

Government Contract Services

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Defense Federal Acquisition Regulation Supplement (DFARS) interim rule - business systems update

Long anticipated, the Department of Defense (DoD) issued a Defense Federal Acquisition Regulation Supplement (DFARS) interim rule "... to improve the effectiveness of DoD oversight of contractor business systems."ⁱ In apparent response to critical comments from the Commission on Wartime Contracting (CWC) regarding the government's oversight of contractors, the interim rule was broadly written to cover the following business systems.

- ▶ Accounting systems
- ▶ Estimating systems
- ▶ Purchasing systems
- ▶ Earned Value Management Systems (EVMS),
- ▶ Material Management and Accounting Systems (MMAS), and
- ▶ Property management systems

Of concern to the government contracting community is the enforcement mechanism written into the interim rule that provides for government billing withholds. Implemented through the introduction of contract clause 252.242-7005 Contractor Business Systems, payments could be withheld on Interim payments under:

- ▶ Cost-reimbursement contracts
- ▶ Incentive-type contracts
- ▶ Time-and-Materials (T&M) contracts
- ▶ Labor-hour contracts
- ▶ Progress payments
- ▶ Performance-based payments

Contractors are required to respond to a government contracting officer's interim determination of significant business system deficiencies, in writing, within 30 days. Should the contracting officer make a final determination of a "significant deficiency," the government may (and we believe likely) direct withholds of up to 5% for one or more significant deficiencies in a single business system or up to 10% per contract should a determination be made that there are significant deficiencies in multiple business systems. A significant deficiency was defined as:

"a shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes."

Throughout the drafting of the proposed rule, industry commentators have expressed concern about the enforcement mechanism that provides for withholdings on contractor invoices when a business system is deemed inadequate. While industry comments have made it clear that the existence of an internal control deficiency does not necessarily translate into a risk to the government, the writers have ignored in the interim rule the lack of linkage between potential harm to the government and the imposition of arbitrary withholdings.

Within 90 days of receipt of contractor notification of corrective action, the contracting officer is to determine whether a contractor has corrected the significant deficiency or there is a reasonable expectation that corrective actions have been implemented. Absent timely determination, the contracting officer is to reduce the withholding by at least 50 % - of concern is that the interim rule would allow withholdings, albeit reduced, even when corrective actions have been implemented by the contractor.

Since publication of the proposed rule, the Defense Contract Audit Agency (DCAA) initiated business system pilot audits at selected contractor sites beginning with billing systems and has recently started audits of accounting systems and general controls. Correspondingly, DCAA introduced audit programs for use in the pilot audits that focus on the internal control deficiencies as set forth in the interim rule. The audit programs are designed for use with both major and non-major contractors. It also appears some DCAA auditors are referring to the earlier DCAA internal control matrices associated with previous audit programs to guide aspects of their review.

Contractors involved in the pilot audits have been expending significant effort preparing for the system demonstrations that follow the business systems audit entrance conference. These system demonstrations are generally attended by the entire audit team and can include the regional audit manager, manager, supervisor and auditors. These system demonstrations have included a walk-through of the business system(s) and encompass a demonstration of the application of internal controls. While senior management participation appears to be appreciated, in the pilot audits, DCAA has discouraged management-only presentations during these walk-throughs and expects participation by those who are actually involved in the processing of transactions. Some of the areas receiving attention in the billing system pilot audits have included (i) refund processing, (ii) the adequacy of contract briefs, (iii) processing of subcontractor billings and (iv) timely submission of final incurred cost proposals and final vouchers. Contractors preparing for business system reviews should have documented their systems (e.g., flowcharts, policies and procedures, desk procedures), addressed any deficiencies in advance of the system demonstration and identified those who will be participating in the system demonstration.

It appears that the business system reviews will generally be conducted over a 12-month period; based on its interim assessments, DCAA will design audit tests to review transactions during the system review period. DCAA sampling of transactions may involve the use of statistical sampling techniques. Relative to the audit sampling, contractors should be familiar with the DCAA statistical sampling techniques outlined in the DCAA Contract Audit Manual, Appendix B, DCAA open audit guidance and also the operation of the DCAA sampling program, EZ Quant (available on the DCAA website).

IRS delays implementation of 3% withholding requirement

In 2004, the General Accounting Office (GAO) issued a report, "Some DOD Contractors Abuse the Federal Tax System with Little Consequence,"ⁱⁱⁱ that alleged DoD contractors owed billions in unpaid federal taxes. A tax withholding requirement was subsequently included in the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222) to help prevent tax abuses. Internal Revenue Bulletin 2010-52 described the legislation as follows.

Section 3402(t) was added by § 511 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (TIPRA), which was enacted on May 17, 2006. Section 3402(t)(1) provides that the Government of the United States, every State, every political subdivision thereof, and every instrumentality of the foregoing (including multi-State agencies) making any payment to any person providing any property or services (including any payment made in connection with a government voucher or certificate program which functions as a payment for property or services) shall deduct and withhold from such payment a tax in an amount equal to 3% of such payment. There are many exceptions to the § 3402(t) withholding requirements, including the exception provided by § 3402(t)(2)(G) for payment made by a political subdivision of a State (or an instrumentality of a political subdivision of a State) which makes less than \$100,000,000 of payments for property or services annually (other than payments otherwise exempt from § 3402(t) withholding, such as payroll payments). TIPRA originally provided that §3402(t) applies to payments made after December 31, 2010.ⁱⁱⁱ

The tax withholding requirement has been the subject of considerable public comment (and criticism). The Internal Revenue Service (IRS) issued IRS Bulletin 2011-23, June 6, 2011, Extension of Withholding to Certain Payments Made by Government Entities.^{iv} The implementation date has been pushed back twice (now to 2013) as lawmakers debate whether the legislation should be repealed.

In March 2011, House Ways and Means Chairman Dave Camp (R-MI) indicated an effort to repeal the legislation was forthcoming; as of this writing, three bills have been introduced to repeal the tax withholding legislation:

- ▶ H.R. 674 by Representatives Wally Herger (R-CA) and Earl Blumenauer (D-OR)
- ▶ S. 89 by Senators David Vitter (R-LA), Richard Burr (R-NC), James Inhofe (R-OK), Johnny Isakson (R-GA), and Roger Wicker (R-MS)
- ▶ S. 164 by Senators Scott Brown (R-MA) and Olympia Snowe (R-ME)

We continue to monitor developments regarding this legislation in hopes of its eventual repeal.

Proposed DFARS rule for safeguarding unclassified information

Following security breaches at various DoD contractors that apparently included compromised RSA SecurID electronic tokens, DoD announced a program titled the Defense Industrial Base (DIB) Cyber Pilot to provide defense contractors assistance in defending their networks. After this announcement, a proposed DFARS rule^v was published June 29 that set forth requirements for safeguarding non-classified DoD information and require reporting of “cyber intrusion events” that affect DoD information.

The proposed rule distinguishes between basic and enhanced data wherein enhanced data encompasses DoD information:

- ▶ Designated as Critical Program Information in accordance with DoD Instruction 5200.39, Critical Program Information (CPI) Protection Within the Department of Defense
- ▶ Designated as critical information in accordance with DoD Directive 5205.02, DoD Operations Security (OPSEC) Program
- ▶ Subject to export controls under International Traffic in Arms Regulations and Export Administration Regulations
- ▶ Exempt from mandatory public disclosure under DoD Directive 5400.07, DoD Freedom of Information Act (FOIA) Program, and DoD Regulation 5400.7-R, DoD Freedom of Information Program
- ▶ Bearing current and prior designations indicating controlled access and dissemination (e.g., For Official Use Only, Sensitive But Unclassified, Limited Distribution, Proprietary, Originator Controlled, Law Enforcement Sensitive)
- ▶ Technical data, computer software and any other technical information covered by DoD Directive 5230.24, Distribution Statements on Technical Documents, and DoD Directive 5230.25, Withholding of Unclassified Technical Data from Public Disclosure
- ▶ Personally identifiable information including, but not limited to, information protected pursuant to the Privacy Act and the Health Insurance Portability and Accountability Act

It should be noted that DoD has stated that the eventual implementation of the proposed rule may have an economic impact on a “substantial number of small entities.”

“DoD estimates that the rule will apply to approximately 76 percent of DoD’s small business contractors in that they will be required to provide protection of DoD information at the enhanced level. DoD awarded contracts to 64,427 businesses with unique parent Data Universal Numbering System identified as small businesses in fiscal year 2010, so the estimated impact of this rule is to 48,965 unique small businesses. Additionally, a reasonable rule of thumb for small businesses is that information technology security costs are approximately 0.5 percent of total revenues. Because there are economies of scale when it comes to information security, larger businesses generally pay only a fraction of that estimated cost as a percentage of total revenue.”

Enhanced safeguarding requirements are set forth within the proposed rule. Procedures for reporting cyber incidents are to be discussed in subsequent rulemaking.

As the cost may be significant, small business contractors should consider the expense of complying with the proposed rule and their pricing approaches with attention to the treatment of those costs under their established government cost accounting practices.

The proposed rule was published June 29, 2011, noting that although comments were due in 60 days, comments provided to the Office of Management and Budget (OMB) within 30 days would be most useful.

FAR interim rule extends restriction on subcontracting with suspended or debarred contractors

An interim rule amending the Federal Acquisition Regulation (FAR)^{vi} extends restrictions on subcontracting with parties listed in the Excluded Parties List System (EPLS). Some exceptions are made for contracts for the acquisition of commercial items and commercially available off-the-shelf items. The interim rule states that

“contractors shall not enter into any subcontract in excess of \$30,000, other than a subcontract for a commercially available off-the-shelf item, with a contractor that has been debarred, suspended, or proposed for debarment unless there is a compelling reason to do so. If a contractor intends to subcontract, other than a subcontract for a commercially available off-the-shelf item, with a party that is debarred, suspended, or proposed for debarment as evidenced by the parties' inclusion in the EPLS (see 9.404), a corporate officer or designee of the contractor is required by operation of the clause at 52.209-6, Protecting the Government's Interests when Subcontracting with Contractors Debarred, Suspended, or Proposed for Debarment, to notify the contracting officer, in writing, before entering into such subcontract. For contracts for the acquisition of commercial items, the notification requirement applies

only for first-tier subcontracts. For all other contracts, the notification requirement applies to subcontracts at any tier.”

Contractors subject to requirements contained in FAR Subpart 44.3, Contractors Purchasing Systems Reviews, will have already included the use of the EPLS in their purchasing processes; others should review their purchasing processes to assure compliance.

Proposed DFARS rule requires reporting DoD post-employment compliance

In response to a May 2008 General Accounting Office (GAO) report, “DEFENSE CONTRACTING, Post-Government Employment of Former DOD Officials Needs Greater Transparency”^{vii}, the proposed rule requires offerors at time of contract award to represent that all former DoD officials that are covered by the Procurement Integrity Act are in compliance with government post-employment restrictions.

18 U.S.C. 207 contains post-employment prohibitions according to the former official's involvement and position:

- a. Former personnel are permanently barred from representing their new employer to their former agencies for matters on which they were personally and substantially involved.
- b. Even if the former officials were not directly involved in the matter, former personnel may not represent their new employer to their former agency on matters that were pending under their official responsibility in their last year of service for two years after leaving Federal service.
- c. Former senior-level officers and employees may not contact their former agency on particular government matters that are pending or are of substantial interest to the former agency for one year after leaving Federal service.”

41 U.S.C. 2104 (formerly, 41 U.S.C. 423) imposes a “cooling-off period” for certain government officials.

- ▶ “DoD and other Government acquisition officials may not accept compensation from a defense contractor during a one year cooling-off period if the official performed certain duties at DoD involving the contractor and a contract valued in excess of \$10 million. However, the individual may accept employment from a division or affiliate that does not produce the same or similar items.”

Section 847 of the National Defense Authorization Act (NDAA) for Fiscal Year (FY) 2008

- ▶ “Section 847 requires that senior DoD officials who have been personally and substantially involved in contracts over \$10 million request a written post-employment ethics opinion before receiving compensation from a contractor. It also applies to the

employees who are affected by the one-year compensation ban of 41 U.S.C. 2104.”

Comments on the proposed rule are due August 5, 2011

Proposed rule to standardize government-wide past performance reporting

A proposed rule to standardize processes involving past performance evaluation information was published in the Federal Register June 28, 2011.^{viii}

Incorporating recommendations set forth in Government Accountability Office Report GAO-09-374, “Better Performance Information Needed to Support Agency Contract Award Decisions” and Office of Federal Procurement Policy (OFPP) memorandum “Improving the Use of Contractor Performance Information,” the proposed rule follows earlier changes that included migration by various federal agencies to a single Contractor Performance Assessment Reporting System (CPARS).

Under the proposed rule, federal agencies would use standardized past performance evaluation factors and performance ratings when submitting past performance evaluations. Agencies would be required to report contractor performance on each contract that exceeds the simplified acquisition threshold at least annually.

Comments on the proposed rule are due August 29, 2011.

For more information or questions about the Government Contract Services newsletter, please contact:

- ▶ **Robert A. Esernio, Jr., Partner
National Leader
Ernst & Young LLP**
Phone: +1 203 674 3305
Email: robert.esernio@ey.com
- ▶ **Todd LaMastres, Partner
Ernst & Young LLP**
Phone: +1 214 969 8484
Email: todd.lamastres@ey.com
- ▶ **Robert Malyska, Partner
Ernst & Young LLP**
Phone: +1 949 437 0302
Email: robert.malyska@ey.com
- ▶ **Deborah Nixon, Partner
Ernst & Young LLP**
Phone: +1 703 747 1478
Email: deborah.nixon@ey.com
- ▶ **Darl Rhoades, Executive
Director
Ernst & Young LLP**
Phone: +1 720 931 4022
Email: darl.rhoades@ey.com
- ▶ **Steven Tremblay, Executive
Director
Ernst & Young LLP**
Phone: +1 617 375 2420
Email: steven.tremblay@ey.com

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Endnotes

- i Defense Federal Acquisition Regulation Supplement; Business Systems–Definition and Administration
http://www.acq.osd.mil/dpap/dars/dars/fr/changenotice/2011/20110518/fr_2009-D038.pdf
- ii US Government Accounting Office, FINANCIAL MANAGEMENT, Some DOD Contractors Abuse the Federal Tax System with Little Consequence
<http://www.gao.gov/new.items/d04414t.pdf>
- iii Internal Revenue Bulletin 2010-52, December 27, 2010, Notice 2010-91, Interim Guidance on the Application of Section 3402(t) to Payment Card Transactions
http://www.irs.gov/irb/2010-52_IRB/ar15.html
- iv Internal Revenue Bulletin 23-2011, June 6, 2011, TD 9524, Extension of Withholding to Certain Payments Made by Government Entities
http://www.irs.gov/irb/2011-23_IRB/ar07.html#d0e982
- v Defense Federal Acquisition Regulation Supplement; Safeguarding Unclassified DoD Information (DFARS Case 2011-D039)
<http://www.gpo.gov/fdsys/pkg/FR-2011-06-29/pdf/2011-16399.pdf>
- vi Federal Acquisition Regulation; Uniform Suspension and Debarment Requirement
<http://edocket.access.gpo.gov/2010/2010-30565.htm>
- vii US Government Accounting Office, DEFENSE CONTRACTING, Post-Government Employment of Former DOD Officials Needs Greater Transparency,
<http://www.gao.gov/new.items/d08485.pdf>
- viii Federal Acquisition Regulation; Documenting Contractor Performance
<http://www.federalregister.gov/articles/2011/06/28/2011-16169/federal-acquisition-regulation-documenting-contractor-performance#p-12>