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March 16, 2010

Mr. Mark Gomersall
OUSD (AT&L), DPAP (DARS), IMD
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3062 Defense Pentagon
Washington, DC 20301-3062

Re: DFARS Case No. 2009-D038, Business Systems – Definition and Administration
CODSIA Case No. 03-10

Dear Mr. Gomersall:

The undersigned members of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to comment on the proposed rule entitled "Business Systems – Definition and Administration" that was published in the Federal Register on January 15, 2010. The case proposes rules to define specific contractor business systems and to implement a compliance enforcement approach through a business systems clause that requires contracting officers to withhold at least ten percent of contract payments per system on DoD contracts whenever they determine that one of the enumerated business systems contains one or more deficiencies as that term is defined in the proposed rule.

We strongly oppose the proposed rule as an unnecessary intrusion on the contractual relationship between industry and government that unfairly and arbitrarily establishes a punitive approach to managing contractor business systems purportedly to curb fraud, waste and abuse. We strongly recommend that the proposed rule be withdrawn. However, if the Government does not agree with this recommendation, we respectively request that no further action be taken to finalize this proposed rule until the Government meets with the contracting community to openly discuss the proposed rule's myriad fatal flaws.

Despite the Government's wide array of existing statutory, regulatory, and contractual tools to deter, detect, and punish contractor fraud, waste, and abuse, the Government now (apparently reacting to the recent findings of the Commission on Wartime Contracting (CWC)) advances this proposed rule as being the missing ingredient that will improve the effectiveness of DCMA's and DCAA's oversight of contractor business systems. Rather than explore ways to improve the effectiveness of DCMA's and DCAA's existing tools by focusing oversight activities on establishing a causal nexus between specific system deficiencies and *billed* unallowable costs, this proposed rule effectively supplants the Government's long-established, broad oversight capability and responsibility with a highly subjective and coercive "compliance enforcement mechanism" (i.e., payment withholding.) While we agree with DynCorp's CEO, who testified before the CWC that it "doesn't have to be a big withhold to catch a contractor's attention,"[1]

[1] Testimony before the CWC of Mr. Ballhaus, representing DynCorp, August 11, 2009, p.106.

doing something to get someone's attention is not, in itself, sufficient justification for doing it – a key point that is underscored throughout this letter.

Moreover, this proposed rule establishes contractor internal control requirements as well as tedious contracting officer approvals of the type that the DAR and FAR Councils – just 15 months ago – expressly disclaimed in its promulgation comments to FAR 52.203-13, Contractor Code of Business Ethics and Conduct:

> "The Councils note that there is no rigidness to our proposed requirement to establish an internal control system. The rule just sets forth minimum requirements. The contractor can use its own judgment in the details of setting up a system that meets the minimum requirements. The clause does not require contracting officer approval of this system." [2]

Part and parcel of the FAR Case that established the clause above, new language was added to FAR 3.1003 making clear that contractors face being "suspended and/or debarred for knowing failure…to timely disclose credible evidence of a significant overpayment." It seems to us that this regulation provides an ample and powerful incentive for contractors to establish effective systems of internal control to prevent and detect overpayments (i.e., *actual harm* to the Government). Given this powerful incentive, why is it also necessary via the DFARS proposed Business System rule to punish contractors financially for a hypothetical *risk of harm*?

As a threshold matter, and as detailed within the balance of this letter, we are concerned that this proposed rule uses a broad brush approach to what appears to be a narrow problem growing out of battlefield contingency contracting and that, contrary to its intended purpose, this proposed rule will do little or nothing to assist the Government in achieving its goal of reducing fraud, waste and abuse. Indeed, we strongly believe this rule would do far more harm than good should it be finalized as drafted. Unintended macro consequences are assured, detrimental to both industry and Government, and would likely include:

- Increased administrative costs to achieve and maintain the high degree of subjective perfection required, ultimately leading to a reduced responsible contractor base;
- Decreased industrial base vitality as contractors bear increased – and unallowable (interest) – costs to finance contract performance necessitated by significant cash flow impacts from withholdings;
- Increased disputes and litigation over minor system administration problems that nevertheless result in significant withholds; and
- Other unforeseen negative circumstances.

One of our member associations has reasonably estimated that the average value of payment withholdings arising under this proposed rule could range between $5 and $15 billion at any point in time. This level of payment withholding would cause contractors to incur between $25 and $75 million *per month*[3] in unallowable financing costs. Additionally, a $2 billion adverse

[2] Federal Register Vol. 73, No. 219, p. 67075
[3] Assuming borrowing costs of 6% APR (0.5% per month)

impact on contractor working capital – at financing costs of $10 million *per month* – is anticipated as invoices containing withholds take longer to approve, process, and pay than those invoices not including withholdings. Moreover, invoices containing withholds will require more costly manual processing by DFAS, DCAA, DCMA, and Contractors; these non-value added administrative costs are expected to be $10 million a year – yet more waste that this rule is purportedly designed to curb.

We wholly support the Government's desire to minimize fraud, waste, and abuse in the federal acquisition process. However, we believe it is imprudent and fiscally unwise for the Government to accept the very real negative administrative and financial consequences of this proposal that is based on an unsubstantiated presumption that marginally beneficial improvements in contractor business system internal controls will meaningfully reduce contractor fraud, waste, and abuse. At a time when the Secretary of Defense is trying to encourage a more rapid and responsive acquisition process, streamline source selection and control cost and schedule creep, this rule is a grossly disproportionate response to the objectives articulated as the basis for the rule. Similarly, this proposed rule will work against OMB's recent initiative to increase competition in contracting[4] by erecting yet more barriers to enter the government marketplace.

In addition to our fundamental philosophical objections to this proposed rule, we have identified many other conceptual and practical flaws that are no less important for full consideration in the rule-making process. In this regard, the proposed rule –

1. Does not logically follow its stated premise;
2. Unfairly shifts onto contractors the burden of accomplishing its stated purpose;
3. Needlessly supplants adequate, pre-existing contractual and regulatory remedies;
4. Is unbalanced and biased in the Government's favor;
5. Establishes withholding requirements that are both unprecedented and prejudicial;
6. Requires withholdings to be applied indiscriminately;
7. Incorrectly presumes the Government has the requisite capacity and capability to implement and administer it;
8. Contains numerous unacceptable inconsistencies, ambiguities, subjective terms, and open-ended requirements that would make implementation a certain disaster for both contracting parties.

In light of the points above, more fully developed below, we believe the terms of this proposed rule are irreconcilable with the Guiding Principles of the Federal Acquisition System set forth in FAR 1.102. In particular, the proposed rule seems to offer no credence to or consideration of FAR 1.102-2(b) (minimize administrative operating costs), FAR 1.102-2(c) (conduct business with integrity, fairness, and openness) and FAR 1.102-4, which affords contracting officers wide latitude, in the absence of regulatory direction, "to innovate and use sound business judgment that is otherwise consistent with law and within the limits of their authority."

1. <u>The proposed rule does not logically follow its stated premise.</u>

In the absence of a preamble, we must assume that the proposed rule springs from the brief two sentence premise that introduces the rule's supplementary "Background" section. These two

[4] See generally October 27, 2009, OMB Memorandum for Chief Acquisition Officers and Senior Procurement Executives, "Increasing Competition and Structuring Contracts for the Best Results"

sentences, apparently taken verbatim from page 2 of the CWC's Special Report on Contractor Business Systems, are as follows:

> "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."

Fundamentally, each statement is self evident. We wonder, however, why this proposed rule is *now* necessary given that there has been no new revelation. If recent occurrences of fraud, waste and abuse in relation to overall contracting activity exceed historical trends, we would reasonably expect to see persuasive, objective evidence of this circumstance presented in a preamble. We would also expect to see direct evidence implicating weak contractor business system internal controls as being either the cause of or a significant contributing factor to an increase in fraud, waste, and abuse. The proposed rule seems to presume this to be the case in the absence of evidence other than testimonial anecdotes about a small handful of battlefield contractors (hardly representative of all defense contractors) – and in spite of testimony that DCMA does not currently receive the evidence it needs "to show a logical nexus or causality between the specific system deficiency and the cost, meaning that the specific deficiency is likely to lead to unallowable costs."[5] By removing the need to show a causal nexus between internal control deficiencies and unallowable costs, as this rule proposes, will unallowable costs be reduced? We fail to see how this proposed rule's required payment withholdings will reduce the risk of unallowable costs when, ironically, DCMA's current judicious use of withholds is directly attributable to the lack of a demonstrated causal connection between system deficiencies and billed unallowable costs.

Moreover, apparently ignored in the two sentence premise, is the simple truth that business system internal controls are not the *only* line of defense against contractor fraud, waste and abuse. Countless laws and regulations form a web of defensive lines to deter, detect, and punish contractor fraud, waste, and abuse. [6] Legions of internal auditors, external auditors, government auditors and investigators, contracting officers and their staffs, the Justice Department, public watchdog groups, the press, and congressional committees all cast vigilant eyes toward contractor profiteering and illicit activity. Is this proposed rule, therefore, a tacit acknowledgement that *all other* lines of defense are somehow inadequate for the task? It is hard to understand why the Government has chosen to pursue, through the use of arbitrary and punitive measures, nebulous improvements in contractor business systems when it perhaps should instead pursue substantive improvements in its existing oversight capability as explicitly recommended by the CWC.[7]

[5] Testimony before the CWC of Mr. Ricci, August 11, 2009, p. 36
[6] For example, the False Claims Act, Foreign Corrupt Practices Act, Truth in Negotiations Act, etc.
[7] CWC Special Report 1, p 1 & 9

Additionally, while it is true that weak internal control systems *can* increase the risk of unallowable costs being billed under government contracts, this proposed rule neither defines nor targets "weak" internal control systems. Rather the proposed rule makes a quantum leap in logic to assert that *any* individual weakness (i.e., deficiency) renders an entire system of internal control "weak" thus warranting a 10% - 100% withhold. Although the rule requires the auditor or other cognizant functional specialist to assess "the potential magnitude of the risk to the Government posed by the deficiency," the rule fails to establish objective "criteria"[8] for such an assessment, including the need for evidence demonstrating a logical nexus between the deficiency and the risk. The importance of this causal nexus cannot be over emphasized; even DCAA's audit manual is a strong advocate:

> "When possible, significant deficiencies should be linked to relevant historical data that are available or can be reasonably developed. For example, if the auditor can link estimating system deficiencies to questioned costs on proposal audits or positive findings on post award audits, the *importance of correcting the deficiency is more apparent*."[9]

Indeed, if contracting officers received such evidence from DCAA[10], they could proceed with confidence against offending contractors with *existing* contractual remedies to withhold or suspend payments, rendering this proposed rule moot.

Since this proposed rule does not require any evidence of a connection between deficiencies and billed unallowable costs – in disregard for the premise from which it springs – we fear that this rule will be used by the Government as a subterfuge to avoid its responsibility to make a substantiated showing of cause (internal control deficiency) and effect (billed unallowable costs) prior to imposing preemptive withholdings or disallowances. [11] Courts, however, have held that such a showing is indeed necessary.[12]

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[8] See GAO Report on Government Audit Standards, GAO-07-731G, "Criteria: The laws, regulations, contracts, grant agreements, standards, measures, expected performance, *defined* business practices, and benchmarks against which performance is compared or evaluated. Criteria identify the required or desired state or expectation with respect to the program or operation. Criteria provide a context for evaluating evidence and understanding the findings." Emphasis added.

[9] DCAAM 5-109(e), emphasis added.

[10] See CWC Special Report 1, p 5, "Contracting officers need audit opinions with clear and quantifiable risk information. They need DCAA's expert opinion about the relative impact or dollar value…of the deficiency… cost-impact information provided by DCAA could help the contracting officer determine withhold amounts when necessary. Although DCAA has increased the number of its recommendations to withhold payment, it does not always estimate a cost impact for the deficiencies it has identified. This is of utmost importance to the contracting officer who must make a decision that balances the cost risk against the importance of the mission."

[11] See FAR 42.801(c)(3), the notice of intent to disallow costs, at a minimum, shall "[d]escribe the costs to be disallowed, including the estimated dollar value by item and applicable time periods, and state the reasons for the intended disallowance"

[12] *Norair Eng'g Corp.,* GSBCA No. 3539, 75-1 BCA ¶ 11,062 (1975) ("The amount withheld must be justified by reasonable proof of the costs involved" and even if a precise estimate of future costs is not possible, the amount withheld must be a reasonable measure of the contractor's actual obligations) and *Columbia Eng'g Corp.,* IBCA No. 2352, 88-2 BCA ¶ 20,595 (1988) (holding that it was arbitrary and capricious for Government to withhold $50,000 when less than $6,000 was owed in Davis-Bacon Act compliance matter)

Finally, we are unable to reconcile the proposed rule with DCAA's express acknowledgement that non-major contractors are *not expected to have* defined internal controls.[13] DCAA's audit guidance goes one step further to expressly state, with respect to non-major contractors, that a "lack of formal internal controls is not, in itself, a significant deficiency."[14] Similarly, FAR 52.203-13's internal control system requirement does not apply to contracts below $5 million[15] and small businesses.[16] If having a system of internal control is the "first line of defense" against fraud, waste, and abuse risk as implied by this rule's premise, it must follow that non-major contractors and small businesses pose a higher fraud, waste and abuse risk – yet neither DCAA nor FAR 52.203-13 expects them to have formal internal controls?

2. <u>The proposed rule unfairly shifts onto contractors the burden of its stated purpose.</u>

The proposed rule's purpose follows its two-sentence premise:

> "To improve the effectiveness of Defense Contract Management Agency (DCMA) and Defense Contract Audit Agency (DCAA) oversight of contractor business systems"

The direct implication of this purpose is that DCMA and DCAA oversight of contractor business systems has been heretofore ineffective. Given that the proposed rule seeks to accomplish its stated purpose via a "compliance enforcement mechanism" that forces contractors into correcting all alleged system deficiencies, the only logical deduction that can be made is that DCMA's and DCAA's ineffectiveness has been *caused by* deficiencies in contractor business systems. Taking this logic one step further, if contractors can be coerced into correcting system deficiencies, then DCMA's and DCAA's oversight will be "effective." This tortured logic stands in sharp contrast to the CWC's findings. We believe the proposed rule completely misses the root cause of DCMA's and DCAA's perceived ineffectiveness; the root cause must be addressed before imposing more regulation onto contractors, especially as severe and broad as those proposed.

In the table below, we summarize the CWC's findings and recommendations relative to DCMA's and DCAA's contractor business system oversight, then compare the "solution" proffered by this proposed rule to alternate solutions that directly address the root cause of the CWC's findings. Note that the CWC's five findings identify shortcomings attributable to DCMA and DCAA – not contractors. The CWC's recent hearings and its Report concluded essentially that the Government needs to improve government accountability (in terms of contract results) by re-establishing control over the oversight process conducted by DCMA and DCAA and aggressively enforce compliance with those processes. Although no exact means were proposed by the CWC in its Report to accomplish that mandate, the Government has chosen the most extreme solution possible (payment withholding) to remedy what is essentially an internal government communications and management problem only tangentially associated with contractor business system compliance.

CWC Special Report on Contractor Business Systems

[13] DCAAM 5-110(b)(3)
[14] DCAAM 5-110(d)
[15] FAR 3.1004(a)
[16] FAR 52.203-13(c)

Findings and Recommendations

CWC Finding	CWC Recommendation	Proposed DFARS Rule Solution	Alternate Solution
DCMA's and DCAA's divergent and often contradictory behaviors send mixed messages to contractors.	Department of Defense (DoD) needs to ensure that government speaks with one voice to contractors.	Require contracting officers to withhold a varying percentage of contract payments, without limit, until all internal control deficiencies identified by DCAA are corrected, regardless of whether or not such deficiencies bear any logical nexus to cost risk or the costs being withheld.	Require DCAA to provide substantive evidence of causal nexus between control deficiencies and unallowable costs; require contracting officers to assess materiality, costs, benefits, and risks, as well as use existing contractual remedies to protect government's interest
Separate government reporting lines of authority complicate issue resolution.	DoD needs to improve government accountability by rapidly resolving agency conflicts on business systems.		Require DCAA to provide substantive evidence of causal nexus between control deficiencies and unallowable costs; require contracting officers to assess materiality, costs, benefits, and risks, as well as use existing contractual remedies to protect government's interest; require DCAA to abandon independence-impairing goals and reach objective opinions based on sufficient evidence consistent with GAGAS.
Audit reports are not informative enough to help contracting officers make effective decisions.	DCAA needs to expand its audit reports to go beyond rendering a pass/fail opinion.		Require DCAA to form professional opinions based on sufficient audit work; require DCAA to provide substantive evidence of causal nexus between control deficiencies and unallowable costs
DCMA is not aggressive in motivating contractors to improve business systems.	DCMA needs to develop an effective process that includes aggressive compliance enforcement.		Develop policy guidance and training to help contracting officers evaluate risk based on substantive, objective DCAA findings and use existing contractual remedies to protect government's interest
Agencies are under-resourced to respond effectively to wartime needs.	DCAA and DCMA need to request additional resources and prioritize contingency-contractor oversight workload.		DCAA and DCMA need to request additional resources, including expertise from external organizations, and prioritize contingency-contractor oversight workload.

As this table shows, the proposed rule's solution to DCMA's and DCAA's apparent ineffective oversight of contractor business systems isn't really a solution at all. Instead of taking internal action to address the CWC findings, this proposed rule transfers the Government's burden onto contractors, leaving DCMA and DCAA with no motivation to improve their oversight of contractor business systems. While one could argue that contractors would be pressured to remedy system deficiencies whether or not the Government either transfers its oversight responsibilities to contractors or takes its own internal corrective action, the means advanced by this proposed rule (i.e., unlimited and indiscriminate withholdings) are not justified by the end –

especially when the FAR's Guiding Principle of integrity, fairness, and openness will be compromised in the process[17].

3. **The proposed rule needlessly supplants adequate, pre-existing contractual and regulatory remedies.**

The proposed rule provides no new remedies that are not already available to the Government to ensure contractor compliance. The contracting officer has for decades had remedies and mechanisms for dealing with contractor business system deficiencies. The ability of the contracting officer to enforce a withhold on interim payments, progress payments and performance-based payments is well established;[18] therefore, there is little reason to create a new DFARS clause to affirm it. Moreover, contracting officers can determine a contractor's business system to be inadequate based on DCAA audit recommendations. This remedy can adversely affect a contractor's ability to win new business. Other remedies, such as suspension or reduction of progress payments, award or incentive fee contract provisions, and DCAA Form 1s and Form 2000s also exist. These existing mechanisms are well crafted and require withholds to be fair and in relation to established risk.

What this proposed rule doesn't acknowledge is that there are effective, proven remedies available to the Government other than withholds. These remedies include system approval withdrawals, reduced evaluation scores on competitive source selections, negative past performance evaluations, suspension or debarment for undisclosed overpayments, increased contractor liability (e.g., 52.245-1(h)(1)(ii)), increased oversight (e.g., adjustments in thresholds for advance notification and consent to subcontract), and withdrawal of approval to direct bill DFAS through wide-area-work-flow. All these remedies can be effective if deployed appropriately when necessary. The proposed rule would require the use of excessive withholds instead of (or perhaps in addition to) the other more appropriate aforementioned remedies that can be tailored to address the specific risk in question.

4. **The proposed rule is unbalanced and biased in the Government's favor.**

Notwithstanding the significant flaws addressed above, the proposed rule is unacceptable because it is unbalanced and biased. Examples of imbalance include:

- There is no study, discussion, or mention of expected benefits relative to expected costs of implementing the proposed rule as written. Because the proposed rule focuses on fixing every single alleged deficiency without regard to materiality or a causal nexus to billed unallowable costs, it will force contractors to achieve internal control precision near perfection based on highly subjective criteria interpreted by DCAA auditors, which will come at great administrative cost. No where does the rule require contracting officers or auditors to balance the cost of internal control effectiveness with the degree of risk inherent in a particular activity. The benefit of having effective internal control systems must exceed the cost of implementation and maintenance – a concept wholly consistent with FAR 1.102-2(c)(2), which states "the [Federal Acquisition] System must shift its focus from 'risk avoidance' to one of 'risk management'." Forcing contractors to

[17] FAR 1.102-2(c)
[18] See FAR 42.302(a)(7), Contracting officers "…direct the suspension or disapproval of costs when there is reason to believe they should be suspended or disapproved…"

correct every perceived deficiency without regard to risk, cost, and benefit ignores established auditing standards and this Guiding Principle, which requires a balanced regulatory approach.

- If contractors are required to correct any and all system deficiencies upon Government demand under the threat of endless and limitless payment withholdings, the contractor's costs of correcting such deficiencies and maintaining excessive controls should be made explicitly allowable to ensure balance. The proposed rule does not do that.
- The proposed rule requires contractors to respond to and correct alleged deficiencies in specified time periods, yet the Government has no such time-certain requirement to follow up on contractor corrective actions, make system approval decisions, and remove withholds. Indeed, without balanced time-certain regulations, the Government will have no incentive whatsoever to act and with limited resources it is questionable to us whether the Government would make timely resolution a high priority, which could impair contractor cash flows and financial health long after corrective actions have been implemented. Contractors have no recourse to compel Government action other than the disputes clause; accordingly, we would expect a significant increase in litigation.
- Subjective requirements always shift power and authority to the party that gets to interpret them. Well-defined, objective requirements are necessary to create and preserve balance as recommended by the CWC:

  > "Audits and assessments that are conducted using a *well-defined evaluation methodology* will provide a consistent government position that is clear to the contractor. DCAA and DCMA must work together to develop *agreed-upon standards and processes* that communicate the same message to both the individual contractor and the contracting community and help contractors achieve 'adequate' systems."[19]

  Determining the effectiveness of internal control systems is highly subjective, especially when no substantive evidence links control deficiencies to actual or probable unallowable costs. Nearly every aspect of this proposed rule rests on subjective requirements and, accordingly, the need for highly trained professional judgment. Because most contracting officers will not have the requisite training and expertise to reach independent conclusions relative to auditor/contractor disagreements over internal controls, we expect contracting officers will, more often than not, simply concur with auditor conclusions out of expediency and safety to avoid being reported to the DoDIG for investigation[20] – greatly endangering equity and fairness.

  Furthermore, DCAA audit guidance on the reporting of internal control deficiencies effectively ensures all contractor business systems subject to audit will be found inadequate. This audit guidance states that all internal control deficiencies that did or *could* result in unallowable costs being charged to government contracts are significant deficiencies, thereby establishing that even remote risks will be regarded as significant deficiencies[21]. In this regard, DCAA defines a "significant deficiency" as "the contractor's failure to accomplish *any* control objective," as subjectively defined by

[19] CWC Special Report 1, p 9. Emphasis added.
[20] See DCAA MRD 09-PAS-004(R), issued March 13, 2009
[21] See DCAA MRD 08-PAS-011(R), issued March 3, 2008

DCAA, that "will or could ultimately result in unallowable costs charged to Government contracts, *even when the control objective does not have a direct relationship to charging costs to Government contracts*… It is not necessary to demonstrate actual questioned cost to report a significant deficiency/material weakness…audit reports on contractors' internal controls that include *any significant deficiencies/material weaknesses will result in an opinion that the system is inadequate*. DCAA will no longer report inadequate in part opinions."[22] [Emphasis added]

- The concept of materiality is not mentioned in the proposed rule. Because of its absence, the inevitable consequence will be for the Government to consider every reported system deficiency to be material, consistent with the DCAA's recent audit guidance. In this regard, the CAS Board's 1992 Statement of Objectives, Policies, and Concepts provides relevant instruction for the promulgation of accounting-related rules:

  > "Materiality must be considered in applying the Cost Accounting Standards because, as a practical matter, the cost of an accounting application should not exceed its benefit. Although uniformity and consistency in accounting are desired goals of the Cost Accounting Standards, the Board recognizes that the applications of accounting criteria must consider issues of practical application. Consequently, the application of Cost Accounting Standards in determining the measurement, assignment, and allocation of costs should not be so stringently interpreted that the desired benefits are negated by excessive administrative costs."

Examples or instances of bias include:

- The proposed rule does not establish a business system approval duration, which essentially declares perpetual open-season on all contractor business system internal controls. This omission, coupled with DCAA's metric that 45% of all audits will have findings, will create a perverse incentive for auditors to find something – anything – amiss at any time.[23] Not only will molehills become mountains, but also inefficient audit redundancies have the potential to cripple the contract audit process as system audits remain perpetually open.
- The proposed Business Systems clause is pre-disposed toward the "reporting of deficiencies" rather than the objective reporting of internal control effectiveness. The rule requires auditors to "document deficiencies in a report to the ACO." This requirement is inconsistent with auditing standards and DCAA's audit manual, which require auditors to form an independent opinion, based on objective evidence, relative to the matter subject to audit.[24] The biased wording of this rule encourages a witch-hunt and is arguably a scope limitation impairing the auditor's independence and objectivity. Moreover, this bias will inevitably create a self-fulfilling prophecy toward finding

[22] See DCAA MRD 08-PAS-043(R), issued December 19, 2008

[23] Indeed, the groundwork has already been laid; see DCAA Memorandum for Regional Directors, 08-PAS-041(R), dated December 19, 2008, which states "[w]hen internal control deficiencies are identified in other than an internal control audit…the FAO should not wait to perform a full system review to report the deficiencies."

[24] See generally DCAAM 2-203(a)

deficiencies, regardless of significance, rather than applying objective, independent judgment to assess overall risk.[25]

- The proposed rule's superficial definition of "deficiency" is inherently biased because it cedes all subjective judgment to the Government and ignores well-established risk-based definitions of similar terms and concepts established objectively by the auditing profession. Three terms have been established by the congressionally-charted Public Company Accounting Oversight Board (PCAOB) to recognize and categorize the varying degrees of internal control weaknesses:[26]
    - Deficiency - A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The term "deficiency" is generally used to describe an inconsequential internal control deficiency.
    - Significant Deficiency - A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
    - Material Weakness - A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a *material* misstatement of the annual or interim financial statements will not be prevented or detected

  The auditing profession, including DCAA, understands that systems of internal control are designed to "provide *reasonable assurance* that *material* errors and misstatements will be prevented or detected in a timely manner."[27] As we noted earlier, the proposed rule is devoid of materiality considerations and requires any deficiency, regardless of materiality, to be corrected under the threat of required payment withholding. Internal control systems are not designed, by necessity, to operate in an environment lacking reasonable materiality thresholds; a regulatory environment where nothing less than perfection is adequate—if even possible—would carry an incredibly high and undesirable price tag. This proposed rule is overkill and contrary to established internal control principles, accepted industry practices, and cost/benefit considerations. This bias will exist unless the proposed rule's current definition of "deficiency" is reconciled with and conformed to the risk-based standards and principles defined and established by the accounting and auditing profession.

As a final word regarding bias, we recall the Cost Accounting Standards Board's thoughts on the matter as expressed in its 1992 Statement of Objectives, Policies, and Concepts:

[25] DCAA has already embarked on this slippery slope; rather than performing audits sufficient to form objective opinions, DCAA has arguably self-imposed an independence impairment by establishing "a goal that 45 percent of audit reports will have findings as an indication of the tangible value of the audit work performed." See GAO-09-1009T, p 12.
[26] See generally PCAOB Auditing Standard No.5
[27] DFARS 242.7501; DCAAM 5-107(a)

> "The Board considers a Cost Accounting Standard to be fair when, in the Board's best judgment, it…shows neither bias nor prejudice to either party to affected contracts."

We believe this proposed rule must be held to this long established and accepted standard.

5. **<u>The proposed rule establishes contract billing withhold requirements that are unprecedented and prejudicial.</u>**

The withhold requirements of the proposed rule are unprecedented in several important respects. First, all other withholds prescribed by the FAR and DFARS establish both a percentage withhold and a maximum withhold dollar amount (or a requirement to negotiate a fixed dollar amount).[28] The proposed rule does not stipulate a maximum dollar amount, which could – and likely would – reach epic and crippling sums. Second, all other prescribed withholds relate to objective performance or administrative requirements, which stand in sharp contrast to the highly subjective requirements of this proposed rule. Third, under the current progress payment regulations at FAR 32.503-6, before taking action to suspend or reduce progress payments, contracting officers are required to –

- Never take actions precipitately or arbitrarily;
- Evaluate the effect of the suspension or reduction on the contractor's operations, based on the contractor's financial condition, projected cash requirements, and existing or available credit arrangements; and
- Consider the general equities of the particular situation.

This proposed rule lacks such sensibilities, which are imperatives to the financial heath and operational capability of all contractors. The financial consequences of this proposed rule to contractors' operational cash flow could impair their ability to perform on Government contracts.

Finally, and perhaps most importantly, the proposed rule does not explicitly state when withholds will be paid. The ambiguous language used throughout the proposed rule states that "[t]he ACO shall notify the contractor… [of] system approval and the ACO's decision…to reduce or discontinue the withholding of payments…" Additionally, the proposed rule expressly exempts withholds from Prompt Payment Act interest, thus removing another potential incentive for the Government to pay timely the amounts withheld. This lack of specificity regarding withhold payment terms is both troubling and unprecedented in that it reflects a lack of appreciation for the importance of contractor cash flow and the time value of money.

Applying limitless withholds to contractor invoice payments for undisclosed and uncontrollable periods of time, based on the satisfaction of highly subjective requirements, without clear payment terms – all while failing to assess the financial implications and general equities of the situation – will cause certain and significant harm to both the contractor and the customer.

Not only are the withholds imposed by this rule unprecedented, they are also prejudicial. Because withholds of an arbitrarily prescribed percentage are required regardless of the

[28] FAR 52.216-8, -9, -11, -12; FAR 52.227-13, - 21; FAR 52.230-6; FAR 52.232-7, -9; FAR 52.242-2; DFARS 227.7103-14

deficiency and whether or not the deficiency has any causal nexus to potential unallowable costs, all contractors will be presumed guilty of the same "crime" (i.e., increased risk of fraud, waste, and abuse) and will receive the same punishment. Noted criminologist Donald R. Cressey once said, "[t]hings in law tend to be black and white. But we all know that some people are a little guilty while others are guilty as hell." His words resonate with familiarity in the context of this proposed rule. Indeed, it is prejudicial to promulgate regulations that treat all contractors with an internal control deficiency as if they were "guilty as hell" of fraud, waste, and abuse, when there is no evidence to support it and we intuitively know it is not true.

6. <u>The proposed rule requires withholdings to be applied indiscriminately.</u>

In addition to the flaws identified above, the withhold mechanism advanced by the proposed rule is unjust for other reasons. First, withholdings arising from a particular system deficiency are either unjustly applicable to an entire invoice rather than only to those elements of cost that are likely to be impacted by the deficiency or unjustly applicable to invoices that are not even based on costs incurred.[29] For example:

- A deficiency in a contractor's government property system would require a withhold to be indiscriminately applied to the entire invoice amount rather than, say, only the cost of contractor acquired government owned equipment.
- A deficiency in a contractor's purchasing system would require a withhold applicable to all reimbursable costs – even those that have nothing to do with the purchasing system, such as labor, ODCs, indirect costs, etc.
- A deficiency in a contractor's EVMS system would require an indiscriminant withhold when it is entirely possible, perhaps highly likely, that the system deficiency has nothing to do with the allowability of incurred costs.
- A deficiency in a contractor's estimating system must be considered by the contracting officer in connection with cost/price negotiations *and* a withhold must also be applied to the invoices under that negotiated contract, effectively punishing the contractor twice for the same deficiency.
- Deficiencies in any business system would require withholds to be indiscriminately applied to performance-based payments even though these financing payments bear no connection to costs incurred.[30]

It is not hard for us to foresee how this proposed rule could (and very likely would) quickly devolve into an unfavorable condition where both contractors and Government customers are harmed far more than the harm presumed to be occurring from contractor internal control deficiencies.

Second, the proposed rule would indiscriminately impact small businesses, non-major contractors, non-profit institutions, and others who frequently receive contracts that contain at least one of the six system-related contract clauses that would invoke the proposed Business Systems clause. Do small businesses and non-major contractors, who DCAA acknowledges are

[29] See *Martin Marietta Corp.*, ASBCA No. 31248, 87-2 BCA ¶ 19,875 (1987) (holding that it was "unnecessary, therefore arbitrary and capricious" for Government to withhold from billings the entire cost of contractor's internal audit department during disagreement over whether contractor was obligated to provide certain records under the audit clause of its contract)

[30] See FAR 32.102(b)(4) and FAR 32.102(f)

not expected to have formal systems of internal control, receive automatic withholds? How would these companies get the withholds removed or released without first establishing the formal system of internal controls that they are not expected to have? Would these companies survive this process?

7. **The proposed rule incorrectly presumes the Government has the requisite capacity and capability to implement and administer it.**

The CWC found that both DCMA and DCAA are under-resourced.[31] This observation was made in the context of the current regulatory and contractual construct and would be exacerbated if this proposed rule is finalized. The following points, noted by CWC in its Special Report on Contractor Business Systems, must be addressed long before the necessity of this proposed rule can be discussed in any meaningful way:

- "There have been too few experts to conduct reviews and too few personnel to validate that contractor corrective action was properly implemented."
- "As a result of personnel shortfalls, DCAA system reviews and follow-ups are not always timely"
- "Corrective actions taken by contractors sometimes remain unvalidated for extended periods of time."
- "DCAA's practice is to conduct follow-up assessments on contractors' corrective actions within 6 to 12 months. In some cases, however, these assessments take more than a year to complete."
- "Another indication of personnel shortages is the small number of DCMA personnel devoted to contractor purchasing system reviews (CPSR)."
- "The Commission believes that many of the untimely reviews are due to the failure of both DCAA and DCMA to prioritize their business-system workload in a wartime environment."
- "DCAA is under-resourced for comprehensively reviewing all contingency contractors' business systems on a timely basis."

These agencies must have the resources necessary to make –

- Independent, objective, and consistent expert professional judgments relative to contractor internal control systems;
- Timely initial system adequacy reviews;
- Timely follow up reviews to assess contractor corrective actions.

Currently, this capability and capacity simply does not exist.

8. **The proposed rule contains numerous unacceptable inconsistencies, ambiguities, subjective terms, and open-ended requirements that would make implementation a certain disaster.**

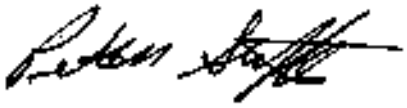
[31] CWC Special Report 1, p 1 & 9

Attachment A to this letter sets forth an extensive, although not comprehensive, summary of flawed language that appears throughout the proposed rule. We categorized the flawed language into four major types: inconsistencies, ambiguities, subjective terms, and open-ended requirements. These flaws, either alone or in concert with the flaws addressed previously, would most certainly create a disaster for both contractors and the Government.

In conclusion, the CODSIA membership strongly opposes the proposed rule. It is unnecessary given existing contractual remedies where sound auditing and risk assessment is an essential prerequisite. This proposed rule supplants current government responsibility with an unfair, arbitrary, and punitive approach to managing contractor business systems. We strongly recommend that the proposed rule be withdrawn. However, if the Government does not agree with this recommendation, we respectively request that no further action be taken to finalize this proposed rule until the Government meets with the contracting community to openly discuss and resolve the concerns raised in this letter.

Thank you for the opportunity to comment. We would be happy to discuss any aspect of this submission with you. If you have questions, please contact Ruth Franklin, Director of Procurement Policy at the National Defense Industrial Association at 703-247-2598 or by email at rfranklin@ndia.org.

Sincerely,



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Appendix A

Examples of Flawed Language

Flaw Category	Proposed Rule Reference	Language at Issue	Industry Comment
Inconsistency & Ambiguity	234.207(7)	The ACO shall withdraw the finding of system noncompliance when the ACO determines that the contractor has ***substantially corrected the system deficiencies***	Why do the implementing regulations and contract clauses contain two separate standards: "substantially corrected" and "completely corrected"? What is the important distinction between the two? Why is it necessary? Who gets to determine how to interpret "substantially corrected"?
	242.7203(c)(3)	The ACO shall approve the MMAS when the ACO determines that the contractor has **substantially corrected the system deficiencies**	
	242.70X1(b)(3)(i)	The ACO shall withdraw the initial notification if the contractor has **corrected all deficiencies**...	
	242.70X1(b)(3)(ii)(B)(3)	Payments shall be withheld until the ACO determines that ***all deficiencies have been corrected***	
	252.242-7XXX(d)(2)	…the ACO will increase the amount of payment withheld to ten percent of each payment under this contract until the ACO determines the contractor has ***completely corrected the deficiencies*** in the business system	
	244.305-70(b)(3)	The ACO shall approve the purchasing system when the ACO determines that the contractor has ***substantially corrected the system deficiencies***	
	242.7502(d)	The ACO shall approve the accounting system when the ACO determines that the contractor has ***substantially corrected the system deficiencies***	
Inconsistency	252.215-7002(a)(3)	Is consistent with and ***integrated with the contractor's related management systems***	Both requirements exist in the same clause (Estimating System), but they conflict; one requires the system to be integrated with related management systems and the other requires information to be integrated where appropriate. Does a contractor who complies with (d)(4) but doesn't comply with (a)(3) have a system deficiency?
	252.215-7002(d)(4)	***Integrate information available from other management systems where appropriate***	
Inconsistency	215.407-5-70(e)(2)	The contracting officer responsible for negotiation of a proposal generated by an estimating system with an identified deficiency shall evaluate whether the ***deficiency impacts the negotiations***. If it does not, the contracting officer should proceed with negotiations. If it does, the contracting officer should consider other alternatives-	This portion of the regulation implies that certain deficiencies do not have any impact, which is inconsistent to other language in the new rule suggesting any deficiency warrants a withhold.
Inconsistency	252.234-7002(g)	…The government will acknowledge receipt of the request in a ***timely manner (generally within 30 calendar days)***	Is this what timely means in all cases throughout the rule? This is the only time it is defined.
Inconsistency	252.242-7YYY(c)(12)	***Exclude from costs charged to government contracts*** of amounts	This part of the Accounting System clause is inconsistent with

Flaw Category	Proposed Rule Reference	Language at Issue	Industry Comment
		which are not allowable in terms of FAR Part 31…	FAR 31.202, which requires direct costs of a contract to be charged directly to that contract, regardless of allowability. Unallowable direct costs charged to government contracts must not be *billed* to the Government.
Ambiguity & Inconsistency	242.70X1(b)	The report shall describe the deficiencies in sufficient detail…and the ***potential magnitude of the risk*** to the Government posed by the deficiency.	What does "potential" mean? It is not an accounting term-of-art. Similar accounting terms include "possible" and "probable". We suggest the standard should be "probable" with an established causal nexus between the deficiency and unallowable cost.
	242.7203(c)	The auditor shall document the MMAS review findings and recommendations in the MMAS report to the ACO. If there are any MMAS deficiencies, the report shall provide an ***estimate of the adverse impact*** on the Government resulting from these deficiencies.	Different language from that noted above. Need to conform to avoid confusion
Ambiguity & Inconsistency	215.407-5-70(f)(1)-(2)	The ACO, in consultation with the auditor, shall- Approve the system; ***and*** pursue correction of any system deficiencies	Is it possible for the ACO first to approve the system and then correct deficiencies? Would a withhold be applicable in this circumstance since the system is approved?
Ambiguity	234.201(5)(ii)	Pursue correction of any ***noncompliance*** with the contractual EVMS requirements	Is the ACO pursuing correction of non-compliances or deficiencies? Is there a difference or does this mean that a noncompliance is synonymous with a deficiency?
Ambiguity	Many	…reduce or discontinue the withholding of payments"	Which one is it? Is this discretionary even if the contractor has corrected all deficiencies?
Ambiguity	252.242-7YYY(b) 252.244-7XXX(b)	Failure to maintain an acceptable accounting system, as defined by this clause, ***may*** result in disapproval of the system by the ACO ***and/or*** withholding of payments.	Is there an circumstance where failing to maintain an adequate system would not result in disapproval of the system? If so, that circumstance should be defined. Also, is there a circumstance where the system can be approved but payments are withheld? The use of "and/or" suggests so.
Ambiguity	252.242-7YYY(c)(8)	***Periodic*** monitoring of the system ***as appropriate***	How often is periodic? Who gets to decide? What is appropriate? Who gets to decide?
Ambiguity	252.242-7YYY(c)(14)	Segregation of ***preproduction*** costs from ***postproduction*** costs	These terms are undefined in the FAR and CAS; this requirement will effectively create a new cost principle; why is this a requirement of an acceptable accounting system?
Ambiguity	252.244-7XXX(c)(1)	Have an adequate system description including policies, procedures, and ***operating instructions***…	What are operating instructions? Why are they necessary for an acceptable purchasing system?

Flaw Category	Proposed Rule Reference	Language at Issue	Industry Comment
Ambiguity	252.244-7XXX(a)(2)	Policies and procedures ***assure*** purchase orders and subcontracts contain all flowdown clauses, including terms and conditions required by the contract ***and any other clauses required to carry out the requirements of the contract***	Internal controls (i.e., policies and procedures) cannot provide absolute assurance as required here; the standard is "reasonable assurance." Also, in the case of 252.244-7XXX, what other clauses may be necessary beyond required flowdowns? Who gets to decide this?
Ambiguity	252.234.7002(f)	The MMAS shall have adequate internal controls to ***ensure*** system and data integrity	
Ambiguity	252.244-7XXX(c)(4)	Purchase orders are based on authorized requisitions and include complete ***history files***	What are history files?
Ambiguity	252.234-7002(h)(3)	The ACO will evaluate the Contractor's response and notify the Contractor of the determination concerning remaining deficiencies, the adequacy of any proposed or completed corrective action***, and any portions of the system that are noncompliant with ANSI/EIA-748***	How does noncompliance fit into his rule? Is it treated the same as a deficiency? Would you get a 10% payment withhold if a non-compliance was found?
Ambiguity	242.70x1(b)(4)	The ACO reserves the ***right to take other actions*** within the terms and conditions of the contract	Does this mean other actions in addition to withholds, or one or the other?
Ambiguity	244.305-70(a)(1)-(2)	The ACO, in consultation with the purchasing system analyst (PSA) or auditor shall—***Grant***, withhold, or withdraw ***system approval; and pursue correction of any system deficiencies***	Is it possible to grant system approval while corrective actions are being pursued? Would withholds apply in this circumstance?
Ambiguity	252.242-7XXX(d)(1)	***If*** the Contractor receives a final determination with a notice of the ACO's decision to withhold payments for deficiencies in a business system required under this contract, the ACO will immediately withhold ten percent of each of the Contractor's payments under this contract.	If? Or when?
Ambiguity	252.244-7XXX(d)(2)	If the Contractor submits an acceptable corrective action plan within 45 days of receipt of a notice of the ACO's intent to withhold, but has not completely corrected the identified deficiencies, the ***ACO will reduce the amount withheld to an amount equal to five percent of each payment until the ACO determines that the Contractor has corrected the deficiencies*** **in the business system.**	Will the other five percent previously withheld be returned?
Ambiguity	252.242-7XXX(d)(3)	If the ACO is withholding payments for deficiencies in more than one business system, the cumulative percentage ***of payments withheld shall not exceed fifty percent*** on this contract	Is this referring to 50 percent of the contract value, or 50 percent of each payment once the withhold is initiated? Is it possible for more than 50 percent to be taken from a single payment if previous payments were made in full in order to retroactively withhold funds?
Subjective Terms	252.244.7XXX(c)(7)	Use competitive sourcing to the maximum extent practicable and	Unnecessary word; is it possible to *improperly* exclude them?

Flaw Category	Proposed Rule Reference	Language at Issue	Industry Comment
		ensure debarred or suspended contractors are ***properly*** excluded from contract award	
Subjective Terms	252.215-7002(a)(1)	Is ***maintained***, ***reliable***, and consistently applied	What does "maintained" and "reliable" mean?
Subjective Terms	252.215-7002(a)(4)	Is subject to ***applicable financial control systems***	What does "applicable financial control system" mean?
Subjective Terms	252.242-7YYY(c)(4)	A ***logical*** and consistent method for the accumulation and allocation of indirect costs to intermediate cost objectives.	This is a new word used in connection with cost allocations; what is wrong with causal/beneficial?
Subjective Terms	252.242-7YYY(c)(10)	Perform ***appropriate*** cost or price analysis and technical evaluation for each subcontractor and supplier proposal or quote	Who gets to determine what "appropriate" means and under what circumstances?
Subjective Terms	252.242-7YYY(c)(15)(i)	Cost accounting information as required to ***readily*** calculate indirect cost rates from the books of account	Why is "readily" important? Who gets to decide when something is or isn't "readily" available?
Subjective Terms	252.244-7XXX(a)(3)-(4)	An organizational and administrative structure that ensures effective and ***efficient*** procurement of required quality materials and parts at the most economical cost from responsible and ***reliable*** sources; Selection processes to ensure the ***most*** responsive and ***responsible sources*** for furnishing required ***quality parts*** and materials and to promote competitive sourcing among ***dependable suppliers*** so that purchases are ***reasonably priced*** and from sources that meet contractor quality requirements	How would these subjective terms be evaluated in the determination of an acceptable purchasing system?
Subjective Terms	215.407-5-70(d)(1)	An acceptable system shall provide for the use of appropriate source data, utilize ***sound estimating techniques*** and good judgment, maintain a consistent approach, and adhere to established policies and procedures.	What estimating techniques would be considered "sound" according to this standard?
Subjective Terms	252.242-7YYY(c)(17)	***Adequate, reliable*** data for use in pricing follow-on acquisitions	What does "adequate" and "reliable" mean in this context?
Subjective Terms	252.242-7XXX(c)(12)	Seek, take, and document ***appropriate*** purchasing discounts, including cash discounts, trade discounts, quantity discounts, rebates, freight allowance, and company-wide volume discounts	What does the term "appropriate" mean in this context? Who gets to decide?
Subjective Terms	252.242-7XXX(c)(14)-(17)	Maintain subcontractor surveillance to ensure ***timely delivery*** of an acceptable product and procedures to notify the Government of potential subcontract problems that may impact delivery, quantity, or price…Notify the Government of the award of an auditable subcontract and perform ***adequate audits*** of those subcontracts. Enforce ***adequate policies*** on conflict of interest, gifts, and gratuities…	What would be considered timely in this situation? What constitutes an adequate audit? What is the standard for an adequate policy?
Subjective Terms	252.242.7004(f)(5)	Establish and maintain ***adequate levels*** of record accuracy, and include reconciliation of recorded inventory	What is an "adequate level"?

Flaw Category	Proposed Rule Reference	Language at Issue	Industry Comment
		quantities to physical inventory by part number on a periodic basis	
Subjective Terms	252.244-7YYY(a)(2)	Accounting System means the Contractor's system or systems for accounting methods, procedures, and controls established to gather, record, classify, ***analyze***, summarize***, interpret***, and present accurate and timely financial data for reporting data in compliance with applicable law, regulations, and management decisions	To what standard will "analyze" and "interpret" be held?
Open- Ended Requirement	252.215-7002(a)(4)	"Estimating system" means the Contractor's policies, procedures, and practices for generating estimates of costs ***and other data*** included in proposals submitted to customers in the expectation of receiving contract awards.	What other data?
Open-ended Requirement	252-215-7002(a)	Acceptable estimating system means an estimating system that complies with, ***but is not limited to***, the system requirements in paragraph (d) of this clause and provides for a system that –	Who gets to decide what other requirements to which a contractor will be held? Will anyone tell the contractor? Will all contractors be treated consistently with regard to these extra requirements? This clause will allow the rules of the game to be re-written continuously.
	252.215-7002(d)(4)	An acceptable estimating system shall accomplish, ***but not be limited to***, the following functions	
	252-242-7YYY(c)	The contractor's accounting system shall be in compliance with applicable laws and ensure proper recording, accumulating, and billing of costs on government contracts, including ***but not limited to*** providing, as applicable	
	252-244-7XXX(a)	Purchasing system includes, ***but is not limited to –***	
Open-ended Requirement	242.70X1(e)	System review matrix. Refer to the matrix at PGI 242.70X1(e) to ***cross reference DCAA internal control reviews and other business system audits to the list of "business systems" defined in 252.242-7XXX, Business Systems***	Is the Government defining system requirements applicable to contractors via DCAA ICAPS audit criteria? These audit criteria can be changed endlessly outside of the rule-making process such that the "rules of the game" can be changed unilaterally and arbitrarily by an organization that has no regulatory authority?
Open-ended Requirement & Inconsistency	252.244-7XXX(a)(3)	An organizational structure and administrative structure that ensures effective and efficient procurement of required ***quality*** materials and parts at the ***most economical cost***	This clause drags in the contractor's entire QA/QC system with one unnecessary adjective: "quality". Now, if someone asserts poor materials were purchased, it will be a purchasing system deficiency. Moreover, the standard by which most purchasing systems operate, including the Government, is "best value", not "most economical cost."