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DCAA

DCAA's Business Systems Audit Guidance: Clarity. . . and Reason for Concern



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Recent Defense Contract Audit Agency audit guidance sets forth how DCAA will implement the Department of Defense business systems rule. Not surprisingly, contractors will find that this guidance is a “mixed bag,” at best.

On the one hand, the guidance offers much needed clarity on what DCAA will conclude constitutes “significant deficiencies,” which is critical to contractors because such deficiencies, if accepted by the contracting officer, will result in government withholdings of payments otherwise due to contractors on covered contracts. On the other hand, by including the term “material weakness,” which has no relevance to the business systems rule, DCAA has set up a scheme that could result in the improper expansion of withholdings under the business systems rule.

This article briefly summarizes DCAA's guidance and what it may mean for government contractors.

I. DOD's Business Systems Rule. On February 24, 2012, DOD issued its final business systems rule. The rule, set forth in seven DOD Federal Acquisition Regulation Supplement clauses and related provisions, mandates

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that certain contractors create and maintain six specific business systems. If contractors fail to meet the myriad requirements of the business systems rule in a way that “materially affects the ability of officials of the Department of Defense to rely upon the information produced by the system,” a “significant deficiency” exists and contracting officers are required to disapprove the deficient system and withhold 5 percent of payments until the issue is resolved.

In addition to being a significant change for contractors, the business systems rule represents a major shift in the role and responsibility of DOD's two primary contract administration agencies: DCAA and the Defense Contract Management Agency. Together, these agencies are responsible for determining if contractors subject to the business systems rule are complying with the rule's detailed requirements. Both DCAA and DCMA have issued guidance to assist their personnel with implementing the business systems rule in a uniform and predictable manner.

II. DCAA Audit Guidance. DCAA's recent guidance (12-PAS-012(R)) addresses a variety of administrative issues relating to business systems audits in general and accounting systems audits in particular. The most useful aspect of the guidance for contractors and their counsel, however, is the discussion of DCAA determinations of “significant deficiencies.” As noted above, it is DCAA's finding of a significant deficiency, and the contracting officer's concurrence with DCAA, that triggers government withholdings against contractors under the business systems clause.

The business systems rule defines a significant deficiency 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.” Using this definition as a starting point, the DCAA guidance states:

The contract clause for each DFARS business system provides specific criteria with which an acceptable system must comply. The clause at DFARS 252.242-7006, Accounting System Administration provides 18 criteria. Compliance with those criteria provides reasonable assurance that applicable laws and regulations are complied with; the ac-

counting system and cost data are reliable; the risk of misallocations and mischarges is minimized; and the contract allocation and charges are consistent with billing procedures. A *material* noncompliance with any one of the 18 criteria indicates a significant deficiency/material weakness exists and that the contractor has not complied in all material respects with the DFARS criteria.

(Emphasis original). The guidance goes on to note that auditors should consider “the likelihood that the identified noncompliance . . . will result in noncompliance with other applicable government contract laws and regulations (e.g., with FAR Subpart 31.2, CAS, or applicable requirements in FAR Part 15) and the magnitude of those potential other noncompliances” when determining whether a noncompliance is material. “If there is a *reasonable possibility* that the identified noncompliance with the DFARS criteria will result in a material noncompliance with other applicable government contract laws and regulations, either individually or in combination, it is a significant deficiency/material weakness.” (Emphasis original).

Finally, the guidance highlights the following considerations when determining whether a non-compliance is material:

- The nature and frequency of the noncompliance with the DFARS criteria identified with appropriate consideration of sampling risk (i.e., the risk that the conclusion based on the sample is different than it would be had the entire population been tested).
- Whether the noncompliance with the DFARS criteria is material considering the nature of the compliance requirements.
- The root cause of the noncompliance. (Understanding why the noncompliance occurred will help to determine if it is systemic and significant.)
- The effect of compensating controls.
- The possible future consequences of the noncompliance with the DFARS criteria.
- Qualitative considerations, including the needs and expectations of the report’s users, contractor histories of noncompliance, and identifies noncompliances with related laws and regulations.

III. Material Weaknesses in DCAA’s Audit Guidance. If the DCAA guidance had simply provided further instruction regarding identifying and reporting significant deficiencies, it would represent an important step in creating a uniform and predictable process for auditing contractor business systems. The guidance, however, does much more.

Most notably, the guidance attaches the concept of “material weakness” to the DFARS business systems term “significant deficiency”. The American Institute of Certified Public Accountants uses the term “material weakness” to describe significant problems that exist in an entity’s internal controls. This term, however, is of suspect relevance in the context of the DFARS business systems rule. In fact, the DFARS Council specifically stated in response to comments on the interim rule that the term “material weakness” is not relevant to the business systems rule.

While the DCAA guidance acknowledges that significant deficiencies and material weaknesses are separate concepts, it appears likely that auditors will conflate the

terms when issuing accounting systems audits. DCAA’s guidance notes that auditors are to “opine on the contractor’s compliance with the DFARS criteria [i.e., significant deficiencies] rather than on the effectiveness of the contractor’s internal controls [i.e., material weaknesses].” DCAA nevertheless reasons that, because the Generally Accepted Government Auditing Standards requires auditors to report material weaknesses, and because a significant deficiency will also “generally represent a material weakness,” the DCAA guidance and the related audit program should use the term “significant deficiency/material weakness” as a single term that refers to both concepts.

The DCAA guidance defines a “material weakness” as “[a] deficiency, or combination of deficiencies, in internal controls over compliance such that there is a reasonable possibility that a material noncompliance with a compliance requirement (e.g., applicable government contract laws and regulations) will not be prevented, or detected and corrected on a timely basis.” As discussed in the paragraphs that follow, DCAA’s definition of “material weakness” differs substantially from the DFARS’ definition of “significant deficiency.” Specifically, the DCAA-defined “material weakness” appears to be broader and more easily triggered than “significant deficiency.”

“Material weakness,” as defined by DCAA, can potentially cover more circumstances than “significant deficiency.” As DCAA observes, a significant deficiency only relates to a contractor’s compliance with the criteria set forth in the business systems rule. These criteria, while highly detailed, still only constitute a finite number of considerations that are specifically set forth in each business systems clause. On the other hand, a “material weakness,” as defined by DCAA, relates to *any* circumstance that might impact the ability of a system to prevent, detect, and correct noncompliances. The potential triggers for “material weaknesses” are, therefore, limited only by the auditor’s imagination regarding the possible ways in which a contractor’s systems could fail to recognize or correct noncompliances with laws or regulations in the future.

More importantly, a “material weakness,” as DCAA has defined the term, appears to be triggered far more easily than a “significant deficiency.” Pursuant to the business systems rule and its underlying statute, a “significant deficiency” only occurs when an event (i.e., a shortcoming) *materially affects* the reliability of existing information within a contractor system. On the other hand, a “material weakness” exists whenever a *reasonable possibility* exists of a *future* noncompliance. In other words, a “significant deficiency” is necessarily backwards-looking and requires an actual impact on a contractor’s system, while a “material weakness,” as redefined in DCAA’s guidance, appears to endorse auditor speculation as to future noncompliances that are “reasonably possible.” The guidance also appears to conflict with guidance in GAGAS that establishes material weaknesses are found based on the actual existence of a problem and not the speculation that there is a “reasonable possibility” of a problem in the future.

There is nothing inherently improper about DCAA grouping material weaknesses and significant deficiencies together for the purpose of DCAA’s guidance. Indeed, the two terms are similar, and negative audit findings often will constitute both significant deficiencies and material weaknesses. DCAA’s approach, however,

increases the risk of auditor confusion over the two concepts and could improperly expand the scope of withholdings under the business systems rule. Material weaknesses and significant deficiencies are two fundamentally different concepts and require different treatments under relevant auditing standards and the business systems rule. But DCAA's guidance does not require that after identifying a significant deficiency/material weakness, auditors are to undertake the further nuanced step of segregating the material weaknesses from the significant deficiencies. DCAA's use of the joint term "significant deficiency/material weakness" instead appears to encourage auditors to lump the two concepts together in a catch-all category of system shortcomings.

Under the business systems rule, only "significant deficiencies" may result in government withholdings. However, if auditors provide contracting officers with audit reports that contain an undifferentiated mass of alleged significant deficiencies and material weaknesses and the contracting officer then adopts the findings of that report (as history teaches us that the contracting officer almost certainly will) withholdings will occur based on *both* material weaknesses and significant deficiencies. Because the term "material weakness," as defined by DCAA, appears to be both broader and easier to trigger than "significant deficiency"

DCAA auditors might effectively (and improperly) expand the circumstances under which the government will institute withholdings from contractors under the business systems rule.

IV. Recommendations for contractors. Only time will tell if DCAA auditors will fail to distinguish between significant deficiencies and material weaknesses and, as a result, inappropriately expand the scope of mandatory withholdings under the business systems rule, an outcome inconsistent with notice and comment rule-making and other requirements of established administrative law. The DCAA guidance, however, indicates that such auditor failures are likely. The consequences of these failures for contractors are significant and include additional audit findings requiring resolution (in instances where significant deficiencies and material weaknesses exist) and improper systems disapproval (in instances where the only finding is a material weakness). Contractors should, therefore, protest the issuance of audit reports that do not differentiate between significant deficiencies and material weaknesses and vigorously oppose any contracting officer determinations of "significant deficiencies" and related withholdings that are, in reality, based on material weaknesses and thus are improper.