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DoD SET TO WITHHOLD CONTRACT PAYMENTS

Notwithstanding recent amendments to its earlier proposed rule, the Department of Defense (DoD) is poised to begin withholding payments under cost reimbursable and time and materials contracts whenever it finds contractors' business systems deficient. This proposed rule represents a significant change in the contracting environment for companies performing work for DoD. As originally proposed, the Defense Federal Acquisition Regulations Supplement (DFARS) rule would have allowed contracting officers to withhold 10%, 50% or even 100% of contractor payments when the contracting officer decides that a contractor's "business systems" are "deficient." Amendments now lower the amounts that can be withheld, but even as amended the proposed rule would impose new compliance requirements that are difficult to understand on their face. Without clear criteria in the proposed rule, contractors face potentially substantial compliance costs in addition to severe monetary penalties for noncompliance.

Background

In September 2008, the GAO reported its investigations revealed that Defense Contract Audit Agency (DCAA) auditors were both too comfortable with contractors and were "production oriented."[1] Among other findings, GAO reported that DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence and failed to comply with generally accepted government accounting standards (GAGAS).

Following this report, DCAA's then newly-appointed Director, April G. Stephenson, articulated the view that, going forward, even a single internal system defect rendering a contractor's business system inadequate should be met not with assistance to the contractor to facilitate compliance, but rather by withholding of contract payments. Subsequent DCAA guidance also set forth procedures that increased demands on contractors who fail immediately to comply with compliance requests. In addition, Director Stephenson made public comments in May 2009 before the Commission on Wartime Contracting proposing a regulatory structure requiring automatic withholding of contract funds when a contractor fails to maintain internal control systems.

The Proposed Rule

The proposed DFARS rule attaches enforcement muscle to Director Stephenson's views by adding a required clause to DoD contracts obligating contractors to certify that no major defects in their contractor "business systems" exist. "Defects" include any shortcoming in accounting systems, estimating systems, purchasing systems, earned value management systems, material management and accounting systems, and property management systems. As originally proposed in January 2010, DoD would have had the power to withhold 10 percent of contract

[1] GAO Report 09-468, *DCAA Audits: Widespread Problems with Audit Quality Require Significant Reform*, September 23, 2008.

payments if *any* business system was found to be deficient and 100 percent of contract payments if a major business system deficiency was found. Under the new proposal published in December 2010's Federal Register, DoD would now be able to withhold 5 percent of contract payments against large businesses and 2 percent for small businesses for any deficiencies. If the deficiencies are considered major or high risk, the maximum amount that could be withheld would be capped at 20 percent, down from 100 percent in the original proposal.[2] The proposed rule would reduce the amounts from 5 percent of total contract payments to 2 percent (2 percent to 1 percent for small businesses) when the contractor submits an acceptable corrective action plan within 45 days of a notice of the Contracting Officer's intent to withhold payments. Notably, the proposed rule does not clearly define what makes a deficiency "high risk" or "major."

Improved Oversight or a Compliance Nightmare?

DoD stated that the purpose of the proposed rule is "to improve the effectiveness of Defense Contract Management Agency (DCMA) and DCAA oversight of contractor business systems."[3] However, the proposed rule has drawn a heavy dose of criticism from commentators who note the rule's lack of objective standards.[4] Admittedly, revisions to the rule, as proposed, attempt more specifically to describe what qualifies as a deficiency within a given business system by setting forth criteria for finding deficiencies in each system. For example, the proposed rule sets forth seventeen attributes of an acceptable estimating system and eighteen attributes of an acceptable accounting system. But, even these elements of an acceptable system lack the objectivity and clarity to provide sufficient guidance to contractors seeking to comply. For instance, DoD states that an acceptable accounting system must create a "logical and consistent method for the accumulation and allocation of indirect costs to intermediate and final cost objectives." Of course, what exactly constitutes a "logical and consistent method for accumulation of indirect costs" will unfortunately not be clear to the contracting community until DCAA and contracting officers begin to assert deficiencies and withhold contract payments.

In addition, DoD's likely approach to enforcing the rule is unclear. Although the rule has been revised to state that the contracting officer has discretion regarding imposition of penalties, how that discretion will be exercised remains a mystery. Before DCAA's recent policy shift, contracting officers and DCAA auditors might have worked with the contractor to correct a business system deficiency or to assist the contractor in improving compliance. Auditors and inspectors would present deficiencies to contractors in draft form, giving them a chance to explain or correct the deficiency before finalizing their findings and issuing penalties. The discretion of the contracting officer to work with contractors to solve deficiencies has been, after all, an essential part of the authority vested in the contracting officer under the FAR.[5] But, DoD's proposed rule and DCAA's recent policy utterances appear to undermine contracting officer discretion by creating significant disincentives to take any action other than accepting auditors' findings of deficiency and impose a penalty.[6] Contracting officers may simply avoid

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[2] *See* DFARS Case 2009-D038, 75 Fed. Reg. 75550 (December 3, 2010).
[3] DFARS Case 2009-D038, 75 Fed. Reg. 2457 (January 15, 2010).
[4] DFARS Case 2009-D038, 75 Fed. Reg. 75550 (December 3, 2010) and comments therein.
[5] FAR 1.602-1; FAR 1.602-2.
[6] *See* Note 4, *supra*.

possible career limiting challenges to audit findings by "rubber stamping" those findings now that DCAA has adopted a policy of permitting auditors and inspectors to challenge a contracting officer's decision not to heed their advice and findings.[7]

Moreover, although the proposed rule states that penalties should only be assessed against the contractor, for example, "if the contracting officer determines that there are one or more system deficiencies that adversely affect the contractor's earned value management system, leading to a potential risk of harm to the Government[,]"[8] will contracting officers be willing to defend an assessment of no adverse effect, in the face of DCAA disagreement? The recent DCAA guidance, coupled with the current assumptions that government procurement professionals and contractors have too comfortable a relationship, may foster an environment that leads to "knee jerk" determinations of adverse effect.

Should you have any questions about the proposed rule or its consequences, please feel free to contact Jim Kearney and Holly Svetz or any member of Womble Carlyle's Government Contracts practice team.

[7] MRD No. 09-PAS-004(R), *Audit Guidance on Reporting Significant/Sensitive Unsatisfactory Conditions Related to Actions of Government Officials* (March 13, 2009) (stating that "[U]nsatisfactory conditions may warrant an independent assessment" of significant/sensitive unsatisfactory contractor conditions or systems and that DCAA auditors should separate themselves from contracting officers and independently assess contracting officers' decisions where the contracting officer ignores a DCAA audit report or takes action inconsistent with regulations); s*ee also* DCAA Memorandum entitled *Audit Quality Month – August* 2008, August 6, 2008, sent from DCAA Director April Stephenson (stating that the contracting officer should not cause audit quality to suffer or impair the objectivity of the DCAA auditors).

[8] This is the language shift from the first proposed rule suggesting that a contract provision would be inserted providing that the contracting officer "will immediately withhold ten percent of each of the Contractor's payments under this contract" if the contracting officer determines that a business systems is deficient.