



# The Interim DFARS Business Systems Rule is “In Play”

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Government Contracts Update

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### **The Interim DFARS Business Systems Rule is “In Play”**

Section 893 of the National Defense Authorization Act (NDAA) for Government Fiscal Year 2011 sets forth statutory requirements for the improvement of Contractor Business Systems to ensure that such systems provide timely, reliable information for the management of Department of Defense (DOD) programs (for more, see Public Law 111-383).

In implementing the Act, the DOD amended the Defense Federal Acquisition Regulation Supplement (DFARS) to improve the effectiveness of DOD oversight of contractor business systems. The effective date of this DOD interim rule was May 18, 2011 and it applies to solicitations issued on or after that date as well as contracts expected to be awarded on or after August 16, 2011.

We are seeing this DOD interim rule in solicitations and award modifications for existing contracts, and it is definitely creating concern in the federal contracting community. The Defense Contract Audit Agency (DCAA) is using this DOD interim rule as the basis for either determining that proposals are unsupported or reducing invoice payments to contractors that have “significant system deficiencies”.

With that background, let’s review the key definitions and core requirements of this DOD interim rule that are creating all this uncertainty.

#### **Definition of Contractor Business Systems**

The rule addresses six “contractor business systems” that drive government contractors’ compliance and internal controls:

- Accounting Systems,
- Cost Estimating Systems,
- Contractor Purchasing Systems,
- Earned Value Management Systems (EVMS),
- Material Management And Accounting Systems (MMAS), and
- Property Management Systems.

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### **Contractor Business Systems (CBS) Clause 252.242-7005**

The CBS clause defines the rights and obligations associated with contractor business systems. This clause established a uniform framework for the government to administer the clauses associated with the six specific business systems.

The CBS clause is a mandatory clause that is inserted in solicitations and contracts when: (a) the resulting contract will be a CAS covered contract **and** (b) the solicitation or contract includes any of the following clauses: (1) 252.215-7002, Cost Estimating System Requirements, (2) 252.234-7002, Earned Value Management System, (3) 252.242-7004, Material Management and Accounting System, (4) 252.242-7006, Accounting System Administration, (5) 252.244-7001, Contractor Purchasing System Administration, and (6) 252.245-7003, Contractor Property Management System Administration.

For this rule to apply, the solicitation or contract must include any of these six clauses. If a contractor has a legitimate basis for taking exception to the CBS clause (such as basis of award, dollar trigger requirements for clause applicability, or type of entity), it should insist that the clause and the accompanying individual business system clauses(s) be removed from the solicitation or contract.

### **Definition of a Covered Contract**

A covered contract is defined as a contract that is subject to the Cost Accounting Standards (CAS) under 41 U.S.C. Chapter 15, as implemented in regulations found at 48 CFR 9903.201-1. A CAS covered contract may be subject to Full CAS [all 19 standards, or Modified CAS (four standards only)]. Contracts awarded to firms that qualify as a small business under the size standard of the contract are exempt from CAS and the CBS clause (but might not be exempt from the specific business system clauses). Solicitations and/or awards based on FAR Part 12, Commercial Item acquisitions or Firm-Fixed-Price competitive awards without submission of cost or pricing data should also be exempt from this CBS clause.

### **Payment Withholds**

Clause 252.242-7005 **allows** Contracting Officers (CO), after consultation with functional specialists/auditors and written notice to a contractor, to withhold up to 10% of contract payments when a contractor's business systems (multiple ones) contain significant deficiencies, or up to 5% for significant deficiencies in a single business system. Payments can be withheld on cost type contracts, incentive type contracts, time-and-materials/labor hour contracts, progress payments, performance-based contracts, and firm fixed price contracts. As noted, a CO has **discretion** to withhold payments from

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contracts with the clause 252.242-7005 versus the automatic withhold language in the two prior DOD proposed rules (released on January 15, 2010 and December 3, 2010).

### **Definition of a Significant Deficiency**

A significant deficiency is defined as “a shortcoming in the business system that affects materially the ability of DOD officials to rely upon information produced by the system that is needed for management purposes”. Under Generally Accepted Government Auditing Standards (GAGAS), material deficiencies are those that adversely affect the contractor's ability to initiate, authorize, record, process or report data reliably. Deficiencies can include things that do not directly relate to unreasonable or unallowable costs but which can lead to harm or pose a risk to the Government. As we see it, the determination of a significant deficiency starts first with the DCAA and then is subject to the CO's subjective judgment. Given DCAA's tendency to ignore materiality when reaching audit conclusions, and inadequate training for CO regarding contractor business systems, we fully expect that the outcome may be widespread payment withholdings.

### **Process for Addressing Significant Deficiencies**

If an auditor finds a significant deficiency, he/she must explain it in sufficient detail so that the CO understands it. After the CO assesses the deficiency, and if they agree with the auditor/functional specialist finding(s), then the CO must notify the contractor in writing of the deficiencies and explain the deficiencies in sufficient detail.

Once the contractor receives this written CO notification, the contractor has 30 days to provide its written response to the CO that describes: (a) the corrective action(s) already taken, (b) the corrective action plan to be implemented (or already in partial implementation), or (c) the rationale/justification that a significant deficiency does not exist (i.e., an isolated instance that does not have a material impact on the reliability of data used by DOD officials to monitor their programs).

After the CO reviews the contractor rebuttal response and if the CO still believes the contractor still has significant deficiencies, then the CO issues a final determination letter. The contractor has 45 days to either correct the deficiency or submit an acceptable corrective action plan with milestones supporting the elimination of the deficiency. If the CO approves the corrective action plan, the CO can reduce the payment withholding to 2%.

### **Follow-up Action Requirement for CO**

After the contractor notifies the CO in writing that a deficiency has been corrected, the CO must make a determination within 90 days as to the acceptability of the contractor's remedial action. If the CO fails to meet this deadline, then the amount of any future withholds must be reduced by 50% until the CO makes the **required determination**. We note that this language is "open-ended" with no firm timeline for the CO to make the required follow-up determination that would reduce the withhold percentage to "zero".

### **Acceptable System**

Once a significant deficiency has been corrected **and no other** material deficiencies remain, the CO will deem the system acceptable and authorize the contractor to bill any monies previously withheld. In today's DCAA environment, the requirement to achieve a "no remaining significant deficiencies" rating before a contractor can receive withheld payments is likely to be problematic.

In our opinion, this DOD interim rule defers to the position taken by auditors and then to the judgment of the CO regarding business systems issues with which they are unfamiliar. In addition, the vague language in the six individual clauses further increases the risk of perceived contractor non-compliance.

The Government believes this rule is necessary to combat "fraud, waste, and abuse", and DOD plans to issue the final rule without "any significant changes". The Government plans to implement a similar rule for civilian agencies through a new Federal Acquisition Regulation (FAR) clause. Contractors should proactively plan for increased scrutiny and ensure their compliance by assessing their current systems.

We hope this Government Contracts Update provides useful information on the interim DFARS Contractor Business Systems rule. Should you have questions or concerns, please contact Nadine A. Massih at 703.657.0270 or [info@costtrend.com](mailto:info@costtrend.com).