



Government Contracts Advisory

January 25, 2009

Proposed DFARS Rule May Significantly Impact Contractor Cash Flow Under Government Withholds for “Deficiencies” in Contractor “Business Systems” and Ambiguous “Business Systems” Requirements

On January 15, 2010, the Department of Defense issued a proposed DFARS rule that, if enacted, may significantly impact contractor cash flow. See 75 Fed. Reg. 2,457 (Jan. 15, 2010). This rule provides, for the first time, procedures under which administrative contracting officers (“ACOs”) can withhold payments when contractors’ “business systems” contain “deficiencies,” as determined by ACOs, with assistance from government auditors, including the Defense Contract Audit Agency (“DCAA”). This rule also imposes ambiguous requirements on contractor accounting, estimating and purchasing systems, providing increased opportunity for the government and its auditors aggressively to assert deficiencies in contractor business systems, potentially without need to identify any material risk of government overpayment.

Withholds for “Business Systems” “Deficiencies”

The rule provides ACOs authority to withhold contractor payments based on “deficiencies” in “business systems.” The rule does not define “deficiencies” for each system. Where defined for certain systems, “deficiencies” mean a failure to maintain an element of an acceptable system. Thus, although it is unclear what may cause deficiencies for all systems, deficiencies likely exist where a contractor fails to maintain any element of an acceptable system. Moreover, it is unclear when deficiencies under the rule will result in “Significant Deficiencies,” as defined in DCAA Memorandum 08-PAS-043(R) (Dec. 19, 2008), Subject: Audit Guidance on Significant Deficiencies/Material Weaknesses and Audit Opinions on Internal Control Systems.

The rule defines “business systems” to include, as applicable to any certain contract, an: (1) Accounting System; (2) Earned Value Management System (“EVMS”); (3) Estimating System; (4) Material Management and Accounting System; (5) Property Management System; or (6) Purchasing System. Potential contractor payments at issue include interim payments under cost-reimbursement contracts, progress payments and performance-based payments.

The rule details procedures for government determinations that contractor business systems are inadequate, and corresponding government payment withholds. First, the ACO, usually based on audit information provided by DCAA, issues an “initial determination of deficiencies” that identifies any deficiencies in the contractor’s business systems. The contractor has thirty days to respond. If, after reviewing the contractor’s response, the ACO determines that a contractor business system contains deficiencies, the ACO issues a “final determination” that includes a “notice of decision to withhold payments.” Under the rule, a “notice of decision to withhold payments” must be issued by the ACO whenever any deficiency, regardless of severity, is identified.

CONTACTS

If you would like more information, please contact any of the McKenna Long & Aldridge attorneys or public policy advisors with whom you regularly work. You may also contact:

[Thomas A. Lemmer](#)
303.634.4350

[Steven M. Masiello](#)
303.634.4355

[Taylor M. Menlove](#)
303.634.4339

After the government issues a “notice of decision to withhold payments,” the rule requires that the ACO “immediately withhold ten percent of each of the Contractor’s payments” under relevant contracts. Similar to the “notice of decision to withhold payments,” the ten percent withhold is automatic, regardless of severity of deficiency.

Following the initial withhold, the contractor has forty-five days to “either correct the deficiencies or submit an acceptable corrective action plan showing milestones and actions to eliminate the deficiencies.” If, during this time period, the contractor corrects the identified deficiencies, the amounts are refunded. If the contractor submits an acceptable corrective action plan during this period, but has not completely corrected the identified deficiencies, the ACO will reduce the withhold to an amount equal to five percent of each payment.

Any amounts withheld following this forty-five day period are not paid to the contractor until the ACO determines that the contractor has corrected the corresponding deficiencies. Further, if the ACO finds that more than one contractor business system has deficiencies, the ACO can withhold ten percent of the payment owed the contractor for each such business system, and up to fifty percent of payments owed the contractor under an applicable contract.

Moreover, under the proposed rule, the ACO can, apparently without any procedure for contractor comment, withhold one-hundred percent of payments owed contractors under an applicable contract if the ACO determines that business system deficiencies “are highly likely to lead to improper contract payments being made, or represent an unacceptable risk of loss to the Government.” The rule contains no guidance on when system deficiencies “are highly likely to lead to improper contract payments” or “represent an unacceptable risk of loss.”

Ambiguous Requirements on Contractor Accounting, Estimating and Purchasing Systems

The rule also imposes ambiguous requirements on contractor accounting, estimating and purchasing systems. These ambiguous requirements provide the government and its auditors increased opportunity aggressively to assert deficiencies in contractor business systems and, accordingly, withhold contractor payments. The risk to contractors is amplified by recent DCAA audit activity, following DCAA criticisms in Government Accountability Office reports released in July 2008 and September 2009, resulting in an increase of audit opinions finding contractor systems inadequate.

These requirements present potentially significant administrative challenges for contractors. For example, under the proposed rule on accounting systems, contractors must maintain “[a] timekeeping system that identifies employees’ labor by intermediate or final cost objectives.” This requirement, and many others, may be onerous on certain contractors, especially contractors entering the federal government marketplace that do not have, in place, sophisticated systems.

The proposed rule, and its ambiguous requirements, also create risk that the government and its auditors will impose unreasonable demands on contractors. For example, under the rule on estimating systems, contractor purchase orders must “include complete history files” and contractors must “[e]stablish and maintain adequate documentation to provide a complete and accurate history of purchase transactions to support vendors selected and prices paid.” The proposed rule, however, does not explain when history files will be “complete” or when contractors will be deemed to have “adequate documentation” of purchase transactions. Accordingly, increased opportunities will exist for the government and its auditors to find deficiencies in contractor systems previously deemed adequate for government contract purposes.

Importantly, these requirements under the proposed rule apply to all contractors, regardless of size, except for the EVMS and Estimating System requirements. All requirements, however, apply to a variety of types of contracts. For example, the proposed rule on accounting systems applies to all cost-reimbursement, incentive type, time-and-materials and labor-hour contracts, and certain fixed-price and construction contracts. Under the proposed rule, therefore, small and mid-sized contractors performing a variety of contracts will be required to implement and maintain the same business systems as those systems implemented and maintained by the largest contractors. In this manner, the proposed rule presents particular risk for small and mid-sized contractors.

Recommendations

Due to the potentially significant impact of the proposed rule on contractor payments and cash flow, we recommend that contractors and industry associations submit comments to the proposed rule. Comments are due on or before March 16, 2010, and contact information for comments can be found at 75 Fed. Reg. 2,457. Specifically, contractors should encourage the agency to publish more precise definitions of elements of an acceptable “business system” and “deficiencies” in an effort to reduce the inevitable disputes that will arise from

the current language. If more clarity is not provided, all concerned can look forward to a significant increase in claims and disputes associated with payment withholds.

© Copyright 2009, McKenna Long & Aldridge LLP, 1900 K Street, NW, Washington DC, 20006

About McKenna Long & Aldridge LLP

McKenna Long & Aldridge LLP is an international law firm with 475 attorneys and public policy advisors. The firm provides business solutions in the areas of environmental regulation, international law, public policy and regulatory affairs, corporate law, government contracts, political law, intellectual property and technology, complex litigation, real estate, energy and finance. To learn more about the firm and its services, log on to <http://www.mckennalong.com>.

Subscription Info

If you would like to be added or removed from this mailing list, please email information@mckennalong.com.

*This Advisory is for informational purposes only and does not constitute specific legal advice or opinions. Such advice and opinions are provided by the firm only upon engagement with respect to specific factual situations. This communication is considered Attorney Advertising.