signed on January 7, 2011
- Interim rule published on May 18, 2011 (76 FR 28856)

*“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.”*

## Overview of the Business Systems Rule

- DCMA has oversight of the following contractor business systems:
  - Accounting: DFARS 242.75, Clause 252.242-7006, PGI 242.7502
  - Cost Estimating: DFARS 215.407-5-70, Clause 252.215-7002, PGI 215.407-5-70(e)(3)
  - Purchasing: DFARS 244.1, Clause 252.244-7001, PGI 244.305-70
  - Material Management and Accounting (MMAS): DFARS 242.72, Clause 252.242-7004, PGI 242.7203
  - Property Control: DFARS 245, Clause 252.245-7003, PGI 245.105
  - Earned Value Management (EVM): DFARS 234.001, Clause 252.234-7002, PGI 234.201 (7)(iii)
- Implements a Contractor Business Systems clause that addresses the administration of the review and approval of business systems and Government remedies of disapproved systems.

## Overview of the Business Systems Rule

What contracts will have the new clauses?

- Covered Contracts defined as those contracts subject to CAS. IE if the contract contains the CAS clause, it will contain the applicable business systems clauses if the criteria below are met:

Purchasing System:

- Cost-reimbursement contract
- Letter contract that exceeds the simplified acquisition threshold (SAT)
- Fixed-price contract that exceeds the SAT under which unpriced contract actions (including unpriced modifications or unpriced delivery orders) are anticipated;
- Time-and-materials contract that exceeds SAT
- Labor-hour contract that exceeds the SAT

## Overview of the Business Systems Rule

What contracts will have the new clauses?

- **Accounting:** Cost-reimbursement, incentive type, time-and-materials, or labor-hour contracts; and Contracts with progress payments made on the basis of costs incurred by the contractor or on a percentage or stage of completion.
- **Earned Value Management:** For cost or incentive contracts valued at \$20,000,000 or more, and for other contracts for which EVMS will be applied in accordance with 234.201(1)(iii) and (iv)



# Overview of the Business Systems Rule

What contracts will have the new clauses?

## Estimating System:

- All solicitations and contracts to be awarded on the basis of cost or pricing data.
- A large business contractor is subject to estimating system disclosure, maintenance, and review requirements if—
  - In its preceding fiscal year, the contractor received DoD prime contracts or subcontracts totaling \$50 million or more for which cost or pricing data were required; or
  - In its preceding fiscal year, the contractor received DoD prime contracts or subcontracts totaling \$10 million or more (but less than \$50 million) for which cost or pricing data were required and the contracting officer, with concurrence or at the request of the ACO, determines it to be in the best interest of the Government (e.g., significant estimating problems are believed to exist or the contractor's sales are predominantly Government).



## Overview of the Business Systems Rule

What contracts will have the new clauses?

### Government Property System:

- All cost reimbursement, time-and-material, and labor hour type solicitations and contracts; and
- Fixed-price solicitations and contracts when the Government will provide Government property.
- Contracts or modifications awarded under FAR Part 12 procedures where Government property that exceeds the SAT, as defined in FAR 2.101, is furnished or where the contractor is directed to acquire property for use under the contract that is titled in the Government.



## Overview of the Business Systems Rule

What contracts will have the new clauses?

Material Management and Accounting System:

All solicitations and contracts exceeding the SAT that are not for the acquisition of commercial items and—

Are not awarded to small businesses, educational institutions, or nonprofit organizations; and

Are either—

- Cost-reimbursement contracts; or
- Fixed-price contracts with progress payments made on the basis of costs incurred by the contractor as work progresses under the contract.

## Intent of the Business Systems Rule

- Improve the effectiveness of DoD oversight of contractor business systems
  - First line of defense against fraud, waste, and abuse
  - Weak business systems increase our risk of:
    - Inflated contract prices/costs
    - Paying costs that are unallowable, unreasonable, and not allocable to the contract
    - Inflated subcontract costs
    - Property systems that increase our risk of loss

## The Rule in Summary

- The Cognizant Contracting Officer (CO) in consultation with DCAA and/or Functional Specialists shall
  - Determine the acceptability of the contractor's business systems
  - Approve or disapprove the systems
  - Pursue correction of significant deficiencies
  - Withhold Payments in accordance with the requirements of 252.242-7005, Contractor Business Systems, until significant deficiencies are corrected
- Significant Deficiency: a shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes
  - Standard Definition in all business system related clauses
  - The rule requires a CO to provide, in his/her initial determination, a description of each significant deficiency identified during the review of a system in sufficient detail to allow the contractor to understand the deficiency
  - If the CO, in his/her final determination, determines that the contractor's business system contains significant deficiencies, the final determination will include a notice to withhold payments

## Withholds for Disapproved Systems

- 5 percent for one or more significant deficiencies in any single contractor business system.
- Up to 10 percent for one or more significant deficiencies in multiple contractor business system deficiencies.
- COs are required to reduce withholds to 2 percent per system, if the contractor submits an acceptable corrective action plan within 45 days of the CO's final determination.
- If a contractor has submitted notification of correction of the deficiencies and/or implementation of the corrective action plan to address the signification deficiencies and the CO has not made a follow-up determination within 90 days, the CO is required to reduce payment withholding by at least 50 percent.
- In order to be subject to a withhold, a contract must have both the Contractor Business System Clause (252.242-7005) and the applicable system clause for the system containing the deficiency.

# Accounting System Criteria

## DFARS 242.75



1. Sound internal controls
2. Segregation of direct from indirect costs
3. Accumulate direct costs by contract
4. Accumulate direct costs to intermediate and final objectives
5. Accumulate costs in general ledger
6. Reconcile subsidiary ledgers to general ledger
7. Approve/document adjusting entries
8. Periodic monitoring of system
9. Timekeeping system for employees
10. Labor distribution system for charging direct and indirect labor
11. Monthly posting of books of account
12. Excludes unallowable costs (FAR Part 31 and other contract provisions)
13. Identify costs by CLIN and units if required by contract
14. Segregate preproduction from production costs
15. Cost accounting info required by contract clauses and to readily calculate indirect cost rates from books of accounts
16. Billings can be reconciled to cost accounts for current and cumulative amounts claimed and to comply with contract
17. Adequate, reliable data for pricing follow-on acquisitions
18. Compliance with CAS and GAAP

# Estimating System Criteria

## DFARS 215.407-5-70



1. Clear responsibility for cost estimates and budgets
2. Organization and duties of people responsible for cost estimates and budgets
3. Sufficient training, experience, and guidance
4. Data sources, estimating methods and rationale
5. Adequate supervision
6. Consistent application
7. Error detection and correction
8. Avoid duplication and omission
9. Historical experience
10. Appropriate analytical methods
11. Integrate information
12. Management review
13. Internal review
14. Update cost estimates timely
15. Ensure reasonable subcontract prices
16. Sound proposals adequate to reach fair and reasonable price
17. Adequate system description

# Purchasing System Criteria

## DFARS 244.1



1. Adequate system description
2. Applicable subcontracts contain all flow-down clauses
3. Clear lines of responsibility and authority
4. Purchased orders (POs) based on authorized requisitions
5. Document history of purchase transactions
6. Consistent make-or-buy policy
7. Competitive sourcing which excludes debarred or suspended contractors
8. Evaluate price, quality, delivery, technical and financial capabilities of competing vendors
9. Justification and cost or price analysis for sole or single source award
10. Adequate cost or price analysis, tech evaluation to ensure fair and reasonable prices
11. Document negotiations in accordance with FAR 15.406-3
12. Seek, take, and document discounts
13. Select proper contract type and prohibit cost-plus-percentage-of-cost subcontracts
14. Subcontract surveillance to ensure timely delivery of acceptable product and to notify Government of potential subcontract problems that may impact delivery, quantity, or price
15. Justify subcontract changes that affect cost or price

## Purchasing System Criteria

16. Notify the Government of all subcontracts with flow-down clauses that allow for Government audit
17. Policies on conflict of interest, gifts, and gratuities
18. Perform internal audits, training, and maintain policies to ensure integrity of the purchasing system
19. Policies to ensure POs and subcontracts contain mandatory flow-down clauses required by FAR, DFARS, and prime contract provisions
20. Org. and admin. structure for procurement of required quality materials and parts at the best value from responsible and reliable sources
21. Selection processes ensure most responsive and responsible sources for furnishing required quality parts, materials and to promote competitive sourcing among dependable suppliers
22. Adequate price or cost analysis on purchasing actions
23. Ensure proper types of subcontracts are selected and that there are controls over subcontracting, including surveillance
24. Ensure Contracting Officer is notified in writing if Contractor changes subcontracts after award to >70% of total cost of work performed and verify Contractor added value or any subcontractor increases value of lower-tier subcontracts to >70%

## Purchasing System Overview

- The purchasing and subcontracting function includes make or buy decisions
- The selection of vendors
- Analysis of quoted prices
- Negotiation of prices with vendors
- Placing and administering of orders
- Expediting delivery of materials

## Key Differences-Summary

- In the past, DCAA had audited 10 major systems.
- New rule consolidates those into 6 audits.
- Labor, Indirect/ODC, Control Environment, Billing, IT, and Accounting now combined into Accounting System
- Compensation now completed as part of the incurred cost audit.
- Estimating now includes Budget and Planning
- New Audit Programs for Accounting System issued in April 2012
- Audit Programs for Estimating/Purchasing to be issued shortly

## MRD: Audit Guidance on Auditing Contractor Business Systems: Accounting System

- Issued in April. Provides guidance on the audit approach and definitions of key terms
- Describes significant deficiency: A shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.
- Factors to consider:
  - The nature and frequency of the noncompliance with the DFARS criteria identified with appropriate consideration of sampling risk (i.e., the risk that the conclusion based on the sample is different than it would be had the entire population been tested).
  - Whether the noncompliance with the DFARS criteria is material considering the nature of the compliance requirements.
  - The root cause of the noncompliance. (Understanding why the noncompliance occurred will help to determine if it is systemic and significant.)
  - The effect of compensating controls.

## MRD: Audit Guidance on Auditing Contractor Business Systems: Accounting System

Factors to consider continued:

- The possible future consequences of the noncompliance with the DFARS criteria.
- Qualitative considerations, including the needs and expectations of the report's users. For Government contract cost issues, qualitative considerations also include serving the public interest and honoring the public trust.

The following indicators of a significant deficiency/material weakness also should be considered:

- History of noncompliances found in contractor assertions (e.g., public vouchers, incurred cost submissions, proposals) requiring correction.
- Identification of material noncompliances with applicable Government contract laws and regulations (e.g., with FAR Subpart 31.2, CAS, or applicable requirements in FAR Part 15) either in the business system audit or another audit.

## MRD: Audit Guidance on Auditing Contractor Business Systems: Accounting System

- All findings will be summarized in a memorandum for record (MFR).
- If deficiencies exist, a Deficiency Report will be prepared.
- The Audit Findings will be provided to the CO who will make the final determination on withholds, etc.

What are the implications for large contractors?

## Business Systems: Key Considerations

- New audit approach includes walkthroughs like former audits, however there is an increased focus on transaction testing.
- Accounting system transactional testing will include timekeeping, invoices, direct versus indirect costs. etc.
- Estimating system/purchasing system will also have transactional testing.
- DCAA is hiring! Expected growth from 4,900 in FY2011 to 5,600 in 2016
- More demand for contractor time and contractor liaisons.
- Cost Recovery: Time to be creative:
- Can procurement be partially direct?
- CAS Practice Change/Exemption
- Service Center Approach?

## Accounting System: Key Considerations

- New audit approach requirements are similar to SF1408 and other former requirements
- Key change: How will this affect other audit disputes. Ex. New compliance requirement for CAS
- Transaction testing could be significant: Timekeeping, billing, journal entries, etc.
- Need for centralized files, dedicated resources
- Employees need to be trained to follow disclosed process.
- Consider DCAA Liaison Policy/Access to records

## Estimating System: Key Considerations

- Key change: Supporting each proposal key especially with transactional testing
- Documentation key to surviving transactional testing.
- Transaction testing could be significant: proposal files
- Need for centralized files, dedicated resources
- Employees need to be trained to follow disclosed process now!

## Purchasing System: Key Considerations

- Key change: Contractually obligated to effectively monitor subcontracts and notify the government of potential problems that may impact delivery, quantity, or price.
- Documentation key to surviving transactional testing.
- Transaction testing could be significant: Purchasing Files
- Need for centralized files, dedicated resources
- Employees need to be trained to follow disclosed process now!

What are the implications for contractors with only one or limited CAS covered contracts?

## Does not Apply to Small Businesses Since the Clause is Self-Deleting if CAS Does Not Apply

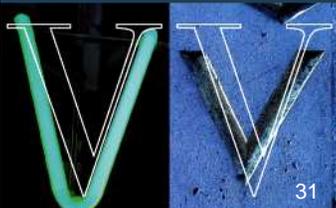
- The rule will not apply to small business primes, since it is self-deleting if CAS does not apply
- Small businesses should ensure that the self-deletion is intact in the flow downs in a subcontract
- Small business should assess whether or not they will lose their CAS exemption in the near term (for example, by organic growth or acquisition) and ensure the implementation is considered in future bids.

## Business Systems: Key Considerations

- Increased costs during austerity mean it is time to analyze how best to charge allowable costs of implementation.
- Bidding the costs of implementing as direct if possible?
- Service Center Approach?
- Understanding how the process will work upon contract award.

# DCMA v. DCAA Roles

| DCAA  | DCMA  |
|---|---|
| <ul style="list-style-type: none"> <li>■ Audits—               <ul style="list-style-type: none"> <li>– Accounting System</li> <li>– Estimating System</li> <li>– MMAS</li> <li>– Performs attestation examinations for contractors' compliance with the DFARs system criteria</li> </ul> </li> </ul> | <ul style="list-style-type: none"> <li>■ Requests EVMS Audit</li> <li>■ Oversight over purchasing system</li> <li>■ Determines whether significant deficiencies exist               <ul style="list-style-type: none"> <li>– Initial determination</li> <li>– Final determination, including whether to withhold</li> </ul> </li> <li>■ Review of corrective action plan</li> </ul> |



## Experiences with Business Systems Reviews Under Prior Rule

### Lack of Regulatory Rigor

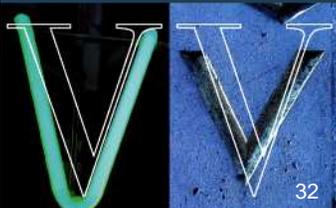
- Use of vague guidelines
- Failure to cite to regulatory or acquisition law support

### Time Consuming

- In 2011, 4,225 auditors released 7,390 reports (avg. **2 reports per year**)
- Average time between start of audit and report for “other audit” (including business systems), **283 days**.

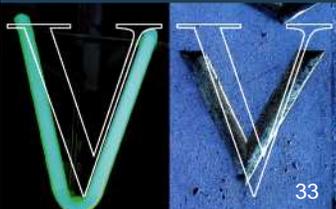
### Inexperienced Auditors

- 700 new auditors added in 3 years
- Plans to increase by another 700 auditors from FY2011 to FY2016



## Other DCAA Problem Areas

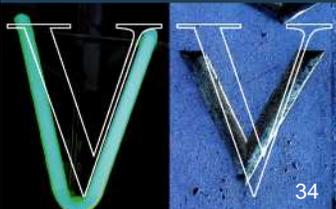
- Access to Internal Records
- Attorney/Client Privilege Documents
- Ethics Internal Investigations
- Disconnect between HDQS and Field Auditors



# Audit Tips

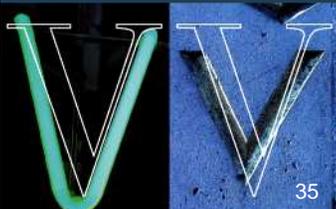
How to **Prepare** for a DCAA/DCMA Audit:

- Review prior DCAA audit reports and identify issues.
- Review DCMA reviews and identify issues.
- Conduct contract walk-through.
- Review policies and procedures.
- Test internal control structure relating to area to be audited.
- Ensure documentation (data) is current and available.
- Ensure employees are trained.
- Ensure practices compliant w/ policies & procedures.
- Perform sampling of area to be audited.
- Select a liaison(s) to work with the auditors.



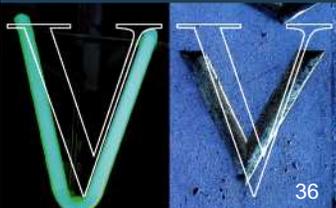
## Audit Tips (continued)

- Review the notification to understand scope of audit and determine whether you have enough time to prepare.
- If audit is with an OIG consider having counsel present.
- Explain your Business Systems during the entrance conference.
- Actively manage the audit throughout the process (GC and Internal Audit) – Internal Control Mechanism & Key POCs.
- Establish a document log for all incoming and outgoing correspondence.
- Document all questions, discussions, answers, disagreements, and misunderstandings with the auditors before, during and at conclusion of audit.
- Keep management informed.
- Draft a rebuttal to draft audit report.



## Audit Tips (continued)

- Develop a professional rapport with the auditors.
- Take notes on auditor's request for documents/request that the auditor put their request in writing.
- Listen to the auditor's questions/request that questions be put in writing.
- Provide documents that are requested in a timely manner and in the form requested (establish ground rules).
- Do not establish too many levels of review for release of documents.
- Ensure that the company liaison to the auditors has the knowledge and authority to release documents.
- Avoid deemed denial of access to records.
- Do not be afraid to ask questions and be prepared to answer questions.
- Document disputes.



## Effective Management of an Audit

At the outset of an audit, contractors must internally communicate:

- Types of audits and risk assessment levels.
- How and why an audit occurs; the length and scope of an audit; resources needed for an audit.

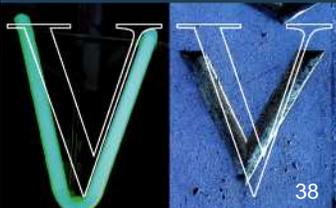
In the interim, it is important to understand contractor data and relevant facts, and identify any omissions or mistakes.

At the completion of an audit, contractors should analyze and respond to the results within an auditor's draft report to account for any discrepancies.



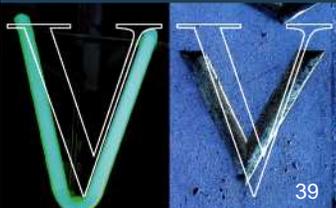
## Legacy Issues

- Review of Legacy Reports
  - Failure in one area may not be considered a significant deficiency
  - The CO must consult with the auditor and initiate a follow-up review of the system in accordance with system criteria identified in the applicable business system clause.
- Review of Legacy Determinations
  - CO should initiate a follow-up review in accordance with current system criteria



## Disputes

- “Final determinations on the adequacy of the contractor’s business systems under the rule are not contracting officer’s final decisions for the purposes of the Contract Disputes Act of 1978 (CDA).” Preamble to Final Rule
- “Nothing in the rule negates the contracting parties’ rights and obligations under the Contract Disputes Act and disputes clause, the availability of other avenues of dispute resolution, or the entitlement to Contract Disputes Act interest on contractor claims.” Preamble to Final Rule



# Prime Contractors v. Subcontractors

## Prime's Interest

- Ensure—
  - Reasonable subcontractor prices
  - Controls over subcontracting
- Subcontract surveillance to notify Government of potential subcontract problems that may impact delivery, quantity, or price
- Pass cost risk of withholds to subcontractor
- Monitor % of work performed by subcontractors (Pass-through restrictions)
- Subcontractor control of property management
- Flow down of clause is not mandated, but may be prudent

## Subcontractor's Interest

- Refuse to accept flow down of business system clauses as not required
  - Especially if subcontractor is not CAS covered
- If commercial item contract, restrict prime's ability to audit records
- If subject to audit, consider direct reporting of costs to Government or third party



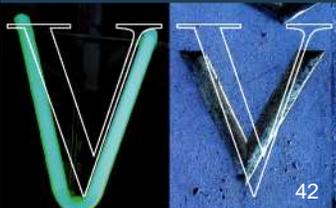
## Pre-Award Concerns – Deficiency

- Significant deficiency may impact evaluation of—
  - Cost risk
  - Cost or most probable cost of performance
  - Performance risk
- To mitigate a significant deficiency in business systems during source selection—
  - Timely communicate any corrective action plan (CAP) (in proposal or otherwise)
  - Have third party verify plan, pending receipt of DCAA audit report
  - Close communication with DCAA and DCMA regarding issue



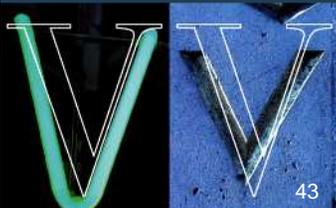
## Lack of Controls May Impact Responsibility

- To be determined presently responsible, a prospective contractor must have the necessary—
  - Organization
  - Operational controls
- Suspension or Debarment
  - Presence or absence of internal controls is a factor in the decision whether to suspend or debar
  - Failure to report a significant overpayment is a cause for suspension or debarment



## Impact of Business Systems Rule

- Contractors need to take preemptive steps in response to DCAA's increased oversight and compliance requirements:
  - Increase effectiveness of internal compliance procedures, allocated resources, and communications regarding potential or ongoing audits.
  - Increase communications with DCAA and DCMA officials.
  - Keep abreast of current regulatory regime to ensure effective compliance.



## Questions and Comments

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