



# FEDERAL CONTRACTS



## REPORT

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DOD

### Contractor Business Systems Oversight: A Debacle is Brewing

BY BRENT A. CALHOON

**O**n January 15, 2010, DOD published in the Federal Register a proposed DFARS rule entitled “Business Systems—Definition and Administration.” The rule proposes to define specific contractor business systems and to implement a compliance enforcement mechanism that requires contracting officers to withhold at least ten percent of contract payments per business system on defense contracts whenever a business system contains one or more “deficiencies.” This proposed rule uses a broad-brush approach to what appears to be a narrow problem growing out of battlefield contingency contracting, and a critical analysis of it quickly exposes an unfair, arbitrary and punitive approach to managing contractor business systems under the guise of curbing fraud, waste, and abuse.

Despite the government’s existing wide array of statutory, regulatory, and contractual tools to deter, detect, and punish contractor fraud, waste, and abuse, the government—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 the Defense Contract Management Agency’s and the Defense Contract Audit Agency’s oversight of contractor business

systems. DOD appears to have embraced a contractor’s testimony before the CWC that it “doesn’t have to be a big withhold to catch a contractor’s attention.”<sup>1</sup> A truism, for sure. But is doing something to get someone’s attention sufficient justification for doing it? Ends do not always justify means, especially when the means are highly subjective and coercive.

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 harm both the contractor and the government. Unintended macro consequences are assured and would likely include at least the following:

- 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; and
- increased disputes and litigation over minor system administration problems that nevertheless result in significant withholdings.

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<sup>1</sup> Testimony before the CWC of Mr. Ballhaus, representing DynCorp, August 11, 2009, p.106.

In addition to these basic philosophical objections, this proposed rule contains many more conceptual and practical flaws. In this regard, the proposed rule:

1. does not follow its stated premise;
2. unfairly shifts onto contractors the burden of accomplishing its stated purpose;
3. is unbalanced and biased in the government's favor;
4. establishes withholding requirements that are unprecedented;
5. requires withholdings to be applied indiscriminately; and
6. incorrectly presumes the government has the requisite capacity to implement and administer it.

The proposed rule also contains numerous inconsistencies, ambiguities, subjective terms, and open-ended requirements that would preclude any sort of effective implementation. But fixing these lower-order flaws would do nothing to redeem the higher-order flaws listed above, still rendering the proposed rule ill-advised and ill-conceived.

In addition to its higher-order flaws, which are more fully developed below, the terms of this proposed rule are irreconcilable with the Guiding Principles of the Federal Acquisition System set forth in Federal Acquisition Regulation 1.102. In particular, the proposed rule affords 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 allows 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."

**The proposed rule does not follow its stated premise.**

The proposed rule springs from the brief two-sentence premise in its supplementary "Background" section. These two sentences, recited from page two of the CWC's Special Report on Contractor Business Systems, are:

- "Contractor business systems and internal controls are the first line of defense against waste, fraud, and abuse"; and
- "Weak control systems increase the risk of unallowable and unreasonable costs on government contracts."

Fundamentally, each statement is self-evident and has always been self-evident. Why then is this proposed rule *now* necessary, given that there has been no new revelation? Even if it were now necessary, the proposed rule does not flow from these two statements because: (a) its onerous approach treats contractor business system internal controls as if they were the *only* line of defense against fraud, waste, and abuse, and (b) it fails to make the critical distinction between a "weak control system" and an immaterial control weakness (i.e., deficiency). Moreover, direct evidence implicating weak contractor business system internal controls as being either the cause of or a significant contributing factor to fraud, waste, and abuse should be a prerequisite for such a far-reaching regulation. The proposed rule presumes 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 contradictory testimony that DCMA does not currently receive the evi-

dence 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."<sup>2</sup>

The proposed rule's premise infers that business system internal controls are not the *only* line of defense against contractor fraud, waste, and abuse. On the contrary, countless laws and regulations form a web of defensive lines to deter, detect, and punish contractor fraud, waste, and abuse.<sup>3</sup> 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?

While it is true that "weak 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 an illogical leap to assert that *any* individual weakness (i.e., deficiency) renders an entire system of internal control "weak" thus warranting a 10 percent to 100 percent 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"<sup>4</sup> for such an assessment, including the need for evidence demonstrating a nexus between the deficiency and the risk. The importance of this causal nexus cannot be over-emphasized; even DCAA's audit manual strongly advocates it:

"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.*"<sup>5</sup>

Indeed, if contracting officers received such evidence from DCAA<sup>6</sup>, they could proceed with confidence against offending contractors with *existing* contractual

<sup>2</sup> Testimony before the CWC of Mr. Ricci, August 11, 2009, p. 36

<sup>3</sup> For example, the False Claims Act, Foreign Corrupt Practices Act, Truth in Negotiations Act, etc.

<sup>4</sup> 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.

<sup>5</sup> DCAAM 5-109(e), emphasis added.

<sup>6</sup> 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."

remedies to withhold or suspend payments, rendering this proposed rule moot. Since the proposed rule does not require any evidence of a connection between deficiencies and billed unallowable costs, it is likely 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.<sup>7</sup> Courts, however, have held that such a showing is indeed necessary,<sup>8</sup> which raises the question as to whether or not the proposed rule's payment withholding regime would withstand legal challenge.

Finally, the proposed rule cannot be reconciled with DCAA's express acknowledgement that non-major contractors are *not expected to have* defined internal controls.<sup>9</sup> 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."<sup>10</sup> Similarly, FAR 52.203-13's internal control system requirement does not apply to contracts below \$5 million<sup>11</sup> and small businesses.<sup>12</sup> Since having a system of internal control as the "first line of defense" against fraud, waste, and abuse risk is a conceptual cornerstone of this proposed rule, 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?

**The proposed rule unfairly shifts onto contractors the burden of its stated purpose.** 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 something less than effective. 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 as set forth in the table below. Here, its findings and rec-

ommendations regarding contractor business system oversight are compared to the "solution" proffered by this proposed rule. Note that the CWC's five findings identify shortcomings attributable to DCMA and DCAA—not contractors.

CWC Finding	CWC Recommendation	Proposed DFARS Rule Solution
DCMA's and DCAA's divergent and often contradictory behaviors send mixed messages to contractors.	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 contractor internal control deficiencies (regardless of materiality) are corrected, and regardless of whether or not such deficiencies bear any logical nexus to cost risk or the costs being withheld.
Separate government reporting lines of authority complicate issue resolution.	DOD needs to improve government accountability by rapidly resolving agency conflicts on business systems.	
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.	
DCMA is not aggressive in motivating contractors to improve business systems.	DCMA needs to develop an effective process that includes aggressive compliance enforcement.	
Agencies are under-resourced to respond effectively to wartime needs.	DCAA and DCMA need to request additional resources 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. Rather, it is a passing of the buck—a turning of the table—to contractors. 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 corrective actions, 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<sup>13</sup>.

**The proposed rule is unbalanced and biased in the government's favor.** Notwithstanding the significant flaws already addressed, the proposed rule is unacceptable because it is unbalanced and biased. Examples of imbalance include:

- The proposed rule does not require contracting officers or auditors to balance the cost of internal con-

<sup>7</sup> 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"

<sup>8</sup> *Norair Eng'g Corp.*, GSBICA 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)

<sup>9</sup> DCAAM 5-110(b)(3)

<sup>10</sup> DCAAM 5-110(d)

<sup>11</sup> FAR 3.1004(a)

<sup>12</sup> FAR 52.203-13(c)

<sup>13</sup> FAR 1.102-2(c)

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 implementing and maintaining them—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 correct every perceived deficiency without regard to risk, cost, and benefit ignores established accounting and auditing standards and the Guiding Principles, which require a balanced oversight approach.

- 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 to act. Contractors have no recourse to compel government action other than the disputes clause because the proposed rule provides no new appeal process.

- Subjective requirements 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.”<sup>14</sup>

Determining the effectiveness of internal control systems is highly subjective, especially when no substantive evidence links control deficiencies to actual or probable unallowable costs. Because most contracting officers will not have the requisite training and expertise to reach independent conclusions relative to auditor/contractor disagreements over internal control effectiveness, it is reasonable to expect that contracting officers will, more often than not, simply concur with auditor conclusions out of expediency and safety to avoid being reported to The DOD IG for investigation<sup>15</sup>—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<sup>16</sup>. In this regard, DCAA defines a “significant deficiency” as “the contractor’s failure to accomplish any control objective,” as subjectively defined by 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.”<sup>17</sup> [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.

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 percent of all audits will have findings, will create a strong incentive for auditors to find something—anything—amiss at any time and keep systems audits open indefinitely.<sup>18</sup>

- The proposed Business Systems clause is predisposed 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.<sup>19</sup> The wording of this rule encourages audit bias and is arguably a scope limitation impairing the auditor’s independence and objectivity. Moreover, this bias, coupled with the proposed rule’s many imbalances, will inevitably create a self-fulfilling prophecy toward finding deficiencies, regardless of significance, rather than applying independent judgment to objective evidence and assessing material risks.<sup>20</sup>

- 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 by the auditing profession. Three terms have been established by the congressionally-chartered Public Company Accounting Oversight Board (PCAOB) to recognize and categorize the varying degrees of internal control deficiencies:<sup>21</sup>

1. 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.

<sup>17</sup> See DCAA MRD 08-PAS-043(R), issued December 19, 2008

<sup>18</sup> 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.”

<sup>19</sup> See generally DCAAM 2-203(a)

<sup>20</sup> 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.

<sup>21</sup> See generally PCAOB Auditing Standard No.5

<sup>14</sup> CWC Special Report 1, p 9. Emphasis added.

<sup>15</sup> See DCAA MRD 09-PAS-004(R), issued March 13, 2009

<sup>16</sup> See DCAA MRD 08-PAS-011(R), issued March 3, 2008

2. **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.

3. **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."<sup>22</sup> As noted earlier, the proposed rule is devoid of materiality considerations and requires any asserted 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 for all involved.

**The proposed rule establishes contract billing withhold requirements that are unprecedented.** 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).<sup>23</sup> The proposed rule does not stipulate a maximum dollar amount, which could—and likely would—reach financially 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 for the financial health and operational capability of all contractors.

Finally, and perhaps most importantly, the proposed rule does not establish when withholds will be paid. The proposed rule's ambiguous language 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 pro-

posed rule expressly exempts withholds from Prompt Payment Act interest, thus removing a key incentive for the government to pay timely. This lack of specificity regarding withhold payment terms is unprecedented because it ignores established regulations that acknowledge the importance of contractor cash flow and the time value of money.

**The proposed rule requires withholdings to be applied indiscriminately.** In addition to the above flaws, the proposed rule's withhold mechanism 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.<sup>24</sup> 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 indiscriminate 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.<sup>25</sup>

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 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?

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

<sup>24</sup> 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)

<sup>25</sup> See FAR 32.102(b)(4) and FAR 32.102(f)

<sup>22</sup> DFARS 242.7501; DCAAM 5-107(a)

<sup>23</sup> 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

The CWC found that both DCMA and DCAA are under-resourced.<sup>26</sup> This observation was made in the context of the current regulatory and contractual construct and would be exacerbated if this proposed rule becomes regulation. 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.”

- “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.”

The government simply does not currently have the capacity to implement and administer the proposed rule’s onerous internal control requirements.

**Conclusion.** While business system internal controls are indeed a critical element of contractor accounting

and regulatory compliance processes, attempting to regulate them with onerous subjective requirements and a coercive enforcement mechanism will likely degrade—not improve—the government’s oversight. By misallocating its scarce resources in a futile attempt to mitigate limitless theoretical risks, the government is greatly increasing the likelihood that real risks will be overlooked.

To illustrate this key point, assume that the government identifies, during an exhaustive internal control audit, a deficiency in a contractor’s accounting system, earning that contractor a mandatory 10 percent withhold on its cost-reimbursement contract billings. Subsequent to contract completion, the contractor demonstrates to the government’s satisfaction that the deficiency has been remedied prompting the contracting officer to pay the cumulative amount withheld. On its face, it would seem that the withholding regime was a wild success. But was it really? While the deficiency existed, were unallowable costs being billed on that contract? We won’t know, since this proposed rule does not require evidence of a causal connection between a deficiency and billed unallowable costs. Who has benefited here – the government? Contractors? Both? Neither? At what cost?

Is it possible that the government is missing the forest for the trees with this proposed rule? Is it heresy to suggest that a regimen of well-designed, balanced, and objectively-executed contract cost audits might be a better solution to improve the government’s oversight effectiveness? A follow-on article, “*Contractor Incurred Cost and Internal Control Oversight: Back to the Future*,” will explore these questions and the possibility that the government’s current intense focus on contractor internal controls could be, ironically, the cause of its apparent oversight ineffectiveness rather than the solution for improving it.

<sup>26</sup> CWC Special Report 1, p 1 & 9