

More Details Emerge on Administration of Contractor Business Systems Rule

Written by Nick Sanders

Wednesday, 07 December 2011 00:00



As our readers know, we have been following the new DFARS rule on contractor business systems since the beginning, even going so far as to submit comments to the DAR Council. The [first draft rule](#) was a disaster. The [second iteration](#)—issued as an interim rule—was better, though (in our view) far from perfect. Subsequently, DCMA put out [policy guidance](#) that gave us some hope administration of the new rule wouldn't be as problematic as it could be.

We continue to scrutinize implementation of the new rule, sensitive in particular to how DCMA uses its new authority (authority which it has always had, in our view) to reduce payments to contractors when DCAA auditors and/or DCMA functional specialists report that business systems contain one or more “significant deficiencies” that render the business systems “inadequate”. A couple of new developments have come to our attention, and we want to share them with you.

First, a recent industry/DPAP “cross-talk” touched on implementation of the new rule. The following notes report that discussion—

It was confirmed by DPAP that system deficiencies will be considered to be site specific if the system functions at specific sites, not enterprise-wide. If a system operates only within a certain segment of a company, the same limits would apply. The deficiency would incur consequences

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company-wide only when the system is used company-wide. ... The part of the company using the deficient system will reap whatever consequences might be imposed.

So what that tells us is that any business system that is segment-specific (i.e., one whose policies, procedures and practices are limited solely to one segment) that is found to inadequate will not automatically “infect” the other company segments. On the other hand, enterprise-wide business systems (e.g., enterprise-wide accounting systems or earned value management systems) that are found to be inadequate may well trigger withholds on all covered contracts across the enterprise, even if the deficiencies are limited to non-compliant practices of only one segment.

Companies performing risk assessments on potential issues with their six business systems might want to take that aspect into account. Enterprise-wide systems potentially carry with them larger financial penalties (in terms of reduced cash flow), so we would advise that they be targeted first when performing internal compliance checks and employee training.

And if you are a contractor subject to the new DFARS contractor business systems rule, and you are not performing any risk assessments, or are not performing internal compliance checks, or are not ensuring that employees are thoroughly trained in command media and practices associated with your business systems ... well, we don't have many nice things to say about you. It might be fairly said that you're either blindly optimistic, or more likely recklessly negligent.

Moving on, the second new development that's come to our attention is that the Navy and the cognizant Administrative Contracting Officer (ACO) reportedly have become the first to actually reduce contractor payments under the new rule. And the winner in the race to be the first contractor to have a business system found to be inadequate and, as a result, have payments reduced is [Huntington Ingalls Industries](#) !

Readers may remember that about eighteen months ago (March, 2010) Northrop Grumman spun-off its shipbuilding business and created Huntington Ingalls. Since that time, the new entity has announced facility closures and layoffs (both voluntary and involuntary), all while reporting lackluster financial results. So the news that the entity was the first to have contract payments reduced under the authority of the new business systems rule might be seen as the

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continuation of a series of not-good news.

On November 9, 2011, InsideDefense.com (subscription required) reported that—

The Navy will penalize shipbuilder Huntington Ingalls Industries for management problems by withholding millions of dollars under new Pentagon rules that crack down on contractors' deficient business systems. ... The Navy notified the shipbuilder in late October that it would withhold 5 percent of progress payments for the \$698 million contract awarded in September for the construction of an Arleigh Burke-class destroyer (DDG-114) at Ingalls, Naval Sea Systems Command spokesman Chris Johnson told Inside the Pentagon. The money is being withheld in accordance with new DOD acquisition rules on contractor business systems. ...

The DDG-114 award is the first contract awarded to Ingalls that includes the new clause, which does not necessarily require the government to withhold payments, even if the contractor has a history of management deficiencies. First, the contractor is "given due process," said Noble. Before withholding money, the department must initially determine there is a problem and give the contractor an opportunity to respond. After evaluating the response, a contracting officer makes a final decision about withholding payments.□

'No withholding of payments occurs until a final determination is made that a significant deficiency exists,' said Navy spokeswoman Pat Dolan. Huntington-Ingalls Industries went through that process, but did not pass muster. □ In June, the administrative contracting office initially disapproved of Ingalls' earned value management system, Dolan said. ... The Defense Contract Management Agency determined this summer that Ingalls was violating 19 of the 32 rules.□

The agency also reaffirmed this summer that Huntington-Ingalls Industries' shipyard in Newport News, VA, the sole builder of U.S. aircraft carriers, was breaking 16 [EVMS] rules.□

That story was followed closely by [this one](#) in Aviation Week & Space Technology, in which it reported—

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The Naval Sea Systems Command said 5 percent of progress payments were being withheld on a \$697.6 million contract awarded in September for a new Arleigh Burke-class destroyer.

The Navy did not specify the sum being held back. It cited deficiencies in the company's 'Earned Value Management System,' ... referring to a federal contracting performance yardstick.

The penalty amounted to millions of dollars under new Defense Department rules aimed at boosting contractors' performance, said Inside the Pentagon, a trade publication that was the first to report the sanction.

The Defense Contract Management Agency found deficiencies representing 'systemic and material internal control weaknesses' under 19 of the 32 'guidelines,' Jacqueline Noble, an agency spokeswoman, told Reuters. ...

The problems at Huntington Ingalls crossed each of the five overall areas at issue—Organization; Planning, Scheduling, and Budgeting; Accounting Considerations; Analysis and Management Reports; and Revisions and Data Maintenance, Noble said in an emailed reply.

For its part, the company put a good face on its problems, saying that it did not expect the payment withholds to "impact its financial outlook," AW&ST reported.

As we stated above, we think this new DFARS rule is going to be problematic for defense contractors. We are advising our clients to make an honest and forthright assessment of their six business systems, to identify control gaps and noncompliant practices. From there, we advise our clients to remediate control gaps immediately, to revisit and enhance command media. Affected employees should be thoroughly trained in each system's policies, procedures, and practices. Finally, frequent internal compliance reviews should check and double-check compliance with system controls. In our view, that's not overkill; that's a rational response to the increased financial risk associated with systems that are determined to be inadequate.

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Sure, it costs a lot to execute our recommended approach. But as Huntington Ingalls found out, investing in assessing and remediating business systems (and other internal controls) is always cheaper than experiencing payment withholds ... or fines, penalties and/or legal judgments.