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DoD Publishes Second Version of Rules on Contractor Business Systems and Withholding of Contract Payments

For the second time this year, the Department of Defense has published a Defense Federal Acquisition Regulation Supplement (DFARS) proposed rule regarding contractor business systems. 75 Fed. Reg. 75550 (Dec. 3, 2010).

In previous Venable Government Contracts Updates®, we analyzed the **earlier proposed rule** and also explained a related shift in **DCAA's approach to audits**. The first proposed rule ("first rule") elicited 370 comments from 25 sources. Many comments were from industry leaders concerned about the fairness of the rule, particularly its provision that required contracting officers to withhold 10% of contract payments and permitted withholding of as much as 50% or 100% of payments otherwise due a contractor in some circumstances. Industry commentators expressed widespread concerns that problems with the Defense Contract Audit Agency (DCAA), including flawed audit guidance, insufficient resources, and an inability to coordinate with the Defense Contract Management Agency (DCMA) would lead to the indefinite withholding of payments even after a contractor remedied auditors' concerns.

The preamble to the second proposed rule ("new rule") highlights several significant changes made in response to public comments. Perhaps most importantly, under the new rule the business systems clause caps the amount that a contracting officer may withhold at 20% of contract payments (10% for small businesses) and states that contracting officers rather than auditors have sole discretion over the decision to withhold funds. The new proposed rule also limits the application of the business systems clause to contracts with expected values of \$50 million or more and states that commercial item contracts will generally be exempt from the rule. DoD reiterated several times in its response to comments that the temporary withholding provision was not intended as a penalty for a business system deficiency, but rather represented a good-faith estimate sufficient to mitigate the government's risk where the actual amounts are difficult to estimate or quantify. While acknowledging that the withholding provision grew out of a frustration with overcharging in contingency contracts in Iraq and Afghanistan, the DoD maintained that appropriate business systems with effective internal controls were necessary to mitigate government risk in all contracts.

Below we highlight several topics addressed in the commentary to the new rule.

DCAA/DCMA Issues

According to the DoD,

[A] number of respondents expressed concern that DCAA lacks the resources to perform required audits timely and adequately; that the [first] rule...essentially declares perpetual open-season on all contractor business system internal controls, and that the DCAA follow-up audit...will result in an endless cycle of deficiency reports and follow-up audits; that DCAA audit guidance on the reporting of internal control deficiencies, which requires all deficiencies to be considered significant, effectively ensures that all contractor business systems subject to audit will be found inadequate; that audit reports are not informative enough to help the contracting officer make effective decisions, and that DCAA needs to expand its audit reports to go beyond rendering a pass/fail opinion, and include an analysis of the materiality of any deficiency.

(75 Fed. Reg. at 75551)

In response to these emphatic concerns, DoD assures contractors that DCAA has committed to "making follow-up audits a priority," and revised the rule to say "the report shall describe the deficiencies in sufficient detail to allow the contracting officer to understand the deficiencies and potential adverse impact to the government." DoD similarly dismissed comments concerning the need for public comment on DCAA and DCMA policies, the well-publicized failure of DCAA and DCMA to coordinate, and the lack of government resources. *Id.*

Amounts to Be Withheld from Payment Otherwise Due Contractors

The new rule clarifies that withholding for business system deficiencies applies only to contracts that contain the clause, but that payments may be withheld on multiple contracts affected by a business system deficiency. The amount to be withheld for each deficient business system was reduced from 10% in the first rule to 5% in the new rule. For small businesses, only 2% may be withheld for each deficient system. DoD removed the 100% withhold from the rule and lowered the compounding of deficiencies to a maximum withholding of 20% (10% for small businesses). The contracting officer "will, as appropriate," reduce withholding to 2% (1% for small businesses) for each deficiency upon receipt of an acceptable corrective action plan. The contracting officer shall discontinue withholding and release previously withheld payments when the contracting officer determines, and an auditor or functional specialist verifies, that the contractor has corrected all system deficiencies. In consultation with the auditor or functional specialist, the rule allows the contracting officer to discontinue withholding payments, pending a follow-up audit, if the contractor presents evidence that deficiencies have been corrected.

The chart below summarizes the provisions of the original and new proposed rule with respect to withholding of contract payments where a contracting officer determines that one or more contractor business systems are deficient:

	First Rule	New Rule	New Rule (Small Business)
Proposed Withholding per Deficient Business System	10% withholding per business system deficiency	5% withholding per business system deficiency	2% withholding per business system deficiency
Maximum Potential Withholding for Multiple Deficient Business Systems	Up to 50% withholding for multiple business system deficiencies; 100% withholding where CO determines "significant threat..."	Up to 20% maximum withholding for multiple business system deficiencies	Up to 10% maximum withholding for multiple business system deficiencies
Reduction in Withholding on Receipt of Contractor's Plan	No express provision	Reduce withholding to 2% as appropriate upon receipt of an acceptable plan	Reduce withholding to 2% as appropriate upon receipt of an acceptable plan
Discretionary Discontinuance of Withholding		Contracting Officer may discontinue withholding, in consultation with auditor, based on contractor evidence that all discrepancies have been corrected	Contracting Officer may discontinue withholding, in consultation with auditor, based on contractor evidence that all discrepancies have been corrected
Required Discontinuance of Withholding	Discontinue withholding and release withheld funds upon auditor verification of correction of all business system discrepancies	Discontinue withholding and release withheld funds upon auditor verification of correction of all business system discrepancies	Discontinue withholding and release withheld funds upon auditor verification of correction of all business system discrepancies

If you are having problems viewing the table above, [click here](#).

Contracting Officer Discretion to Withhold Payments

The DoD received comments regarding the lack of clear guidance and criteria for contracting officers to apply as well as inconsistent terminology throughout the first rule that posed a perceived risk for improper and unequal application of withholding. Additionally, commentators questioned whether contracting officers would be capable or willing to exercise independent judgment given DCAA audit guidance and the likelihood that contracting officers would not challenge audit findings. The DoD pointed to a December 4, 2009 memo titled "Resolving Contract Audit Recommendations" as providing clearly defined roles and responsibilities of DCAA and DCMA. Further, DOD expressed its "confidence that contracting officers possess the technical knowledge, skills, and experience necessary to reach independent determinations on business systems based on sound judgment...."

Practice Tips

Our previous comments and tips remain valid, notwithstanding that DoD has made a number of positive changes and clarifications to the proposed rule on Contractor Business Systems and withholding. The deadline for public comments has been extended to January 10, 2011 for anyone who wishes to provide comments on the proposed rule.

- As always, contractors should endeavor to cooperate with their contracting officer and DCAA and satisfy all contractual, legal and regulatory obligations. Nonetheless, where DCAA makes unreasonable requests for records or demands access to personnel, contractors need to know their rights and be willing to exercise them to avoid the expense and distraction of auditors engaged in inappropriate activities.
- For every DCAA audit, contractors should consider identifying a single point of contact to the DCAA for all requests for records, information, and access to employees. The point of contact should have direct access to senior management so that issues and problems relating to audits can be quickly escalated prior to DCAA issuing any notice or taking adverse action.
- Consider performing an external audit or assessment of internal controls prior to any DCAA audit. This should enable a contractor to address any potential weaknesses in advance of the DCAA audit and, hopefully, avoid having to address any DCAA-identified inadequacies in internal controls in the context of an adverse audit report.

There are many business benefits to maintaining internal controls. They provide visibility over critical contract metrics and allow businesses to manage workload and costs. At the same time, companies must make informed decisions about the business tools they invest in and the types of contracts they choose to compete for. Contractors should keep abreast of any changes in anticipation of implementation of a final rule.

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