

AN ALERT FROM THE BDO GOVERNMENT CONTRACTING PRACTICE

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► SUBJECT

PROPOSED CHANGES TO THE DFARS BUSINESS SYSTEM RULE: SELF- ASSESSMENTS AND EXTERNAL AUDITS – WHAT DOES THIS MEAN?

The Department of Defense (DoD) proposed a new rule on July 15 that would amend the current Defense Federal Acquisition Regulation Supplement (DFARS) business system rules. The proposed rule introduces new requirements for large government contractors, including annual reporting, triennial CPA audits and documentation requirements.

None of the requirements apply to small businesses, and the changes only affect accounting, estimating and material management and accounting systems (MMAS), coinciding with the systems for which the Defense Contract Audit Agency (DCAA) has primary responsibility. The other three business systems subject to DCMA review (purchasing, earned value management and government property) are not addressed.

DoD has long been considering a new approach to business system audits. On November 3, 2011, the Government Accountability Office (GAO) reported that DCAA was not timely fulfilling its business system audit responsibilities. GAO recommended that DoD consider alternative methods, such as the use of external auditors, to accomplish these audits in a more timely manner, and in response, DoD published this proposed rule.

While many parts of the business system rules remain essentially the same, there are several critical changes to note:

► ANNUAL REPORTS

There would be a new burden on contractors to provide an annual report to the contracting officer regarding a self-assessment of compliance with each business system criteria within six months of the contractor's fiscal year end. DCAA would be provided with the contractor's annual report by the contracting officer. The report is to be signed by a contractor official at a level no lower than a vice president or chief financial officer.

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The report is required to include:

- A statement that the contractor has evaluated the business system's compliance with the system criteria of the clause;
- The contractor's assessment of the business system's compliance with prescribed criteria, including a statement as to whether or not the system complies in all material respects;
- Disclosure of any significant deficiencies with sufficient information for the government to understand the deficiencies;
- The status of any significant deficiencies disclosed by either the contractor's assessment or the independent auditor's report, if applicable; and,
- A corrective action plan with milestones and actions to eliminate any significant deficiencies which have not been corrected as of the date of the contractor's report.

The proposed rule requires a report on each system, e.g. accounting and estimating, meeting the threshold for coverage under the rule. See the accompanying table for the applicable threshold for when a business system is subject to the rule. Also, since the due date for the annual reports on business systems is the same as the due date for incurred cost proposals, contractors will need to anticipate resource needs for these simultaneous reporting events.

► TRIENNIAL CPA AUDITS

In the initial year that the contractor is required to begin providing annual reports, the contractor is also required to obtain an independent CPA's examination of the contractor's compliance with the relevant system criteria and provide the resulting audit report to the government. An independent CPA would perform an audit every three years thereafter, or more frequently if directed by the Contracting Officer.

The proposed rule also describes criteria the contractor should apply when retaining a CPA to establish that the audit firm is independent, objective with respect to the audited entity and qualified to perform the audit. The examination must be performed in accordance with generally accepted government auditing standards (GAGAS), and the CPA's audit report must include sufficient information about reported significant deficiencies for the government to understand.

Note that the definition of "significant deficiency" does not change under the amendments to the business system rule. A significant deficiency is 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."* Findings categorized as significant deficiencies have often been viewed differently by contractors and DCAA, and we may see independent accountants assess the meaning of "significant deficiency" differently too.

Under certain circumstances, contractors may also be required to provide the CPA's audit strategy, risk assessment and audit plan to the contracting officer, who would then pass it along to the DCAA auditor to obtain a review of any potential issues identified by the government auditor. There is uncertainty about the yet-to-be determined DCAA criteria for reviews of the CPA's audit strategy, risk assessment and audit plan. The rule also adds that this review of the CPA's audit strategy, risk assessment and audit plan does not constitute the contracting officer's approval.

The DCAA will also review CPA audit reports, but the proposed rule does not describe what this review will entail. In addition, the contracting officer, and by extension, DCAA, will have access to the CPA's working papers. Access to these kinds of records and level of detail has been contentious between DCAA and contractors over many years, and may not be welcomed by CPA firms either.

► DOCUMENTATION

One of the more interesting documentation issues is the nature and depth of the information that will be expected for supporting a contractor's self-assessment and assertions of compliance with business system criteria. It may be helpful to recall the history of incurred cost proposals, which have evolved from relatively simple statements of rate calculations into sophisticated, prescribed, data-heavy and multi-schedule regulatory requirements, not including supplementary data that is now required by the allowable cost and payment clause at FAR 52.216-7.

Moreover, the Accounting System Administration clause at DFARS 252.242-7006 (b) (2) has been changed to state that the contractor shall: *"Make available to the Government upon request, the results of internal or external reviews or monitoring that have been conducted to ensure compliance with the system criteria... and established accounting system policies and procedures."* This could open up access to records that the DCAA has previously experienced difficulty obtaining due to contractors' resistance, such as for internal audit reports or matters conducted under attorney-client privilege.

Contractors will also be required to maintain documentation about the selection criteria for the CPA firm including the diligence supporting the CPA firm's independence, objectivity and qualifications.

► STRATEGIC CONSIDERATIONS

The obvious key concern for this new rule is increased administrative costs to the contractor. Essentially, the Agency is pushing its former cost to utilize DCAA for these audits to the contractor. It is critical that firms think through how they can recover these costs through a more direct manner in order to avoid increasing G&A costs overall. For instance, could this be a new function in the company and could the company create a new cost allocation? Could these be direct costs to a contract if the company only has a few? Companies should look to resolve these questions in the next few months as they determine the best way to deal with the new requirements.

► OTHER ISSUES

The effect on DCAA's workload for reviews of annual self-assessment reports, triennial audits, and CPAs' audit strategy, risk assessments and audit plans is unknown. However it may be significant because under the accounting system rule alone, every company with a CAS-covered award will have to file annual reports and have triennial CPA audits performed. While most of DCAA's activity will be reviewing the work of others, this may take more time than the limited number of business system audits that DCAA performs today. However, one beneficial outcome may be that contracting officers will have information to be able to make system approval determinations more quickly.

At this stage, the changes are only proposed, and the regulatory process needs to be completed to finalize the rule—implementation of this rule is far from a done deal. But regulatory history suggests that the business system clauses will be changed in some form, and contractors may want to comment on the current proposed rule.

The proposed rule can be found in its entirety on the Federal Register website at: <https://www.federalregister.gov/articles/2014/07/15/2014-16390/defense-federal-acquisition-regulation-supplement-business-systems-compliance-dfars-case-2012-d042>.

Comments on the proposed rule should be submitted in writing to by September 15, 2014 by one of the following methods:

- Portal: Regulations.gov (<http://www.regulations.gov>)
- E-mail: osd.dfars@mail.mil
- Mail: Defense Acquisition Regulations System, Attn: Mr. Mark Gomersall
OUSD (AT&L) DPAP (DARS), Room 3B941
3060 Defense Pentagon, Washington, DC 20301-3060

In addition, a public meeting will be held on August 18, 2014 from 2 to 4 p.m. EST at the Mark Center Auditorium (4800 Mark Center Drive, Alexandria, VA 22350).

THRESHOLDS FOR BUSINESS SYSTEM COVERAGE UNDER THE PROPOSED BUSINESS SYSTEM RULE

ACCOUNTING SYSTEM

The proposed rule applies to contractors who are subject to the Cost Accounting Standards (CAS) under 41 U.S.C. Chapter 15 and as defined in DFARS 242.7001.

ESTIMATING SYSTEM

The proposed rule applies to solicitations and contracts that are with large businesses. The requirement threshold for contractors is provided as follows:

- Contractor received \$50M+ in prime contracts or subcontracts for which certified cost or pricing data were required in the previous fiscal year
– OR –
- Contractor received \$10M+ (but less than \$50M) in prime contracts or subcontracts for which certified cost or pricing data were required and the contracting determines it to be in the best interest of the U.S. Government

MATERIAL MANAGEMENT AND ACCOUNTING SYSTEM (MMAS)

The proposed rule applies to solicitations and contracts that are with large businesses. The requirement threshold for contractors is provided as follows:

- Contractor received \$50M+ of qualifying sales to the U.S. Government during the preceding fiscal year
– AND –
- Cognizant Contracting Officer determines an MMAS review is needed based on a risk assessment of the Contractor's past experiences or current vulnerability.

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