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Government Contractor

# Business Systems Compliance Guide

2nd Edition

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This document was authored by representatives of McKenna Long & Aldridge prior to our combination's launch and continues to be offered to provide our clients with the information they need to do business in an increasingly complex, interconnected and competitive marketplace.

## FOREWORD (2014) (Second Edition)

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The Original Edition of the Government Contractor Business Systems Compliance Guide was published in January 2012. Since that time, the Department of Defense (“DOD”) Business Systems Rule has experienced a number of changes. The Business System Rule was issued in final form in February 2012. Government organizations responsible for administering the Business Systems Rule have issued guidance regarding contractor compliance and the government’s performance of its administrative obligations. A body of contractor experience and practices responding to Business System reviews now exists. And DOD in July 2014 issued a proposed rule that would update the Business Systems Rule to require contractors to self-assess and report on estimating system, accounting system, and material management and accounting system compliance.

Importantly, business system compliance also is no longer limited to DOD contractors. The Department of Energy (“DOE”) in August 2013 issued an Acquisition Letter, effective when issued, that imposes many of the same DOD business system requirements for certain non-Management and Operating DOE contracts. DOE in April 2014 also proposed to amend the DOE Acquisition Regulation to incorporate these business system requirements. The guidance discussed in the Second Edition applies to both the DOD Business Systems Rule and the DOE rule, with some relevant differences which are discussed in this Second Edition. Other agencies may eventually follow DOE’s lead, meaning that contractor business systems compliance is becoming more important than ever.

This Second Edition of the Government Contractor Business Systems Compliance Guide reflects the significant changes and contractor experiences that have taken place since the Original Edition was issued in January 2012 up to August 2014. Additions to pre-existing text in the Original Edition are shown in green text in this Second Edition. Also new to this Second Edition is a Section in Chapters 1-7, titled “2014 Update,” and a new chapter, Chapter 8, which discusses potential future business system developments.

Other changes to business system requirements will likely occur in the future. The government now appears to view business system requirements as a means to impose and enforce standard requirements on contractors, as shown by the recent addition of counterfeit part requirements to the DOD Business Systems Rule. Moreover, continued evolution of the government’s formal and informal administrative practices is likely. Case law also is likely to begin addressing business system requirements.

## FOREWORD (2014) (Second Edition)

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For these reasons, use of this Second Edition, like use of the Original Edition, should be combined with assessments of relevant formal and informal changes to business system requirements that occur after the effective date of the Second Edition to determine what requirements and practices might be relevant at any given time. Similarly, users of the Second Edition should be mindful of the limitations applicable to this Guide described below in the Foreword to the Original Edition.

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*The authors also thank the many partners and associates, and in particular Susan A. Mitchell and Christopher W. Myers, for their assistance in preparing the Original and Second Editions of this Guide.*

## FOREWORD (2012) (Original Edition)

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The Department of Defense (“DOD”) established, through what is called the “Business Systems Rule,” mandatory requirements for six contractor business systems, through changes to the DOD Federal Acquisition Regulation Supplement (“DFARS”), for contracts awarded after May 18, 2011. DFARS § 242.70; see also 76 Fed. Reg. 28,856 (May 18, 2011). The relevant business systems are: (1) accounting and billing; (2) estimating; (3) purchasing; (4) material management; (5) government property; and (6) earned value management. These requirements may become best practices for all government contracts.

The Business Systems Rule requirements reflect a combination of certain requirements that have existed for some time (such as the Cost Accounting Standards (“CAS”) and material management system requirements) with various criteria that the Defense Contract Audit Agency (“DCAA”) has attempted to apply for years (but without any authority to do so) and still other criteria that DCAA has sought to impose since the passage of the Sarbanes Oxley Act in 2002 and the effective date of the FAR Mandatory Disclosure Rule in 2008.

The Business Systems Rule also provides for mandatory financial penalties for any noncompliance that is deemed a “significant deficiency.” The government also may argue that the Business Systems Rule establishes “sound business practices,” creating the basis for the government to attack the reasonableness of costs resulting from a noncompliance with the Business Systems Rule. The Business Systems Rule, therefore, is not mere repackaging of existing requirements or business as usual.

Moreover, while the Business Systems Rule imposes mandatory requirements, it nevertheless continues to vest some discretion in contractors for achieving compliance with these requirements. It is the exercise of this discretion that government reviewing officials, including those from DCAA, the Defense Contract Management Agency (“DCMA”) and the Department of Justice, as well as potential qui tam relators, will assess to determine whether a particular business system requirement is being met.

For each of these reasons, contractors must establish for each of these six business systems, a compliance baseline that sets forth what the contractor has determined is required, given its circumstances, to meet a particular business system requirement. Contractors also must be prepared to show their compliance with these self-defined requirements.

## INTRODUCTION

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The Guide focuses on the DOD Business Systems Rule, with a separate focus on the DOE rule when appropriate, and provides detailed considerations, in question format, for assessing compliance with stated requirements and the various related compliance criteria that the rule identifies. The Guide does not address compliance requirements relating to other than the six business systems covered by the DOD Business Systems Rule or contractor best practices for mitigating the collateral risks that the Rule creates. Significant examples of risk mitigation best practices are how and when to: (1) flow down Business Systems Rule requirements to subcontracts; (2) apply indemnity clauses to address impacts of subcontractor noncompliance with applicable Business Systems Rule requirements; and (3) disclose information generated as a result of the Business Systems Rule under the Truth in Negotiations Act (“TINA”).

The Guide assumes that the user has familiarity with government contract requirements and related terms of art and trade usage. Thus, the Guide defines terms used only when needed based on Business Systems Rule requirements or for clarity.

The Guide does use several terms in a manner intended to assist in communicating the detailed considerations contained herein in as efficient a manner as possible, recognizing that users of the Guide will differ in legal structure, internal organization, size, and the goods and services being sold. Users, therefore, need to bear in mind how the following terms are used in the Guide and then make specific determinations based upon their circumstances.

First, with the exception of Chapter 1, Accounting and Billing Systems, the Guide uses the term “contractor.” This term is intended to apply to whatever legal entity or component of a legal entity bears the responsibility for compliance with the Business Systems Rule, whether at the prime contract or subcontract level. In contrast, Chapter 1 uses primarily the term “segment.” This term is used because CAS requirements are applied generally on a segment-by-segment basis.

Second, the Guide uses the term “contract.” This term is intended to include any prime contract subject to the Business Systems Rule and any subcontract that includes any Business Systems Rule obligations under a flowdown clause. “Contract” also includes all contract types.

And third, the Guide uses the terms “document,” “documentation” and “support.” These terms mean recorded information, whether in paper or electronic format.

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## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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### I. Overview

The Business Systems Rule imposes significant compliance requirements relating to government contract accounting systems. This rule is set forth at DFARS § 252.242-7006, which implements DFARS § 242.7503. These requirements apply to any contract subject to CAS. DFARS § 242.7500(a).

The Business Systems Rule defines “accounting systems” as:

“[T]he contractor’s system or systems for accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions, and may include subsystems for specific areas such as indirect and other direct costs, compensation, billing, labor, and general information technology.”

DFARS § 252.242-7006(a)(2).

The Business Systems Rule defines an “acceptable accounting system” as one that complies with the following requirements:

#### **Compliance requirements:**

- (i) [Compliance with] [a]pplicable laws and regulations . . . ;
- (ii) The accounting system and cost data are reliable;
- (iii) Risk of misallocations and mischarges are minimized; and
- (iv) Contract allocations and charges are consistent with billing procedures.

DFARS § 252.242-7006(a)(1).

## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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The Business Systems Rule specifies 18 system criteria for determining when a system meets the compliance requirements listed above. DFARS § 252.242-7006(c). These criteria reflect what has existed for some time (e.g., CAS and the Federal Acquisition Regulation (“FAR”) cost principles at FAR Part 31). Other criteria are new in that, while the government has viewed them as best practices, they have not been requirements. Below, each of these system criteria is aligned with one of the four overall compliance requirements, and the key considerations for assessing compliance with the criteria are presented.

When relating to CAS, FAR or DFARS cost principles, the questions in the following sections are designed to focus on compliance requirements at a level appropriate to permit the user to investigate the full nature of the relevant CAS, FAR or DFARS requirement. Thus, the questions in the sections below do not address everything contained in the CAS, FAR or DFARS cost principles. This section excludes unique and/or immaterial requirements, summaries of very detailed and complex requirements and discussions in the cost principles regarding costs that are not prohibited or limited. The reader is referred to the CAS, FAR and DFARS cost principles for a complete statement of their respective requirements.

### II. References

- DFARS Subpt. 242.75
- DFARS § 252.242-7006
- 48 C.F.R. Pts. 9901, 9903, 9904
- FAR Pt. 31
- FAR § 52.216-7
- FAR § 52.216-10
- FAR § 52.232-16
- FAR § 52.232-7
- DFARS Pt. 231

### III. Key Definitions

See 48 C.F.R. § 9903.301 and 48 C.F.R. § 31.001.

## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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### IV. Compliance with Laws and Regulations

**Compliance requirement:** compliance with applicable laws and regulations.

DFARS § 252.242-7006(a)(1)(i).

The Business Systems Rule sets out various criteria that relate to the requirement of complying with applicable laws and regulations. Meeting these criteria requires, essentially, complying with laws and regulations applicable to cost accounting systems and recognizing what costs, even when accounted for appropriately, are limited or prohibited. These laws and regulations are imposed through contract clauses that require compliance with: CAS; FAR, particularly FAR Part 31, but FAR Parts 3 and 28 are also relevant; and DFARS, particularly DFARS Part 231.

#### A. Government Contracts Cost Accounting

**Compliance criteria:**

- (2) Proper segregation of direct and indirect costs; . . .
- (4) A logical and consistent method for the accumulation and allocation of indirect costs to intermediate and final cost objectives; . . .
- (14) Segregation of pre-production costs from production costs; . . .
- (18) Accounting practices in accordance with standards promulgated by the Cost Accounting Standards Board, if applicable, otherwise, Generally Accepted Accounting Principles.

DFARS § 252.242-7006(c).

## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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Guidelines for assessing compliance with these government contract cost accounting system criteria are addressed below in the following manner:

1. CAS coverage requirements.
2. Consistency requirements found in CAS 401 and 402.
3. General cost measurement requirements in the CAS regulations.
4. General cost assignment requirements in CAS 406 and the CAS regulations.
5. Accounting for unallowable costs under CAS 405.
6. Allocation requirements in CAS 403, 410 and 418, as well as CAS 405.
7. Tangible capital assets (CAS 404 and 409).
8. Compensated absences (CAS 408).
9. Materials (CAS 411).
10. Pensions (CAS 412 and 413).
11. Deferred compensation (CAS 415).
12. Cost of money (CAS 414 and 417).
13. Insurance (CAS 416).
14. Independent research and development (“IR&D”) and bid and proposal (“B&P”) costs (CAS 420).
15. Standard costs (CAS 407).
16. CAS Disclosure Statement requirements.
17. CAS cost impact requirements.
18. Other accounting requirements.

## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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1. CAS Coverage Requirements
  - a. Has the segment ever been awarded a negotiated government prime contract or a subcontract where the government is the ultimate buyer having a value at award of \$7.5 million or greater that is not exempt from CAS under 48 C.F.R. § 9903.201-1(b)(1), (3) through (6), or (13) through (15), establishing the applicability of CAS to this contract?
  - b. During performance of the contract identified in paragraph a., which is called the “trigger contract,” has the segment been awarded any negotiated contract having a value at award of \$650,000 or greater that is not exempt from CAS under 48 C.F.R. § 9903.201-1(b)(1), (3) through (6), or (13) through (15), establishing the applicability of CAS to this contract?
  - c. During the performance of any contract identified in paragraph b., has the segment been awarded any negotiated contract having a value at award of \$650,000 or greater that is not exempt from CAS under 48 C.F.R. § 9903.201-1(b)(1), (3) through (6), or (13) through (15), establishing the applicability of CAS to this contract?
  - d. Did any of the contracts identified in paragraphs a. through c. above have a value of \$50 million or more at award, establishing an obligation of the segment under this contract and all subsequently awarded CAS-covered contracts to comply with all 19 CAS (“full CAS coverage”) as of the date of contract award?
  - e. Did the contracts identified in paragraphs a. through c. above awarded to a segment in any specific fiscal year have award values that, cumulatively, equaled or exceeded \$50 million, establishing an obligation for full CAS coverage for any CAS-covered contract awarded to the segment in its subsequent fiscal year?
  - f. For the contracts identified in paragraphs a. through c. above that are not covered by either paragraphs d. or e. above, did the segment comply with CAS 401, 402, 405 and 406 (“modified CAS coverage”) in accordance with FAR § 52.230-3?



## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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- (a) Is the CAS Disclosure Statement description of practices for distinguishing between a direct and indirect cost clear and correct? 48 C.F.R. § 9904.402-50(b).
  - (b) Does the stated criteria for classifying costs as direct or indirect ensure that costs incurred in like circumstances will be treated consistently? 48 C.F.R. § 9904.402-30(a)(3), (5).
  - (c) Is this criteria applied for both cost accounting and estimating purposes? 48 C.F.R. § 9904.402-50(a).
- (ii) Does the segment document the basis for its decision that a cost, while having the same purpose as other similar type costs, is incurred in differing circumstances, such as when a contract specifically requires a cost or a contract is terminated, thereby requiring a different accounting practice?
  - (iii) When costs having the same purpose are classified differently because of differing circumstances, does the segment ensure that allocation to final cost objectives is appropriate so as to avoid double charging?
3. General Cost Measurement Requirements
- a. Is each type of cost measured consistently to equal:
    - (i) Historical costs?
    - (ii) If not, does the segment have written approval to measure costs using present value or market value when not otherwise permitted by CAS or FAR? 48 C.F.R. § 9903.302-1(a).
  - b. Is each type of cost measured consistently on an actual cost or standard cost basis? 48 C.F.R. § 9903.302-1(a).

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4. Cost Assignment Requirements
  - a. General requirements (48 C.F.R. § 9903.302-1(b)):
    - (i) When assigning a measured cost to a specific accounting period, does the segment use, on a consistent basis, an accounting method or technique that is either an accrual or cash basis method or technique?
    - (ii) Does the selected method or technique result in assigning the cost to the accounting period that benefits from or causes the incurrence of the cost being assigned?
      - (a) Are start-up costs assigned to the period of incurrence?
      - (b) Are pre-production costs assigned to appropriate cost accounting periods?
        - (1) If the segment uses program accounting, or a similar deferral methodology, is this practice appropriate or approved?
        - (2) If deferral is used, is it applied to all like costs incurred in all similar circumstances?
  - b. CAS 406:
    - (i) Does the segment use as its accounting period for government contract accounting the same one-year period that the segment uses as its fiscal year for financial reporting? 48 C.F.R. § 9904.406-40(a).
      - (a) If the segment's accounting period is not its financial reporting fiscal year, has the government agreed to an accounting period that differs from the segment's fiscal year (48 C.F.R. §§ 9904.406-40(a)(2), -50(d)); or

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- (b) If there is a difference, is it because a transitional cost accounting period is being used because of a change in fiscal year (48 C.F.R. § 9904.406-40(a)(3))?
- (ii) Does the segment use consistent practices for cost deferrals, accruals or making other adjustments? 48 C.F.R. §§ 9904.406-40(b), -50(b).
- (iii) Does the segment develop its indirect cost pools using the same cost accounting period for developing pool bases, absent an agreement with the government that the cost accounting period for an allocation base may differ? 48 C.F.R. §§ 9904.406-40(c), -50(e).
- (iv) When an indirect function exists for only part of a year, and the related cost is assigned to only part of the relevant cost accounting period, is the assignment reasonable? 48 C.F.R. §§ 9904.406-40(a), -50(a).
- (v) If “quick closeout” rates are used to close contracts, are the rates appropriate? 48 C.F.R. § 9904.406-50(c).
- (vi) Regarding internal restructuring costs:
  - (a) Are significant costs of non-routine changes in operations or structure intended to reduce overall costs in future periods accumulated? 48 C.F.R. § 9904.406-61(b).
  - (b) Are accumulated costs capitalized and depreciated consistent with CAS 404 and 409 and the segment’s policies and procedures? 48 C.F.R. § 9904.406-61(c).
  - (c) Are accumulated, non-capital costs assigned to the year of incurrence when approved by the administrative contracting officer (“ACO”) or deferred and amortized over no more than five years? 48 C.F.R. § 9904.406-61(e), (h).

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- (d) Are deferred costs excluded from the cost of money calculation? 48 C.F.R. § 9904.406-61(i).
    - (e) Are assigned restructuring costs allocated to one or more segments consistent with the relevant beneficial or causal relationship? 48 C.F.R. § 9904.406-61(j).
- 5. Accounting for Unallowable Costs

See Ch. 1, § IV.A.18.
- 6. Cost Allocation
  - a. CAS 403:
    - (i) Do written procedures exist regarding the allocation of home office costs outside of the home office's CAS Disclosure Statement? If so, are these policies and procedures consistent with the CAS Disclosure Statement?
    - (ii) Are unallowable costs, including directly associated costs, excluded from or at least specifically identified in home office costs allocated to segments?
    - (iii) Are home office costs identifiable to one or more segments directly allocated to these segments? 48 C.F.R. § 9904.403-40(b).
    - (iv) Regarding centralized service functions (e.g., payroll, personnel, data processing) (48 C.F.R. § 9904.403-40(b)(1)):
      - (a) Does the home office identify all material centralized service functions?
      - (b) Is the cost of each material centralized service function allocated based upon the service furnished to, or received by, the segments? 48 C.F.R. §§ 9904.403-40(b)(1), -60(a).

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- (v) Regarding staff management of specific activities (e.g. policy guidance regarding accounting, manufacturing) (48 C.F.R. § 9904.403-40(b)(2)):
  - (a) Does the home office identify all material staff management service functions?
  - (b) Is the cost of each staff management service function allocated over a base representative of the total specific activity being managed? 48 C.F.R. §§ 9904.403-40(b)(2), -60(c).
- (vi) Regarding line management (e.g., management of one or more but not all segments) (48 C.F.R. § 9904.403-40(b)(3)):
  - (a) Does the home office identify all material line management functions?
  - (b) Is the cost of each material line management function allocated based upon total activity of the benefiting segments, if that function services more than one segment? 48 C.F.R. § 9904.403-40(b)(3).
- (vii) Regarding central payments (e.g., pension costs, group insurance or any other cost that exists because of a group of segments) (48 C.F.R. § 9904.403-40(b)(4)):
  - (a) Does the home office identify all material central payments?
  - (b) Is the cost of each central payment allocated over a base representative of the factor(s) upon which total payment is based? 48 C.F.R. §§ 9904.403-40(b)(4), -60(c); 48 C.F.R. Pts. 413 (pensions), 416 (insurance), 420 (IR&D and B&P).
- (viii) Regarding residual costs (i.e., any home office cost not directly allocated to segments or allocated to segments as described in paragraph (iii) through (vii) above) (48 C.F.R. § 9904.403-40(c)(1)):
  - (a) Does the home office identify all residual costs?

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- (b) Are the costs identified as residual costs allocated to segments over a base that is representative of the total activity of the segments unless the “three factor” formula defined in CAS § 403-50(c) is required? 48 C.F.R. §§ 9904.403-40(c), .405-50(c).
      - (c) When a segment receives significantly more or less benefit from any material residual expense than other segments, is that residual expense subject to a special allocation and is it agreed to by the government? 48 C.F.R. § 9904.403-50(d).
- b. CAS 410:
  - (i) Does the general and administrative (“G&A”) pool:
    - (a) Include only costs that benefit the segment as a whole or costs that should be allocated over a total activity base? 48 C.F.R. § 9904.410-50(b), (c).
    - (b) Exclude costs incurred for another segment that have been determined based upon an appropriate causal or beneficial relationship? 48 C.F.R. § 9904.410-50(a).
    - (c) Exclude unallowable costs?
    - (d) Exclude the centralized service functions, staff management and central payments and accruals, if significant, allocated to the segment under CAS 403 on a causal or beneficial relationship basis as home office expenses, and which are then allocated on an appropriate beneficial or causal basis (usually the same basis upon which they were allocated to the segment)? 48 C.F.R. § 9904.410-50(g).
    - (e) Include line management, directly identifiable costs and residual costs allocated to the segment under CAS 403 as home office expenses?

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- (ii) Is the G&A cost pool allocated over a single, appropriate total activity base; i.e., total cost, value added or single element basis? 48 C.F.R. §§ 9904.410-40(b), -50(d).
    - (a) Is the activity base chosen the most appropriate given the segment's circumstances?
    - (b) If a single activity base is not used, is the fragmentation necessary to recognize the need for a special allocation? 48 C.F.R. § 9904.410-50(j).
  - (iii) Are unallowable costs that should have G&A allocated to them (i.e., unallowable direct and overhead costs) included in the base? 48 C.F.R. § 9904.405.
- c. CAS 418:
  - (i) Does the segment maintain overhead cost rates that are appropriate to the segment's circumstances?
    - (a) Does a manufacturer of goods have at least a manufacturing, engineering and material handling overhead rate by location with significant costs, including foreign locations?
    - (b) Does a service provider have overhead rates that align with significant types of services provided at significant locations with significant costs, including foreign locations?
    - (c) Are all overhead pools homogeneous because: (1) each pool component has a similar beneficial or causal relationship to the activities included in the base; or (2) changing the allocation base for a particular cost in the pool would not materially impact the allocation? 48 C.F.R. §§ 9904.418-40(b), -50(b)(1), (2).

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- (d) Is each overhead pool allocated over an appropriate base?
  - (1) Are management or supervisory activities allocated over the activity managed? 48 C.F.R. §§ 9904.418-40(c), -50(d)(2).
  - (2) Is a special allocation of any cost required? 48 C.F.R. § 9904.418-50(f).
  - (3) Are other pools allocated over a consumption or output base? 48 C.F.R. § 9904.418-50(e).
- (ii) Does the segment maintain appropriate expense pool cost rates?
  - (a) Does the segment maintain appropriate expense pools, such as a fringe benefit and an occupancy pool?
  - (b) Is each pool homogeneous because: (1) each pool component has a similar beneficial or causal relationship to the activities in the allocation base; or (2) changing the allocation base for a particular cost in the pool would not materially impact the allocation? For example:
    - (1) Do fringe benefit costs vary materially by location, requiring multiple fringe benefit rates?
    - (2) Do occupancy costs vary materially by location, requiring multiple occupancy pools?
  - (c) Is each expense pool allocated over an allocation base that reflects the pool's beneficial or causal relationship to cost objectives, such as compensation as a base for fringe benefits and square footage for occupancy? 48 C.F.R. §§ 9904.418-40(c)(2), -50(e)(3).

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- (iii) Does the segment maintain appropriate service center rates?
  - (a) Does each service center pool result from a function that provides material services to other cost objectives?
  - (b) Is each service center pool homogeneous because it includes only costs of services that have a similar beneficial or causal relationship to the cost objectives using the services? 48 C.F.R. §§ 9904.418-40(c)(2), -50(e).
  - (c) Is each service center pool allocated based on a:
    - (1) Measure of consumption; or
    - (2) If not practical, a measure of output; or
    - (3) If not practical, a surrogate that measures the activity of the cost objectives receiving the service? 48 C.F.R. § 9904.418-50(e)(1), (3).
  - (d) Are unallowable costs excluded from all overhead, expense and service center cost pools? 48 C.F.R. § 52.216-7(a); see 48 C.F.R. § 9904.405-40, 48 C.F.R. § 42.709 (addressing costs expressly unallowable or specifically designated as unallowable in an ACO's final decision).
  - (e) Are directly associated costs excluded from all overhead, expense and service center cost pools unless the cost with which they are associated is included in the allocation base?
- (iv) Does the segment have written procedures regarding the calculation of overhead cost and G&A cost rates? If these procedures are other than those set forth in the segment's CAS Disclosure Statement, are the procedures in accordance with the practices disclosed in the CAS Disclosure Statement?

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- (v) Are estimated overhead and G&A rates developed in a manner consistent with the development of actual rates? 48 C.F.R. § 9904.401-40(a).
      - (i) Does the segment use a single set of indirect rates, estimated or actual, as appropriate (unless otherwise reviewed and approved), for the following purposes: (a) estimating costs for B&Ps; (b) estimates at completion (“EACs”); (c) billings and claims; (d) government reporting; (e) financial reporting; (f) IR&D, B&P and capital projects; and (g) intercompany cost transfers?
    - d. If the segment uses average costs or pre-established rates for labor, are these rates appropriate because either:
      - (i) The functions to which these rates are applied are not materially disparate and the employees are interchangeable with respect to these functions; or
      - (ii) Although functions are disparate, the employees are involved either in a single production unit yielding homogeneous outputs or perform as part of an integral team?
    - e. If pre-established direct or indirect cost rates are used for billing or other purposes, is the variance from actual costs, if material, spread in proportion to the costs previously allocated? 48 C.F.R. § 9904.418-50(a)(2)(ii), (g)(4).
- 7. Tangible Capital Assets
  - a. Are there written policies or procedures regarding capitalization of assets which:
    - (i) State that the capitalized value must be the acquisition cost? 48 C.F.R. § 9904.404-50(a), (b).
    - (ii) Describe the characteristics of the assets to be capitalized and set standards for capitalization which require that assets having a useful life in excess of two years and an acquisition cost greater than \$5,000 be capitalized? 48 C.F.R. § 9904.404-40(b)(1).

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- (iii) Provide for the identification of asset accountability units to the extent practical? 48 C.F.R. § 9904.404-40(b).
  - (iv) Provide criteria for the capitalization of improvements?
  - (v) Prohibit changing capitalized values because of an acquisition or merger?
- b. Do the segment's policies, procedures and practices for assigning depreciation costs to accounting periods require:
  - (i) Using a proper acquisition cost and service life and a method of depreciation that reflects the pattern of consumption of the asset? 48 C.F.R. §§ 9904.409-40(a), -50(a), (e), (f)(3).
  - (ii) Beginning the asset's service life when the asset is ready for use in a normal or expected fashion? 48 C.F.R. § 9904.409-50(b).
  - (iii) Depreciating individual assets or a group of assets on a consistent basis? 48 C.F.R. § 9904.409-50(d).
  - (iv) Taking into consideration residual values when appropriate? 48 C.F.R. § 9904.409-50(h).
  - (v) Using for contract costing, the same method of depreciation that is used for financial accounting purposes? 48 C.F.R. § 9904.409-50(f)(1).
- c. Are depreciation costs allocated to cost objectives:
  - (i) Directly, if the depreciation cost is determined on the basis of usage and are the depreciation costs for all like assets charged in this manner? 48 C.F.R. § 9904.409-40(b)(1).
  - (ii) Indirectly, in all other circumstances, through inclusion in an appropriate indirect cost pool? 48 C.F.R. § 9904.409-40(b)(2), (3).

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- d. Are gains and losses from the disposal or sale of an asset allocated as the depreciation for that asset would have been allocated? 48 C.F.R. §§ 9904.409-40(b)(4), -50(j); FAR § 31.205-16.
8. Compensated Personal Absence Costs
    - a. Are costs assigned to the period when the segment became liable to compensate the employee or, absent such a liability, when paid? 48 C.F.R. § 9904.408-40(a), -50(b).
    - b. Are compensated personal absence costs allocated on a pro rata basis over the entire cost accounting period? 48 C.F.R. §§ 9904.408-40(b), -50(e).
    - c. Is the liability for personal absence costs calculated correctly, including consideration of anticipated non-utilization and consistent use of either current or anticipated wage rates? 48 C.F.R. § 9904.408-50(c).
    - d. Does the segment appropriately use a suspense account either because of initial compliance with CAS 408 or because of a change in a plan or the creation of a new plan? 48 C.F.R. § 9904.408-50(d).
  9. Pension Costs
    - a. Does each deferred compensation plan classified as a pension plan provide for the systematic payment of benefits to plan participants after retirement that are paid for life or are payable for life at the participant's option? 48 C.F.R. § 9904.412-30(a)(20).
    - b. Is each pension plan in writing, and does it compel the plan sponsor to honor its pension liability, permitting cost recognition on an accrual basis; or may the plan sponsor unilaterally avoid its obligation, requiring cost recognition only when benefits are paid?
    - c. To measure the cost of a defined benefit plan (whether qualified or unqualified) on an accrual basis:

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- (i) Is the annual normal cost measured using:
  - (a) An immediate gain actuarial cost method (48 C.F.R. §§ 9904.412-40(b)(1), -50(b)(1)):
    - (1) That is a projected benefit cost method when the pension benefit is a function of salaries and wages?
    - (2) That is based on employee service when the pension benefit is not a function of salaries and wages? 48 C.F.R. § 9904.412-50(b)(2).
  - (b) Separately identified actuarial assumptions developed for government contract purposes that are the plan sponsor's best estimate of anticipated experience over the long term, considering past experience and reasonable expectations? 48 C.F.R. §§ 9904.412-40(b)(2), -50(b)(4), (6).
- (ii) Is an appropriate portion of an unfunded actuarial liability measured annually, using the same actuarial assumptions that are used to measure normal costs?
  - (a) Is an amortization period used that is applicable to the type of unfunded actuarial liability being amortized and applied on a consistent basis? 48 C.F.R. § 9904.412-50(a)(1), (3).
  - (b) Is any actuarial liability excluded that results from:
    - (1) Pension costs unallowable in previous years?
    - (2) Pension costs assigned to a previous period that were not funded in that year under the then applicable funding requirements in either CAS or FAR? 48 C.F.R. § 9904.412-50(a)(2).
- (iii) Are administrative expenses of the pension plan fund included, unless classified as G&A costs? 48 C.F.R. § 9904.412-50(a)(4).

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- (iv) Is the cost of any pension plan that supplements retirement benefits for all participants in the basic defined benefit plan included, even if the supplemental plan is a defined contribution plan, so long as, together, the plans provide a defined benefit to participants? 48 C.F.R. § 9904.412-50(a)(7).
  - (v) Is an interest equivalent on the unamortized portion of any unfunded actuarial liability included? 48 C.F.R. § 9904.412-40(a)(1).
  - (vi) Is an adjustment for any material actuarial gains and losses included that results from amortization over the year when the gain or loss is first recognized and 14 subsequent years (unless considered fully amortized because of the application of the assignable cost limitation), plus interest on the unamortized amount at the beginning of the year? 48 C.F.R. §§ 9904.413-40(a), -50(a).
  - (vii) Are pension costs measured using an actuarial value of plan assets that considers unrealized appreciation and depreciation of market value, so that the actuarial value falls within 80% to 120% of market value, based on a consistently applied actuarial method but that excludes any amount of a prepayment credit? 48 C.F.R. §§ 9904.412-50(a)(4); .413-40(b), -50(b).
- d. Is the annual cost of a defined contribution plan measured on an accrual basis, equaling the net contribution required to be made under the plan? 48 C.F.R. § 9904.412-40(a)(2).
  - e. Is the annual cost of a defined benefit pension plan, which is measured on a pay-as-you-go basis, the net amount of benefits paid for that period, plus an amortization installment based on 15 years (plus interest) attributable to amounts paid to irrevocably settle an obligation for benefits due in current and in future accounting periods, plus administrative costs? 48 C.F.R. §§ 9904.412-40(a)(3), -50(b)(3).

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- f. Are the pension costs measured for a fiscal year assigned only to that year in an amount:
  - (i) That does not include any amount funded in excess of measured costs, creating a prepayment credit? 48 C.F.R. § 9904.412-50(c)(1).
  - (ii) For qualified defined benefit pension plans, that is not less than zero or more than the assignable cost limitation? 48 C.F.R. §§ 9904.412-40(c), -50(c)(2)(i).
  - (iii) For nonqualified defined benefit plans, that is:
    - (a) An amount measured on an accrual basis consistent with the criteria in CAS § 412-50(c)(3)?
    - (b) An amount equaling a pay-as-you-go amount in any other circumstance?
  - (iv) For any defined benefit plans is the portion that exceeds the amount to be funded pursuant to a waiver under the Employment Retirement Income Security Act, 29 U.S.C. § 1001 *et seq.*, assigned as a cost deficit? 48 C.F.R. § 9904.412-50(c)(5).
  
- g. Are pension costs assignable to a fiscal year properly allocable to cost objectives in performance in that year because:
  - (i) The assignable cost of a qualified defined benefit pension plan is funded by the corporate tax filing date? 48 C.F.R. § 9904.412-50(d)(1), (d)(4).
  - (ii) The assignable cost of a nonqualified defined benefit pension plan is funded in accordance with CAS § 412-50(d)(2) by the corporate tax filing date?
  - (iii) The assignable cost of a plan accounted for on a pay-as-you-go basis equals the amount of benefits paid? 48 C.F.R. § 9904.413-50(d)(3).

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- h. Is cost accounting for defined benefit pension plans “harmonized” with the requirements of the Pension Protection Act? 48 C.F.R. § 9904.413-50(b)(7).
  - (i) Does the contractor separately determine minimum actuarial liability and minimum normal costs?
  - (ii) Does the contractor recognize minimum actuarial liability and minimum normal costs if those liabilities/costs exceed the amount of actual actuarial/normal costs for a fiscal period?
  - (iii) Is the contractor phasing in the concepts of minimum actuarial liability and minimum normal costs in accordance with 48 C.F.R. § 9904.412-64.1?
  - (iv) Is the actuarial gain or loss under the harmonized practices amortized over a ten-year period in accordance with 48 C.F.R. § 9904.413-50(a)(2)(ii)?
- i. Segment Pension Cost Accounting:
  - (i) Does the home office that incurs the pension cost measure, assign and allocate this cost on a segment-by-segment basis and, if not, should this be done based upon any of the criteria in CAS § 413-50(c)(2) or (3)?
  - (ii) When the segment pension accounting is used:
    - (a) Were the market value and actuarial value of pension plan assets allocated appropriately to segments when segment pension accounting began? 48 C.F.R. § 9904.413-50(c)(5).
    - (b) Was the actuarial accrued liability allocated appropriately to segments when segment pension cost accounting began? 48 C.F.R. § 9904.413-50(c)(5).

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- (c) After segment pension cost accounting began, did the segment record plan charges (e.g., contributions, accruals, benefit payments, earnings and expenses)? 48 C.F.R. § 9904.413-50(c)(7).
- (d) Are employee transfers between segments accounted for correctly? 48 C.F.R. § 9904.413-50(c)(8).
- (e) Does the cost for each segment:
  - (1) Include the cost of inactive participants assigned to the segment?
  - (2) Exclude inactive participants, with all inactive participants being included in a separate segment and the resulting cost being allocated to all other segments? 48 C.F.R. § 9904.413-50(c)(9).
- (f) Is any home office treated as a segment and the relevant pension costs allocated pursuant to CAS 403? 48 C.F.R. § 9904.413-50(c)(11).
- (g) Is the actuarial cost method used for cost measurement and cost assignment the same for all segments? 48 C.F.R. § 9904.413-50(c)(10).
- (h) Are the same actuarial assumptions used for all segments, unless segment accounting is required under CAS § 413.50(c)(2)(iii)? 48 C.F.R. § 9904.413-50(c)(10).
- (iii) When composite pension accounting is used for two or more segments:
  - (a) Is the composite pension cost allocated to the relevant segments on a basis representative of the factors that determine the pension benefits (e.g., salaries when salaries determine the benefits earned)? 48 C.F.R. § 9904.413-50(c)(1).

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- (b) For pension plan-wide measurements, when composite accounting is used for some, but not all, segments:
            - (1) Is the maximum tax deduction properly apportioned? 48 C.F.R. § 9904.413-50(c)(1)(i).
            - (2) Is the amount funded properly apportioned, which may include apportioning amounts funded first to segment(s) subject to CAS 413? 48 C.F.R. § 9904.413-50(c)(1)(ii).
        - j. Does the contractor identify all segment closings, plan curtailments and plan terminations and comply with CAS § 413.50(c)(12) by submitting the required calculation within a reasonable time?
10. Deferred Compensation Costs
  - a. Does the segment maintain or participate in a compensation plan that makes awards to employees for services rendered in one year with a right to compensation in one or more future years that is not a pension plan (as defined above) or a bonus plan requiring payment within a reasonable time after the end of an accounting period? 48 C.F.R. § 9904.415-30(a)(1).
  - b. Are deferred compensation costs assigned to the accounting period:
    - (i) When the obligation to pay future compensation arises; or
    - (ii) When no obligation exists prior to payment, when the payment is made? 48 C.F.R. §§ 9904.415-40(a), -50(a), (b).

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- c. Are deferred compensation costs, for a deferred compensation plan that uses an employee stock ownership plan (“ESOP”), assigned to the period when the cash or stock awarded to an employee is allocated to the employee, so long as the allocation occurs by the contractor’s federal tax filing date for the period of the award or, if not, to the subsequent period? 48 C.F.R. § 9904.415-50(f)(2).
- d. Does the cost assigned to a year equal the present value of future benefits when an award is made in money under a plan other than an ESOP? 48 C.F.R. § 9904.415-40(b)(1), -50(d).
  - (i) Does the measurement of the amount of an award properly consider the plan’s provisions for specified, and unspecified, interest rates or for no interest? 48 C.F.R. § 9904.415-50(d)(1)-(3).
  - (ii) Does the measurement of the amount of an award apportion the amount of the award over any period of future performance established as a condition of receipt of the award? 48 C.F.R. § 9904.415-50(d)(4).
  - (iii) Is the present value of the amount of the award based upon the rate specified in CAS § 415-50(d)(5), unless the award results in irrevocable funding to a third party, resulting in a cost that equals the amount funded under CAS § 415-50(d)(6)?
  - (iv) Are forfeitures appropriately accounted for? 48 C.F.R. § 9904.415-50(d)(7), (8).
- e. Does the cost assigned to a year equal the present value of future benefits when an award is made in other than money under a plan other than an ESOP? 48 C.F.R. §§ 9904.415-40(b)(1), -50(e).
  - (i) Is the cost for an award of compensation in the form of stock or stock options based upon the relevant stock values as of the measurement date? 48 C.F.R. § 9904.415-50(e)(1), (2), (7).

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- (ii) Is the cost of a nonmonetary award in other than stock or stock options based upon the proper value as of the award date? 48 C.F.R. § 9904.415-50(e)(4).
      - (iii) If receipt of the award requires performance of future services, is the cost assigned to current and future periods? 48 C.F.R. § 9904.415-50(e)(3), (5).
      - (iv) Are forfeitures accounted for appropriately? 48 C.F.R. § 9904.415-50(e)(6).
    - f. Does the cost for an ESOP assigned to a year equal the amount the contractor contributed to the ESOP trust? 48 C.F.R. § 9904.415-40(b)(2).
  - 11. Insurance Costs
    - a. Does the contractor or a segment purchase insurance or make payments to a trust fund?
      - (i) Is the payment prorated over appropriate periods so that the appropriate cost is recognized in the appropriate accounting periods?
      - (ii) Is the appropriate amount of a deposit determined and recognized in the appropriate future accounting period(s)? 48 C.F.R. § 9904.416-40(a), -50(a)(1).
    - b. When risk is self-insured, is the insurance charge for each period equivalent to the projected average loss for the risk insured?
      - (i) Is the projected average loss measured by a premium that would have been paid to an insurance company for available insurance if the contractor or segment were not self-insured? 48 C.F.R. § 9904.416-50(a)(2)(i).
      - (ii) Is the projected average loss based upon a reasonable actuarial assessment that considers past actual losses and projected future losses and not actual losses for an accounting period?



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- (iv) Develops a factor for each indirect cost pool that equals the measured cost of money divided by an allocation base that is consistent with how the relevant indirect cost pool is allocated to cost objectives? 48 C.F.R. § 9904.414-50(c)(3).
    - (v) Charges the applicable cost of money to each contract subject to full CAS coverage, calculated by multiplying the calculated factor for an indirect cost pool by the amount of the allocation base units (e.g., labor hours) applicable to the contract? 48 C.F.R. § 9904.414-50(c)(3).
  - b. Is the cost of money applicable to investments in capital assets for a segment's own use properly measured and included in the capitalized acquisition cost of the assets? 48 C.F.R. § 9904.417-40.
- 13. IR&D and B&P Costs
  - a. Are there written policies and procedures regarding classification of projects as IR&D or B&P (and related efforts, such as manufacturing and production engineering or selling activities) that:
    - (i) Contain appropriate definitions from FAR and CAS? FAR § 31.205-18(a); 48 C.F.R. § 9904.420-30.
    - (ii) Require that projects be reviewed, prior to beginning work, for classification as IR&D or B&P (or related indirect efforts, such as manufacturing and production engineering or selling activities) or as contract effort, and is a specific determination made that work classifiable as indirect IR&D or B&P (or related efforts) is not sponsored by or not required in performance of a contract?
    - (iii) Require a determination regarding whether a change in classification of a project is necessary due to changes in circumstances (e.g., a contract has been awarded that now sponsors or requires work that was classified previously as IR&D or B&P)?

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- (iv) Assign responsibility to an appropriate individual or group for classifying each project?
    - (v) Require that the individual or group responsible for classifying a project provide information regarding the classification of a project as IR&D or B&P (or related efforts) to those responsible for accounting for the costs of the project and those performing the project?
  - b. Does the CAS Disclosure Statement contain appropriate descriptions, consistent with written policies and procedures, regarding when an R&D and B&P effort generates indirect IR&D and B&P costs, as opposed to direct costs, such as stating that IR&D and B&P exists unless a contract specifically requires the effort in its terms and conditions or statement of work, or the contract price is intended to include the cost of the effort?
  - c. Are direct and overhead costs allocable to IR&D and B&P projects accumulated for individual projects? 48 C.F.R. §§ 9904.420-40(a), (b), -50(a).
  - d. Are the direct and indirect costs accumulated for each individual IR&D or B&P project accumulated into IR&D and B&P cost pools? 48 C.F.R. § 9904.420-40(b), (c), -50(b).
    - (i) Are costs of projects for other segments that do not benefit the performing segment transferred to the benefitting segment? 48 C.F.R. § 9904.420-50(d).
    - (ii) Are costs of projects for other segments that also benefit the performing segment transferred to an appropriate home office for allocation under CAS 403? 48 C.F.R. § 9904.420-50(d).
  - e. Are IR&D and B&P costs allocated to segments:
    - (i) By direct identification, when possible? 48 C.F.R. § 9904.420-50(e)(1).
    - (ii) By special allocation based upon benefits received when the costs benefit some but not all segments? 48 C.F.R. § 9904.420-50(e)(2).

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- (iii) By inclusion in the home office's residual costs when no other allocation means applies? 48 C.F.R. § 9904.420-50(e)(2).
  - f. Do the segment's IR&D and B&P cost pools include all allocable business unit direct and indirect costs and all home office allocations?
  - g. Is the total of the segment's IR&D and B&P cost pools accumulated and allocated using the segment's G&A base, unless the business unit and the government agree that a special allocation is appropriate? 48 C.F.R. §§ 9904.420-40(e), -50(f)(2).
  - h. Are measured IR&D and B&P costs assigned to the period of incurrence? 48 C.F.R. § 9904.420-40(f).
  - i. *For more detailed guidance regarding IR&D and B&P costs, refer to Dentons' "IR&D, B&P, Selling and Related Costs Under Federal Government Contracts - A Practical Guide."*
- 14. Cost of Materials

See Ch. 5, Material Management and Accounting Systems.
- 15. Standard Costs
  - a. Does the segment maintain standard costs (not average costs) that are:
    - (i) Labor cost at standard based upon either a labor rate standard or a labor hour standard or both? 48 C.F.R. §§ 9904.407-30(a)(1)-(3), -50(a)(1)-(3).
    - (ii) Material cost at standard that is based upon a material price standard or a material quantity standard or both? 48 C.F.R. §§ 9904.407-30(a)(4)-(6), -50(b).
    - (iii) Labor and material cost variances that equal the difference between standard costs and actual costs? 48 C.F.R. §§ 9904.407-30(a)(9), -50(d)(1).

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- b. Are the standard costs used for estimating, accumulating and reporting labor and material costs? 48 C.F.R. § 9904.407-40.
- c. Are the standard costs entered into the segment's accounting records (although variance allocations may be by memorandum record)? 48 C.F.R. §§ 9904.407-40(a), -50(e).
- d. Are standard costs and variances appropriately accounted for at the production unit level, with each production unit being a group of activities that uses homogeneous direct labor and direct material inputs, or yields homogeneous outputs? 48 C.F.R. § 9904.407-40(b); see 48 C.F.R. § 9904.407-30(a)(7).
- e. Are practices for setting and revising standards, use of standards and disposition of variances stated in writing and followed consistently? 48 C.F.R. § 9904.407-40(c).
  - (i) Are material standards described accurately so that it is clear when material price and/or material quantity are at standard? 48 C.F.R. § 9904.407-50(a)(2), (b)(1).
  - (ii) Are labor standards described accurately so that it is clear when labor hours and/or labor rates are at standard? 48 C.F.R. § 9904.407-50(a)(3), (4).
- f. Are variances appropriately accumulated and allocated?
  - (i) Are material price variances appropriately accumulated and allocated annually? 48 C.F.R. § 9904.407-50(b)(2)-(6).
  - (ii) Are labor cost variances recognized at the time labor costs are charged to a production unit and accumulated in a labor cost variance account for each production unit? 48 C.F.R. § 9904.407-50(c).

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- (iii) Are variances disposed of in either of the following manners:
            - (a) Variances that are material in amount are allocated annually to final cost objectives on the basis of the respective standard costs allocated to the cost objective or units of output when output is homogeneous?
            - (b) Variances that are immaterial are included in appropriate indirect cost pools? 48 C.F.R. § 9904.407-50(d).
        - g. Are standards initially determined using appropriate bases and criteria, and revised as necessary to maintain accurate standards? 48 C.F.R. § 9904.407-50(a)(1).
        - h. Are initial and revised standards supported by documentation and analysis?
16. CAS Disclosure Statement Requirements
  - a. Have Sections I through VII of the CAS Disclosure Statement been completed for:
    - (i) Any segment selected to receive a CAS-covered contract, valued at the time of selection of \$50 million or more, including options and maximum requirements and indefinite ordering quantities? 48 C.F.R. § 9903.202-1(b)(1).
    - (ii) Any legal entity that, together with its segments, was awarded CAS-covered contracts, valued as of the date of award, totaling \$50 million or more, including options and maximum requirements and indefinite ordering quantities, in its most recent accounting period? 48 C.F.R. § 9903.202-1(b)(2).

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- (iii) Any segment of a legal entity subject to paragraph (ii) above, whose costs, included in the total price of any CAS-covered contract, exceed \$650,000, unless:
      - (a) The contract is of a type or value exempted by 48 C.F.R. § 9903.201-1(b); or
      - (b) In the segment's most recent cost accounting period, the segment's CAS-covered awards are less than 30% of the segment's total sales and less than \$10 million? 48 C.F.R. § 9903.202-1(c).
  - b. Has Section VIII of the CAS Disclosure Statement been completed for each home office that allocates costs to any segment with a CAS Disclosure Statement? 48 C.F.R. § 9903.202-1(d).
  - c. Is each completed section of the CAS Disclosure Statement accurate, complete and current?
  - d. Has each CAS Disclosure Statement been submitted to the cognizant ACO and auditor? 48 C.F.R. § 9903.202-5(b).
    - (i) Has the CAS Disclosure Statement been found adequate?
    - (ii) Has the CAS Disclosure Statement been found compliant?
  - e. Do written policies and procedures exist that set forth:
    - (i) Adequate requirements for completion and submission of an appropriate CAS Disclosure Statement?
    - (ii) Adequate requirements for amending an existing CAS Disclosure Statement?
      - (a) Is the CAS Disclosure Statement reviewed at least annually?

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- (b) Are there processes to ensure that business organization changes and accounting changes are communicated timely to the individuals responsible for maintaining an accurate, complete and current CAS Disclosure Statement?
- (iii) The requirement to measure the value of an award to include the value of all priced options, the maximum value of an ID/IQ contract, or the value of each delivery order issued under a basic ordering agreement?

### 17. Cost Impact Requirements

- a. Does the segment maintain an accurate, complete and current list of contracts showing, for each: (1) the date of award; (2) the date of performance completion; (3) the contract value at award; and (4) the applicable CAS coverage (i.e., none, modified or full)?
- b. Does the segment have policies, procedures and practices to ensure that business organization changes, accounting changes and accounting issues are communicated timely to the individuals responsible for determining when a change in cost accounting practice or a CAS noncompliance has occurred?
- c. Does the segment have policies, procedures and practices for complying with the requirements of FAR §52.230-6, including:
  - (i) Assigning responsibility for determining when a cost impact statement may be required and preparing a required cost impact?
  - (ii) How to measure increased and decreased costs to the government for voluntary (unilateral) changes in cost accounting practice, involuntary (required) changes in cost accounting practice and noncompliances with any of the 19 CAS?
  - (iii) How to measure increased and decreased costs to the government by contract type?

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- (iv) When cost impacts on each contract type may be offset against each other?
  - (v) Ensuring the timely submission of a general dollar magnitude proposal?
  - (vi) Ensuring the timely submission of a detailed cost impact proposed, when required?
18. Other Accounting Requirements
- a. Cost Accounting Policies and Procedures
    - (i) Is “cost” defined to include any obligation or consumption of resources under a consistently applied generally accepted method for defining cost? See *Rumsfeld v. United Techs. Corp.*, 315 F.3d 1361 (Fed. Cir. 2003); FAR § 31.201-1.
  - b. Uncompensated Overtime:
    - (i) Does the segment describe its uncompensated overtime policy in its CAS Disclosure Statement and/or in written policies and procedures that either:
      - (a) Require recording of eight hours per day consistent with a reasonable basis for apportioning hours; or
      - (b) Require recording all hours worked?
    - (ii) Does the segment’s accounting practices for labor costs measure costs of exempt labor in accordance with the segment’s policy on uncompensated overtime?
    - (iii) Does the segment estimate labor costs consistent with its uncompensated overtime practice?
    - (iv) Does the segment calculate estimated and actual indirect cost rates consistent with its uncompensated overtime practice?

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- c. Environmental Cleanup Costs:
  - (i) Does the segment measure environmental costs:
    - (a) Based upon incurred costs for cleanup activities that occurred in the accounting period?
    - (b) Based upon the accrual of a liability in an accounting period for future activities that are probable to occur, and is the amount of the liability capable of reasonable determination and recognized for generally accepted accounting principles (“GAAP”) purposes?
    - (c) By reducing measured costs in an accounting period for cost recoveries from insurance companies, potentially responsible parties or other third parties?
  - (ii) Does the segment assign measured costs to the period of incurrence unless capitalization is required to the extent costs result from efforts that are betterments, improvements or relate to sale of a property?
  - (iii) Are costs which are properly allocable directly to a past or current contract allocated to and recovered under this contract?
  - (iv) Are assigned costs incurred by a segment that are not allocated as direct costs allocated:
    - (a) As G&A costs, when the costs benefit only the segment?
    - (b) By transfer to the appropriate home office when costs benefit another segment or benefit the incurring segment and at least one other segment?

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- (v) Are assigned costs, that a home office either incurs or receives by a transfer of costs from a segment, allocated in accordance with CAS 403 so that:
    - (a) Existing segments that caused the contamination are allocated the costs, including segments that are now performing the work of the closed segment that caused the contamination?
    - (b) All segments of a contractor are allocated costs caused by a segment that is no longer operational?
  - (vi) Do the segments receiving an allocation from a home office allocate these costs as G&A costs?
- d. Post Retirement Benefit (“PRB”) Costs (FAR § 31.205-6(o)):
- (i) Are there costs for PRBs, other than pension benefits, that are provided pursuant to:
    - (a) Law?
    - (b) An employer-employee agreement, including a collective bargaining agreement?
    - (c) An established practice applied consistently so that employees have an expectation of receiving benefits?
  - (ii) Are PRB costs:
    - (a) Measured by the cost paid for benefits provided and assigned to the year in which the benefits are provided or payment is made on behalf of beneficiaries to a fund, such as a voluntary employee benefits association, or an insured or other third-party fund (i.e., pay-as-you-go accounting)?

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- (b) Measured by the amount paid to an insurer or trustee to fund the liability upon employee termination and assigned over a 15-year period beginning in the year of payment (i.e., terminal funding accounting)?
    - (c) Measured and assigned on an actuarial basis (i.e., accrual accounting) so that:
      - (1) Current period costs are measured and assigned in accordance with FAR § 31.205-6(o)(2)(iii)?
      - (2) Any transition obligation is measured and assigned in accordance with FAR § 31.205-6(o)(2)(iii)(A)(1)?
    - (iii) Do measured PRB costs include only the costs of benefits provided to individuals entitled to receive PRB benefits under law, agreement or consistently applied practice?
    - (iv) Are the assets and liabilities of any PRB fund appropriately accounted for during the existence of the fund and at the fund's termination?
  - e. Employee Benefit Costs Other Than Costs for Pensions, PRBs and Compensated Personal Absence:
    - (i) Are these benefits provided pursuant to law, agreement or a consistently applied practice?
    - (ii) Are the costs measured and assigned on a consistent basis, on either a pay-as-you-go or accrual basis?
    - (iii) Do the measured costs include only the costs of benefits provided to individuals entitled to receive these benefits under law, agreement or consistently applied practice?

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- (iv) Are the assets and liabilities of any fund established for employee benefits, such as a voluntary employee benefits association, appropriately accounted for during the existence of the fund and at the fund's termination?
- f. Credits (FAR § 31.201-5):
  - (i) Are any amounts received or accrued, other than as the result of business as usual buy/sell transactions, identified as a credit (i.e., reduction to the related allowable cost) when the amount relates directly to a measured allowable cost because, among other things:
    - (a) The amount represents earnings or other income on the allowable cost, such as interest on funds accounted for as allowable and deposited with a third party?
    - (b) The amount represents a return or a reduction of the allowable cost, such as: (1) insurance premium rebates; (2) retrospective adjustments or retrospective discounts, such as volume discounts; or (3) tax refunds?
  - (ii) Are identified credits measured appropriately?
  - (iii) Are measured credits assigned consistently to either the year of receipt or the year to which the allowable cost was assigned?
  - (iv) Are assigned credits allocated in a manner consistent with the allocation of the cost being reduced and the materiality of the credit?
- g. Gains and Losses on Disposition or Impairment of Depreciable Property:
  - (i) Do measured losses exclude any amounts relating to an impairment write down? FAR § 31.205-16(i).

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- (ii) If CAS 409 is not applicable, are the specified cost measurement, assignment and allocation requirements followed for dispositions other than a sale leaseback? FAR § 31.205-16(a), (c)-(g).
  - (iii) Are gains and losses for a sale leaseback measured appropriately? FAR §§ 31.205-16(b), -36(b).
  - (iv) Are gains and losses on the sale of land and other non-depreciable capital assets excluded from costs? FAR § 31.205-16(h).
- h. Severance Cost Allocation:
- (i) Is normal severance allocated to all work of the segment? FAR § 31.205-6(g)(4).
  - (ii) Is abnormal severance measured on a pay-as-you-go-basis and allocated so that the government pays its fair share based on the circumstances? FAR § 31.205-6(g)(5).
- i. Manufacturing and Production Engineering Costs:
- (i) Are these costs measured: (a) to include the costs of technical development effort relating to manufacturing, such as processes and systems and materials; and (b) to exclude costs of basic or applied research and costs of development of a product for sale? FAR § 31.205-25(a), (b).
  - (ii) Are these costs capitalized in accordance with the segment's capitalization criteria? FAR § 31.205-25(c).
  - (iii) Are these costs allocated through an appropriate overhead pool?
  - (iv) For more detailed guidance regarding MP&E costs, refer to Dentons' *"IR&D, B&P, Selling and Related Costs Under Federal Government Contracts - A Practical Guide."*

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- j. Advance Agreements:
  - (i) Does the segment comply with accounting requirements set forth in advance agreements in its contracts?
  - (ii) Does the segment comply with accounting requirements set forth in advance agreements entered into under FAR § 31.109?
- k. Accounting requirements for identified unallowable costs (see Ch. 1, § IV.B, regarding the identification of unallowable costs):
  - (i) Regardless of the applicability of CAS 405:
    - (a) Are expressly unallowable costs, including directly associated costs that are material, segregated and excluded from any billing, claim or rate submission to the government? 48 C.F.R. § 9904.405-50(a), (b); FAR § 31.201-6(a), (c)(1).
    - (b) Are costs that have been designated as unallowable pursuant to an ACO's decision specifically identified in any billing, claim or proposal submitted to the government? 48 C.F.R. § 9904.405-40(b); FAR § 31.201-6(b).
  - (ii) Does the segment's chart of accounts or a written procedure define each cost in accordance with FAR Part 31 and DFARS Part 231, identifying expressly or designated unallowable costs, as well as any other cost that may not be claimed, in whole or in part, in certain circumstances?
  - (iii) Does the segment use statistical sampling to measure and accumulate unallowable costs where:
    - (a) The sampling procedures comply with FAR § 31.201-6(c)(2)?

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- (b) The sampling procedures are subject to an advance agreement with the cognizant government official? FAR § 31.201-6(c)(4).
  - (iv) Do unallowable costs include salary costs when:
    - (a) Salary costs of a particular activity are identified in regulation or contract as unallowable; or
    - (b) Salary costs result from time spent on a proscribed activity, and this time generates salary costs that are material under FAR § 31.201-6(e)(1)?  
FAR § 31.201-6(e)(2).
  - (v) Do unallowable costs include non-salary costs that are material and are directly associated costs of a proscribed activity because the costs would not have been incurred but for the unallowable activity?  
FAR § 31.201-6(a).
- I. Cost Allocation:
- (i) Does the segment define and allocate direct costs in accordance with FAR §§ 31.201-4 and 31.202 on a consistent basis when CAS is not applicable?
  - (ii) Does the segment define and allocate indirect costs in accordance with FAR §§ 31.201-4 and 31.203 on a consistent basis when CAS is not applicable?

### B. Contract Cost Principles

**Compliance criteria:** exclude “from costs charged to Government contracts of amounts which are not allowable . . . under [FAR] part 31, Contract Cost Principles and Procedures, and other contract provisions; . . .”

DFARS § 252.242-7006(c)(12).

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1. Does the segment maintain written policies and procedures addressing compliance with FAR Part 31 and DFARS Part 231?
2. Does the segment consider as unallowable, costs that are unreasonable because the costs are not of a type or in an amount that a reasonably prudent business person would have incurred in the circumstances? FAR §§ 31.201-2(a)(1), -3.
3. Does the segment consider as unallowable, costs that are not allocable to government contracts based upon an appropriate beneficial or causal relationship? FAR §§ 31.201-2(a)(2), -4.
4. Does the segment consider as unallowable, costs not accounted for in accordance with CAS or, if CAS is not applicable, GAAP? FAR § 31.201-2(a)(3).
5. Does the segment identify as “unallowable” costs (i.e., costs prohibited or limited pursuant to FAR § 31.201-2(1)(4) and (5)), the following costs:
  - a. Advertising costs, except those that are required by a contract and relate to contract requirements for scarce materials, disposal of scrap or surplus materials, the promotion of products usually sold to the U.S. government, or certain recruitment costs? FAR §§ 31.205-1(d), (f), -34.
  - b. Public relation costs, except those listed in FAR § 31.205-1(e)?
  - c. Costs of bad debts, including directly associated costs? FAR § 31.205-3.
  - d. Personal Compensation Payments:
    - (i) General
      - (a) Costs of any element not paid under an established compensation plan or plan consistently applied? FAR § 31.205-6(a)(3).
      - (b) Cost of any element that is unreasonable? FAR § 31.205-6(a)(2), (b).

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- (c) Costs for work performed in prior accounting periods unless the compensation falls within FAR § 31.205-6(g), (h), (j), (k), (m) or (o)? FAR § 31.205-6(a)(1).
- (d) For defense contracts, personal compensation in excess of the normal salary paid, that are part of restructuring costs associated with a business combination? DFARS § 231.205-6(a).
- (ii) Executive compensation in any accounting period in excess of the stipulated amount set forth in statute or regulation? FAR § 31.205-6(p).
- (iii) Special compensation in excess of normal severance pay that is paid because of a merger, reorganization or change in management control? FAR § 31.205-6(l).
- (iv) Severance pay:
  - (a) For other than an involuntary termination?
  - (b) Not required by law, employer-employee agreement, established policy that, in effect, constitutes an implied agreement, or circumstances of the particular employment? FAR § 31.205-6(g)(2).
  - (c) Made despite employment with a replacement contractor offering a continuity of employment and benefits? FAR § 31.205-6(g)(3).
  - (d) Made to foreign nationals performing a contract outside of the United States in excess of amounts typically paid to employees in performing similar services in a similar industry? FAR § 31.205-6(g)(6).
- (v) Pension costs not accounted for in accordance with CAS 412 and 413? FAR § 31.205-6(j).
- (vi) Deferred compensation costs not accounted for in accordance with CAS 415? FAR § 31.205-6(k).

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- (vii) Costs associated with the use of company cars for personal reasons, including commuting to and from work? FAR §§ 31.205-6(m)(2), -46(d).
  - (viii) Compensation paid in corporate securities to the extent that the cost:
    - (a) Exceeds the securities' fair market value on the date the number of awarded securities are known? FAR § 31.205-6(d)(2).
    - (b) Is based on changes in the price of the corporate securities? FAR § 31.205-6(d)(2)(i).
  - (ix) Income tax differentials relating to domestic assignments? FAR § 31.205-6(e).
  - (x) Backpay not for actual work performed or not paid pursuant to a settlement order or decree? FAR § 31.205-6(h).
  - (xi) Employee rebate and discounts programs? FAR § 31.205-6(n).
  - (xii) ESOP costs that do not meet the applicable funding and cost measurement requirements? FAR § 31.205-6(q)?
- e. Contingency costs, meaning costs of a possible future event or condition so long as the outcome is indeterminate? FAR § 31.205-7.
  - f. Contributions and donations? FAR § 31.205-8.
  - g. Cost of money:
    - (i) Not accounted for in accordance with CAS 414 or 417? FAR § 31.205-10.
    - (ii) Precluded by a contract term?

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- h. Depreciation costs that:
  - (i) Exceed the amounts used for financial reporting purposes based on non-government business procedures when CAS 409 is not applicable? FAR § 31.205-11(c).
  - (ii) Are based upon the price of acquiring an asset from an affiliate under common control unless consistent with the practice of all affiliates under common control to depreciate assets acquired from an affiliate at the transfer price? FAR § 31.205-11(e).
  - (iii) Relate to fully depreciated assets, although a reasonable use charge is allowable? FAR § 31.205-11(f).
  - (iv) Relate to assets reacquired after disposition in a sale leaseback to the extent that the costs are measured using a net book value other than the net book value at the time of the sale leaseback, as adjusted? FAR § 31.205-11(g)(3).
  - (v) Exceed the depreciation costs of a “capital lease” measured in accordance with Financial Accounting Standard No. 13 (FAR § 31.205-11(h)), as modified:
    - (a) If a sale leaseback is involved to calculate the depreciation cost using the net book value of the lessee at the time of the transaction? FAR § 31.205-11(h)(1).
    - (b) If the lease is with an affiliate under common control? FAR § 31.205-11(h)(2).
- i. Employee morale costs that relate to:
  - (i) Gifts unless intended to be performance or achievements awards made pursuant to an established plan or policy? FAR § 31.205-13(b).
  - (ii) Recreation unless for company teams or organizations? FAR § 31.205-13(c).

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- (iii) Losses from food and dormitory services unless the segment intends to generate these services on a break-even basis or exceptional circumstances exist? FAR § 31.205-13(d)(i), (iii).
- j. Entertainment costs, including the cost of country clubs, airline clubs, predominantly social functions, alcoholic beverages, etc.? FAR §§ 31.205-14, -51.
- k. Fines resulting from violations of federal, state, local or foreign laws or regulations, unless incurred under the specific term of a contract or pursuant to written instructions from the PCO? FAR § 31.205-15(a).
- l. Costs incurred because of cost mischarging, including costs to identify and measure the amount of the mischarging and to remedy or correct the mischarging? FAR § 31.205-15(b).
- m. IR&D and B&P costs:
  - (i) Not accounted for in compliance with CAS 420 (FAR § 31.205-18), except the following are allowable costs:
    - (a) IR&D costs assigned to future years as deferred IR&D pursuant? FAR § 31.205-18(d).
    - (b) IR&D costs required in the performance of a cooperative arrangement, to the extent unfunded? FAR § 31.205-18(e).
  - (ii) For DOD “major contractors,” (i.e., contractors with covered segments allocating more than \$11,000,000 IR&D/B&P costs to covered contracts during the preceding fiscal year, after segments allocating less than \$1,100,000 of IR&D/B&P costs to covered contracts during the preceding fiscal year are excluded—see DFARS § 231.205-18(a)):
    - (a) IR&D allocations relating to projects that are not “of potential interest to DoD.” See DFARS § 231.205-18(c)(iii)(B).

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- (b) Not reported to the Defense Technical Information Center (DTIC) using the DTIC's on-line input form. See DFARS § 231.205-18(c)(iii) (C).
      - (iii) For more detailed guidance regarding IR&D and B&P costs, refer to Dentons' *"IR&D, B&P, Selling and Related Costs Under Federal Government Contracts - A Practical Guide."*
  - n. Insurance costs:
    - (i) Not accounted for in accordance with CAS 416?
    - (ii) Of purchased insurance, to the extent in excess of stated limitations applicable to insurance purchased from a fronting insurance company? FAR § 31.205-19(d)(2).
    - (iii) Of a self insurance plan:
      - (a) When the plan is not approved under FAR Part 28? FAR § 31.205-19(c)(2).
      - (b) To the extent that plan costs, plus administrative costs, exceed the cost of available insurance? FAR § 31.205-19(c)(3).
      - (c) For a catastrophic risk? FAR § 31.205-19(c)(4).
      - (d) To the extent that plan costs exceed any of the various limitations found in FAR § 31.205-19(e)?
  - o. Interest and other costs associated with raising capital? FAR § 31.205-20.
  - p. Legislative lobbying costs for:
    - (i) Influencing the outcome of federal, state or local elections or the legislative process? FAR § 31.205-22(a)(1), (3), (4).
    - (ii) Establishing, administering, contributing to or paying the expenses of a political party or related group? FAR § 31.205-22(a)(2).

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- (iii) Legislative liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, or analyzing the effect of legislation? FAR § 31.205-22(a)(5).
  - (iv) Attempting to improperly influence an employee or officer of the Executive Branch of the U.S. Government to give consideration to or act regarding a regulatory or contract matter? FAR § 31.205-22(a)(6); see 31 U.S.C. § 1352 (“Byrd Amendment”).
  - (v) Those activities that are the subject of the required certification, properly executed after an adequate review? FAR §§ 31.205-22(d); 42.703-2(a).
- q. Costs of materials equaling the price for materials transferred between divisions, subsidiaries or affiliates under a common control that exceed the transferring organization’s costs, unless the criteria in FAR § 31.205-26(e) and (f) have been met?
- r. Costs incurred for planning, executing, resisting or planning to resist mergers, acquisitions, etc., including employee and nonemployee costs? FAR §§ 31.205-27(a), -47(f)(2).
- s. Patent costs other than costs relating to:
  - (i) Supporting and preparing an invention disclosure? FAR § 31.205-30(a)(1)-(2).
  - (ii) Other patent application costs when the government will receive title or a royalty free license? FAR § 31.205-30(a)(3).
  - (iii) General counseling services relating to patent matters? FAR § 31.205-30(b).
  - (iv) Costs of any other patent activity required by a contract? FAR § 31.205-30(c).
- t. Patent royalties or amortization costs when:
  - (i) The government has title, a license or royalty free use? FAR § 31.205-37(a)(1).

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- (ii) The patent is invalid, unenforceable or expired? FAR § 31.205-37(a)(2)-(4).
  - (iii) The royalties arise in circumstances of less than arms-length dealing? FAR § 31.205-37(b), (c).
- u. Pre-contract costs that are not:
  - (i) Incurred directly pursuant to negotiations?
  - (ii) Necessary to meet the contract's schedule?
  - (iii) Otherwise allowable? FAR § 31.205-32.
- v. Professional and consulting costs (distinguished from purchased labor—see 13-PAC-026(R)):
  - (i) Incurred: (a) to improperly obtain information or to improperly influence the procurement process (see Byrd Amendment); (b) in violation of law or regulation concerning unethical practices; or (c) for a purpose that is inconsistent with the intent of the contract? FAR § 31.205-33(c).
  - (ii) Incurred in connection with mergers and acquisitions, defense of antitrust suits, defense against or prosecution of claims or appeals involving the government, or certain lawsuits between contractors? FAR §§ 31.205-47(d), (e), (f).
  - (iii) That are unreasonable? FAR § 31.205-47(f).
  - (iv) That are not documented adequately (e.g., evidence of agreements, work product (or other evidence of the nature and scope of the work performed), invoices, etc.)? FAR § 31.205-33(d), (e); 13-PAC-026.
  - (v) Paid through a retainer when use of a retainer is not appropriate or reasonable under the circumstances? FAR § 31.205-33(e).

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- w. Relocation costs that do not meet the requirements of FAR § 31.205-35?
- x. Rental Costs:
  - (i) Under operating leases, that are unreasonable lease costs? FAR § 31.205-36(b)(1).
  - (ii) Under a sale and leaseback arrangement, that are in excess of what the segment would have incurred had it retained title to the property, computed using the segment's net book value at the date the segment becomes the lessee, as adjusted? FAR § 31.205-36(b)(2).
  - (iii) Under an agreement with an affiliated organization under common control, that exceed the affiliate's cost of ownership unless the affiliate has a practice of leasing the same or similar property to unaffiliated lessees at a price? FAR § 31.205-36(c).
- y. Selling costs that:
  - (i) Do not result from direct selling efforts that involve person-to-person contacts to sell specific products or services to particular customers, including negotiations, liaison, and technical and application demonstrations? FAR § 31.205-38(a)(5).
  - (ii) Result from payment to other than bona fide employees or established commercial or selling agencies retained by the segment for the purpose of securing business? FAR § 31.205-38(c).
  - (iii) Result from:
    - (a) Technical effort that is properly IR&D because the effort is R&D undertaken to develop a product for sale under potential multiple contracts?
    - (b) Effort that is properly B&P because the effort supports a specific proposal activity?

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- (c) For more detailed guidance regarding IR&D, B&P and selling costs, refer to Dentons' *"IR&D, B&P, Selling and Related Costs Under Federal Government Contracts - A Practical Guide."*
- z. Taxes:
  - (i) Federal taxes? FAR § 31.205-41((b)(1).
  - (ii) Taxes from which the segment is exempted directly or indirectly through the government? FAR § 31.205-41(b)(3).
  - (iii) Taxes on real and personal property used solely for other than government contract work? FAR § 31.205-41(b)(5), (c).
  - (iv) Taxes arising in other unique circumstances? FAR § 31.205-41(b)(2), (4), (6), (7).
- aa. Training and education costs in certain circumstances? FAR § 31.205-44.
- ab. Travel costs that are:
  - (i) Transportation costs and:
    - (a) Exceed actual costs as measured in accordance with a reasonable policy defining actual costs? FAR § 31.205-46(a)(1)
    - (b) For airfare costs, absent a relevant exception, exceed the lowest priced airfare available to the segment during normal business hours, whether travel is by common carrier or owned, leased or chartered aircraft? FAR § 31.205-46(b).
  - (ii) Meals, lodging and incidental costs that exceed the lower of the per diem rates identified in specified travel regulations (adjusted for less than full travel days) or actual costs (if employee reimbursement is based on actual costs) **unless reimbursement of actual costs in excess of per diem is permitted under relevant agency regulations?** FAR § 31.205-46(a)(1)-(6).

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- (iii) Not adequately documented? FAR § 31.205-46(a)(7).
- ac. Cost of money, depreciation and amortization costs arising from asset values determined in accordance with the purchase method of accounting for a business acquisition which exceed the amounts that would have been allowed had the combination not taken place, including goodwill? FAR §§ 31.205-10, -11, -49, -52.
- ad. The following costs related to legal and other proceedings, including investigations:
  - (i) When there is a conviction in a criminal proceeding? FAR § 31.205-47(b)(1).
  - (ii) When there is a finding of contractor liability where the proceeding involves an allegation of fraud or similar monetary penalty? FAR § 31.205-47(b)(2).
  - (iii) When there is a final decision by an appropriate official or agency to debar or suspend the contractor, rescind or void a contract, or terminate a contract for default for failure to comply with law or regulation? FAR § 31.205-47(b)(3).
  - (iv) Twenty percent of all costs incurred in connection with a proceeding involving an allegation of violation of law or regulation that did not settle and did not result in any of the outcomes set forth in paragraphs (i) through (iii) above? FAR § 31.205-47(e)(3).
  - (v) When there is a settlement of any third-party False Claims Act (“FCA”) proceeding and the ACO fails to determine that there was “very little likelihood that the third party would have been successful on the merits?” FAR § 31.205-47(c)(2); see *Geren v. Tecom, Inc.*, 566 F.3d 1037 (Fed. Cir. 2009).
  - (vi) Legal and related costs incurred in connection with the various actions listed in FAR § 31.205-47(f)?

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- ae. Costs of alcoholic beverages? FAR § 31.205-51.
- af. Costs that are losses on other contracts?  
FAR §§ 31.205-23, -48.
- ag. Costs which are not identified as unallowable but are similar to or relate to costs that are unallowable, including costs from a breach of a specific contractual performance requirement? FAR § 31.201-4; see *Tecom*, 566 F.3d at 1037; *Boeing N. Am., Inc. v. Roche*, 298 F.3d 1274 (Fed. Cir. 2002).
- ah. Costs incurred for direct contacts with the government made with the intent to influence, or to attempt to influence, the award or modification of a contract, except for costs of: (1) agency and legislative liaison by a segment's own employees; and (2) certain professional and technical services? FAR Subpt. 3.8.
- ai. Environmental costs that:
  - (i) Result from segment wrongdoing (i.e., is not based on strict liability) under law, regulation, orders or permits?
  - (ii) While classified as environmental costs, are of a type that is unallowable under any other cost principle, including:
    - (a) FAR § 31.205-7, contingency because the costs are not recognized for GAAP purposes?
    - (b) FAR § 31.205-15, fines and penalties?
    - (c) FAR § 31.205-47, legal costs?
- aj. External restructuring costs, resulting from restructuring activities occurring after a business combination that affect the operation of companies not previously under a common control, to the extent the ACO does not determine the costs to be allowable?  
DFARS § 231.205-70.

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- ak. Intangible cost amortization that is not consistent with GAAP?
  - al. Any cost that a contract specifically prohibits or limits, including caps on indirect cost rates?
  - am. Any costs resulting from payments to subcontractors performing other than a firm, fixed-price (“FFP”) subcontract, where the payment to the subcontractor is reimbursement for subcontractor costs that are prohibited or limited by FAR Part 31? FAR § 31.204.
6. Related requirements:
- a. Is an overhead certificate for a final rate submission/ cost incurred proposal executed by the appropriate company official?
  - b. When a cost is subject to two or more provisions of FAR § 31.205, can the cost be apportioned and, if so, was it? If the cost could not be apportioned, was the cost classified under the most appropriate cost principle? FAR § 31.204(c).
  - c. Regarding the Byrd Amendment on legislative lobbying costs:
    - (i) Has a certification been filed (i.e., has a contract been executed that contains FAR § 52.203-11)?
    - (ii) Has the segment made any required disclosures of expenditures for lobbying activities to influence contracts; i.e., disclosed payments for activities subject to the Byrd Amendment other than those falling within the agency liaison or professional or technical services exceptions?
      - (a) Was the disclosure required (i.e., nongovernment contract revenues insufficient to cover costs)?
      - (b) Was the disclosure proper?

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### V. Accounting Systems and Cost Data Reliability and Proper Charging

**Compliance requirement:**

- (ii) The accounting system and cost data are reliable;
- (iii) Risk of misallocations and mischarges are minimized . . . .

DFARS § 252.242-7006(a)(1).

The criteria relevant to assessing compliance with these requirements are discussed below.

#### A. Data Reliability — General

**Compliance criteria:**

- (3) Identification and accumulation of direct costs by contract; . . .
- (5) Accumulation of costs under general ledger control; . . .
- (11) Interim (at least monthly) determination of costs charged to a contract through routine posting of books of account; . . .

DFARS § 252.242-7006(c).

1. Does a general ledger system exist that:
  - a. Identifies and defines types of cost with unique codes?
  - b. Identifies departments by unique codes?
  - c. Identifies contracts by unique codes?
  - d. Identifies contract line item numbers (“CLINs”) and/or work breakdown structure (“WBS”) numbers with unique codes, when necessary?

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- e. Identifies direct costs by unique codes?
    - f. Requires that all costs, at incurrence, be assigned a proper code based on type, contract and any other appropriate identifier?
    - g. Accumulates costs accurately based upon the assigned code in appropriate subsidiary ledgers, including a ledger for each contract and other significant cost objective identified as a collection point for direct costs?
    - h. Requires all costs to be posted to subsidiary ledgers at least monthly?
    - i. Accumulates costs accurately at the general ledger level through the accumulation of subsidiary ledger balances?
2. Does the general ledger system permit costs accumulated at the subsidiary ledger level to be traced to source documentation?
3. Are the various components of the general ledger system integrated:
  - a. Electronically, so that information is electronically transferred between components and from subsidiary ledgers to the general ledger?
  - b. Manually, so that information collected is routinely posted to subsidiary ledgers and then to the general ledger?
4. Are amounts accumulated at the general ledger level routinely reconciled to the subsidiary ledgers?
5. Do internal controls exist to ensure:
  - a. Complete recording of all costs?
  - b. Proper coding of all costs?
  - c. The accurate accumulation of all costs?
  - d. Appropriate approvals of costs prior to incurrence?
  - e. Appropriate approvals of payments for incurred costs?
  - f. Adequate retention of source documentation?

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### B. Data Reliability — Labor Costs

#### **Compliance criteria:**

- (3) Identification and accumulation of direct costs by contracts; . . .
- (9) A timekeeping system that identifies employees' labor by intermediate or final cost objectives;
- (10) A labor distribution system that charges direct and indirect labor to the appropriate cost objectives; . . .

DFARS § 252.242-7006(c).

1. Does a time reporting system exist that has policies, procedures and systems (electronic or otherwise) that are designed to record employee labor accurately and timely?
2. Are time recording policies and procedures distributed and explained to new employees?
3. Are employees trained periodically regarding time recording policies and procedures and system functions?
4. Are standard computerized systems used to record time? Are the automated systems used to record time secure, auditable and reviewed periodically? Is there a back-up of the time records in the event that the computerized system fails?
5. Do the written policies and procedures address charge code management and require that:
  - a. The creation of a charge code be requested by an individual having responsibility for managing performance of a contract, any other project that requires the accumulation of direct costs (e.g., an IR&D project) or a department performing efforts that are classified as indirect costs?
  - b. The assignment of a charge code, based upon an authorized request for a charge code, is made by a separate function with responsibility for accurate recording of costs?

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- c. The charge code assigned is appropriate for recording and accumulating costs in accordance with the segment's accounting system policies and procedures and other relevant requirements (e.g., contract requirements)?
  - d. Assigned charge codes are communicated timely to the individual responsible for a contract, project or department?
  - e. The individual having responsibility for managing a contract, a project or a department requests timely that the assigned charge code be closed when performance has been completed and all costs recorded and accumulated?
6. Do the written policies and procedures address the accurate recording of time and require that:
- a. Each employee (or each employee who charges any time directly) record his or her time daily using the relevant system?
  - b. Charge his or her time to a charge code appropriate for the effort being performed?
  - c. Time be charged in stated increments (e.g., half hour)?
  - d. Describe how to charge training time and break time?
  - e. If another employee may record time for an employee:
    - (i) Are the appropriate circumstances for such action described, such as the employee is offsite or ill?
    - (ii) Is authority limited to the employee's supervisor or similarly situated employee?
    - (iii) Is appropriate justification and sufficient documentation required to support the judgment of the employee's supervisor in charging the employee's time?
  - f. Is each employee's time approved by an appropriate supervisor?

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7. Do the written policies and procedures address mistakes in recording time and require that:
  - a. The erroneous entry be retained?
  - b. The change be documented in a new entry?
  - c. The employee approve the change and provide a written explanation of the change?
  - d. If someone other than the employee may change a time entry, the employee concurs in writing with the change?
8. Do the written policies and procedures require reviews to ensure accuracy of recorded time, such as edit runs, review by supervisors or program managers and reconciliations between time entries and payroll records or time and attendance cards?
9. Do the written policies and procedures address cost transfers to correct time recording errors and require, among other things, adequate documentation as to why the transfer was necessary and appropriate approvals?
10. Is the segment's time recording system subject to internal review, such as floor checks, reconciliations and internal audits?

### C. Segregate Direct and Indirect Costs

**Compliance requirement:** [p]roper segregation of direct costs from indirect costs; . . .

DFARS § 252.242-7006(c)(2).

1. Does the accounting system accurately code costs as direct or indirect?
2. When direct and indirect costs are accumulated in a department, is there clear guidance regarding which costs are direct and which are indirect?
3. Are direct costs accumulated by final cost objective?

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4. Does a “mapping system” exist that aligns departments or indirect costs within a department to the appropriate indirect cost pool?
5. Are actual costs accurately accumulated in indirect cost pools in accordance with the “mapping” of department costs to indirect cost pools?
6. Are actual costs “mapped” to indirect cost allocation bases?
7. Are actual costs accurately accumulated in indirect cost allocation bases in accordance with the “mapping” of costs to indirect cost pools?

### D. Maintain Historical Cost Data

**Compliance criterion:** [a]dequate, reliable data for use in pricing follow-on acquisitions;...

DFARS § 252.242-7006(c)(17).

1. Are data relating to a final cost objective, including any data accumulated below the contract level, maintained and accessible for a reasonable period after contract completion?
2. Do controls exist to ensure that retained data remain accurate and complete?
3. Are individuals responsible for preparing estimates made aware that historical data exists and do procedures exist for these individuals to have access to this data upon request?

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### VI. Cost Reporting and Billing Systems That Accumulate and Report Allocated Costs Consistent With Contract Requirements

#### A. Accumulate Costs in Accordance with Contract Requirements

**Compliance criterion:** [i]dentification of costs by contract line item and by units (as if each unit or line item were a separate contract), if required by the contract; . . .

DFARS § 252.242-7006(c)(13).

1. Does the segment have adequate written policies and procedures to implement this requirement?
2. Does the segment have (or have the use of) a contracts function that is responsible for evaluating and understanding the cost and billing requirements of all awarded contracts?
  - a. Are the individuals assigned to the contracts function experienced regarding government procurement regulations and contract clauses or supervised by personnel with significant experience?
  - b. Do individuals assigned to the contracts function periodically receive appropriate training?
  - c. Is the training recorded in personnel records and are training materials reviewed annually to ensure that they are current and compliant?
3. Does the contracts function:
  - a. Document contract accounting and billing requirements in standardized "Contract Briefs" that describe in detail the cost accounting and billing requirements of all awarded contracts?

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- b. Identify in Contract Briefs specific organizations and/or individuals within the company that are responsible for ensuring that particular contract cost accounting and billing requirements are satisfied?
  - c. Identify in Contract Briefs the FAR, DFARS, other regulatory clauses and special contract clauses (i.e., such as may be found in a contract's Section H) that apply to each particular contract?
  - d. Ensure that Contracts Briefs are reviewed and approved by management?
  - e. Update Contracts Briefs when contract modifications are issued or, at a minimum, before the next billing interval following a contract modification?
  - f. Provide Contract Briefs timely to cognizant accounting and billing personnel?
4. Are there periodic internal audits of Contract Briefs to ensure initial accuracy and that contract modifications are implemented and accounted for?
5. Does the segment routinely conduct internal briefings in which the cost accounting and billing requirements described in the Contract Briefs are reviewed and discussed by contracts, accounting and billing personnel?
6. Does the segment's accounting system permit the capture of any unique contract cost and/or billing requirements, including identification of costs by CLIN, sub-CLIN, or units (see Ch. 1, § V)?

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### B. Provide Timely and Appropriate Funding/Cost Notices/ Accounting Data

**Compliance criterion:** generate cost accounting information, as required “[b]y contract clauses concerning limitation of cost (FAR 52.232-20), limitation of funds (FAR 52.232-22), or allowable cost and payment (FAR 52.216-7); . . .”

DFARS § 252.242-7006(c)(15)(i).

1. Limitation of Cost and Funds Requirements
  - a. Does the segment have written procedures in effect to ensure prompt notification to the customer when contracts are within 75% of the contract cost or funds ceiling so that proper notice can be given in accordance with the “Limitation of Cost” clause (FAR § 52.232-20) and “Limitation of Funds” clause (FAR § 52.232-22)?
  - b. Does the segment prepare monthly reports showing total costs incurred to date with a projected run date for the next 60 days?
  - c. Does the LOF/LOC clause apply to termination costs? Are costs reported monthly consistent with the inclusion or exclusion of termination costs?
  - d. Does the LOF/LOC clause apply to fee? Do monthly reports include fee when the LOF/LOC clause applies to fee?
  - e. Has the segment assigned responsibility to a specific individual to review the monthly report and inform the individual responsible for making the required notification when the 75% cost level is estimated to be reached in the next 60 days?

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- f. Is the responsibility assigned to one individual for the accurate preparation and timely submission of contractually required cost reports, including timely notification that:
    - (i) Contract costs will exceed 75% of the total estimated contract costs or funds within the next 60 days; or
    - (ii) Total contract costs will be greater or substantially less than estimated?
  - g. Is the estimate of total cost of performance included in the contractually required cost report consistent with current internal EACs and/or estimates to complete (“ETCs”) (see Ch. 1, § VI.D.2)?
2. Allowable Cost and Payment Requirements
- a. Are all interim requests for payment made pursuant to the “Allowable Cost and Payment” clause (FAR § 52.216-7) reviewed by a designated individual who is responsible for ensuring that each invoice or voucher:
    - (i) Is supported by accurate cost data found in the accounting system and appropriate documentation?
    - (ii) Uses government-approved indirect cost billing rates, or if such rates do not exist, uses indirect cost rates generated by the function within the organization responsible for developing appropriate indirect cost rates (see Ch. 1, § VI.C)?
    - (iii) Is based on recorded costs that, at the time of the request, the segment has actually paid for items or services purchased directly for the contract, unless costs are of a type that may be billed when accrued (see para. (iv) below on billing costs on an accrual basis)?

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- (iv) If based on costs accrued, includes only accrued costs for:
    - (a) Supplies and services purchased directly for the contract and associated financing payments to subcontractors (provided that such payments are made in accordance with FAR § 52.216-7(b)(1)(ii)(A)(1) through (2)?
    - (b) Materials issued from the segment's inventory and placed in the production process for use on the contract?
    - (c) Direct labor?
    - (d) Direct travel?
    - (e) Other direct in-house costs?
    - (f) Properly allocable and allowable indirect costs established in accordance with FAR § 52.216-7(d) and (e)?
  - (v) Is based on the actual amount of finance payments paid to subcontractors for supplies and services not purchased directly for the contract?
  - (vi) Excludes accrued costs for contributions under employee pension plans until such costs are actually paid (unless the criteria in FAR § 52.216-7(b)(2)(i) through (ii) are met)?
  - (vii) Reflects any refunds, rebates, credits or other amounts (including interest, if any) accrued or received during the previous billing period under FAR § 52.216-7(h)?
- b. Once final indirect cost rates are established for contracts that are still being performed, does the segment conduct "true-up billings" to ensure that all billings are current and accurate?
  - c. Are final payment vouchers for fully performed contracts made pursuant to the "Allowable Cost and Payment" clause (FAR § 52.216-7):

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- (i) Reviewed by a designated individual who is responsible for ensuring timely and accurate final payment vouchers?
    - (ii) Does the segment's function that agrees to final indirect cost rates with the government notify the segment's billing function of final rate agreement in a timely manner?
    - (iii) Is final payment requested within 120 days of agreement on final indirect cost rates for the final year of contract performance, or a subsequent date approved by the PCO?
  - d. Does the segment's accounting system ensure that refunds, rebates, credits or other such amounts relevant to final payment are included in the final billings?
- 3. Final Payment Release
  - a. Does the segment timely execute a properly completed assignment and release at the time of final payment under a fully performed contract?
  - b. Does the segment's accounting system ensure that refunds, rebates, credits or other such amounts received after final payment are properly assigned to the government under FAR § 52.216-7(h)(2)?
  - c. Does the segment have a methodology for identifying any outstanding specified claims, claims based upon liabilities to third parties, and/or other claims for reimbursement of costs prior to final payment that should be excluded from the release? FAR § 52.216-7(h)(2)(ii).
  - d. Is responsibility assigned to an individual within the management organization for executing and delivering the:
    - (i) Assignment of refunds, rebates, credits or other amounts; and
    - (ii) Required release(s) of all claims prior to final payment?

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### C. Ready Calculation of Indirect Cost Rates

**Compliance criterion:** [t]o readily calculate indirect cost rates from the books of accounts; . . .

DFARS § 252.242-7006(c)(15)(ii).

1. Does the segment have appropriate written policies and procedures to implement this requirement?
2. Does the segment assign responsibility to develop and maintain appropriate billing and final indirect cost rates to a function outside the organization's billing function?
3. Does the function responsible for preparing and maintaining billing and final indirect cost rates in accordance with FAR § 52.216-7:
  - a. Provide these rates in a timely manner to the function responsible for preparing interim and final billings in accordance with FAR § 52.216-7?
  - b. Ensure that the most current rates are used for interim and final billing purposes?
  - c. Coordinate with the accounting function to ensure that the accounting system readily accumulates indirect cost pools and bases?
  - d. Coordinate with the function responsible for compliance with CAS and FAR accounting requirements to ensure that the indirect cost rate structure is compliant?
  - e. Review billing rates periodically to assess the need to adjust billing rates based on actual experience under FAR § 52.216-7(e)?
  - f. Ensure that a final indirect cost rate proposal is submitted within six months of the end of an accounting period, absent a written extension agreed to by the cognizant ACO, that is prepared in accordance with FAR Subpart 42.7, including the DCAA "ICE" model? See FAR § 42.705-1(b).

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### D. Billings Are Reconcilable to the Accounting Records

**Compliance criterion:** [b]illings that can be reconciled to the cost accounts for both current and cumulative amounts claimed and comply with contract terms; . . .

DFARS § 252.242-7006(c)(16).

1. All Billings
  - a. Does the segment have appropriate written policies and procedures to implement this requirement?
  - b. Does the segment have a billing function that is responsible for ensuring that appropriate bills are submitted timely?
    - (i) Are billing personnel experienced and trained on the segment's accounting software system?
    - (ii) Is the training of billing personnel recorded in personnel records, and are training materials reviewed annually to ensure they are current and compliant?
  - c. Does the billing function:
    - (i) Review all invoices and/or other billings prior to submission to ensure compliance with all contract cost and/or billing requirements?
    - (ii) Have the authority to withhold billings about which they have questions for assessment/review by management?
  - d. Does management approve each invoice before submission?
    - (i) Has the segment established appropriate dollar thresholds and management approval levels for all billings?

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- (ii) Does the approval process ensure that the invoice is in the required format and accurate and compliant with contract requirements?
  - (iii) Is the approval documented?
- e. Does the segment conduct periodic internal audits of billing records to ensure they comply with all contract cost and/or billing requirements?
  - (i) Does the segment have a procedure to ensure that any deficiencies or inaccuracies identified during an internal audit are corrected by billing personnel?
  - (ii) Does the segment have a procedure/protocol for communicating any deficiencies or inaccuracies to the government, if necessary?
- f. Is the segment's accounting system configured to automatically and accurately update current and cumulative amounts claimed as of a date certain in order to permit the timely preparation of contract billings?
- g. Is the segment's accounting system configured such that any discrepancies between billings and current and cumulative amounts allocated to a contract can be readily identified, investigated and reconciled?
- h. Does the segment perform scheduled (e.g., on a monthly or quarterly basis) reconciliations of all billings to date against current and cumulative amounts allocated to a contract?
- i. Are scheduled reconciliations performed by experienced billing personnel who have been trained to perform reconciliations and to identify/investigate any billing discrepancies?
- j. Does the segment require management to approve the results of all scheduled reconciliations of billings to date against current and cumulative amounts allocated to a contract?

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- k. Does the segment make appropriate and timely adjustments (i.e., offsets or credits)? Is the basis for the adjustment documented?
  - l. Does the segment require management to approve any required adjustments? Is the approval documented?
  - m. Does the segment implement and document any required billing adjustments in a timely manner?
  - n. Does the segment have a standard process for identifying, documenting and issuing credits or making adjustments on the face of subsequent vouchers or invoices?
    - (i) Is this procedure tailored to meet any contract specific requirements for issuing and identifying credits and/or adjustments?
    - (ii) Does the segment comply with contract specific requirements for issuing and identifying credits or adjustments?
  - o. Does the segment notify the government in writing of any necessary credits or adjustments?
  - p. Is an appropriate individual assigned the responsibility to ensure that:
    - (i) There is a valid contractual basis for the claim, billing or invoice?
    - (ii) All costs included in a claim, billing or invoice are allowable costs?
    - (iii) Any required certification is signed only after ensuring compliance with all contractual requirements?
2. ETCs and EACs
- a. Does the segment have appropriate written policies and procedures for ETCs/EACs that require:
    - (i) Timely development of accurate EACs/ETCs?

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- (ii) Timely review for accuracy?
  - (iii) Reconciliations between EACs/ETCs used for different purposes if a reasonable basis supports the existence of differing EACs/ETCs?
- b. Does the segment assign responsibility to develop appropriate and timely EACs/ETCs to a responsible individual within the billing function?
- c. Does the responsible individual, using appropriate personnel when necessary, prepare reasonable ETCs and EACs on a systemic basis (e.g., monthly or quarterly) by:
- (i) Using estimating techniques for calculating ETCs and EACs that are:
    - (a) Used when preparing proposals?
    - (b) Used consistently among various programs or contracts for EAC/ETC purposes?
    - (c) Compliant with the CAS 401 consistency requirement applicable to accounting methods and techniques used in preparing proposals?
  - (ii) Developing ETCs and EACs in conjunction with the individuals who are actually responsible for performances of the tasks?
  - (iii) Using learning curve assumptions for ETCs and EACs based on historical company experience modified to reflect current results as they become available?
  - (iv) Observing physical inventory for the purpose of determining the stage of work in progress and, when appropriate, the pricing of quantities on hand?
  - (v) Delegating to an appropriate, experienced individual the responsibility for monitoring contract costs and for analyzing and reporting significant variances to management for resolution?

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- (vi) Delegating the development of ETCs and EACs so that program personnel estimate remaining hours and material requirements, while accounting applies the appropriate direct and indirect costs?
  - (vii) Using actual cost information in the accounting system?
  - (viii) Taking into account general increases and cost-of-living adjustments?
  - (ix) Ensuring that the information in the ETC and/or EAC is consistent with information found in other financial reports (e.g., billing and bidding rate proposals, progress payment requests, customer reports, and internal budgets/management reports)?
  - (x) Submitting EACs and ETCs for high-value contracts to management for review and approval?
- d. Are internal audit reviews of EACs and ETCs conducted to assess adequacy and consistency of variances?
  - e. Are training opportunities provided to program management, contract administration and financial personnel to explain the proper development and use of ETCs and EACs?
3. Requests for Progress Payments
- a. Do adequate written policies and procedures exist to ensure compliance with FAR § 52.232-16 and Standard Form ("SF") 1443?
  - b. Is an appropriate function responsible for ensuring that, in accordance with FAR § 52.232-16 and SF 1443, the progress payment request:

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- (i) Is supported by accurate cost data found in the accounting system and is based on:
  - (a) Claimed material costs that have been paid and other direct costs that have been accrued (verified by sampling)?
  - (b) Subcontract costs that represent payments actually made to subcontractors, including progress payments?
- (ii) Is consistent with the latest EACs and ETCs?
- (iii) Uses current indirect rates?
- (iv) Is based on prices for delivered articles that correspond to prices stipulated in:
  - (a) An FFP contract, as modified by contract modification; or
  - (b) A fixed price incentive ("FPI") contract as billing prices, as modified pursuant to FAR § 52.216-16(f) (see Ch. 1, § VI.D.4)?
- (v) Claims costs that are reasonably commensurate with the percentage of completion of the contract?
- (vi) Is based upon an accurate amount of unliquidated progress payments because:
  - (a) The amount of unliquidated progress payments does not exceed:
    - (1) Progress payments made against incomplete work; or
    - (2) The value of the incomplete work?
  - (b) In the event that the amount of unliquidated progress payments does exceed such amounts, does the segment have written procedures for tracking and repaying such excess costs to the government?

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- (vii) Does not claim progress payments that, when combined with all previous progress payments, exceeds 80% of the total contract price, as modified?
  - (viii) Measures liquidated progress payments properly by deducting from any delivery payment under the contract (other than advance or progress payments), the total unliquidated progress payments or 80% of the amount invoiced, whichever is less?
  - (ix) After computing liquidations and past payments and adjusting unliquidated progress payments accordingly, reflects repayment to the government of any amounts previously overbilled?
  - (x) Takes into consideration the applicable “loss ratio” for a contract in an estimated overrun condition?
4. QLOP Restriction on FPI Contract Billings
- a. Does the segment have adequate written policies and procedures to ensure compliance with FAR § 52.216-16(f) and (g)?
  - b. Within 45 days after the end of the quarter of the segment’s fiscal year in which delivery is first made and accepted, and for each succeeding quarter, does the segment prepare a Quarterly Limitation on Payments (“QLOP”) Statement that, in accordance with FAR § 52.216-16(f) and (g), accurately reflects:
    - (i) The total contract price of all supplies delivered (or services performed) and accepted by the government and for which final prices have been established?
    - (ii) The total costs (estimated to the extent necessary) reasonably incurred for, and properly allocable solely to, the supplies delivered (or services performed) and accepted by the government and for which final prices have not been established?

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- (iii) The portion of the total target profit (used in establishing the initial contract price or agreed to under FAR § 52.216-16(g)) that is in direct proportion to the supplies delivered (or services performed) and accepted by the government and for which final prices have not been established (increased or decreased to account for any over- or under-recovery relative to the aggregate target costs of the contract supplies or services)?
    - (iv) The total amount of all invoices or vouchers for supplies delivered (or services performed) and accepted by the government (including amounts applied or to be applied to liquidate progress payments)?
    - (v) The difference between the amount in paragraph (iv) above and the total amount of paragraphs (i), (ii) and (iii) above?
  - c. When the results of the steps in paragraph b. reflect a positive difference:
    - (i) Does the government immediately receive a refund or credit for this difference or is this difference added to the unliquidated progress payments account for the contract? FAR § 52.216-16(g)(2).
    - (ii) Are revised billing prices negotiated with the government when the positive number is “significant,” based upon a written policy or procedure that defines what is significant for FPI billing purposes? FAR § 52.21-16(f)(2).
  - d. Do all invoices or vouchers for items delivered to the government at billing prices reflect the then-current estimate of the final price for such items? FAR § 52.216-16(f)(1).
  - e. Is an individual responsible to ensure that billing prices are adjusted when they are substantially greater than the estimated final prices? FAR § 52.216-16(f)(1).

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- f. Final billings under fixed price contracts?
  - (i) Does the segment ensure that total billings under an FFP contract equal the contract price as of the date of completion?
  - (ii) At the end of the month in which the segment has delivered the last unit of supplies or completed the services required under an FPI contract, does the segment submit to the government (within the contractually specified number of days):
    - (a) A detailed statement of all allowable costs incurred up to the end of that month in performing the work?
    - (b) An estimate of costs of further performance, if necessary, to complete the work?
    - (c) A list of all residual inventory and an estimate of its value?
    - (d) Any other relevant data that the PCO may reasonably require? FAR § 52.216-16(c), (d).
- 5. Time and Material (“T&M”) Contracts
  - a. Does the segment bill for effort charged to the contract by:
    - (i) Using the labor rate for each segment employee that is the labor rate for the skill level/category in the contract that appropriately applies to the employee?
    - (ii) Using a rate for each subcontractor employee that is:
      - (a) The labor rate for the skill level/category in the contract that appropriately applies to the subcontractor employee?
      - (b) The labor rate specified in the subcontract for the skill level/category in the subcontract that appropriately applies to the subcontractor employee?

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- (c) A rate consistent with the subcontractor employee's fully burdened cost, plus profit (unless the subcontractor is an affiliated entity under common control, potentially precluding profit)?
- b. Does the segment ensure that it applies to labor skill level/category rates only indirect costs that are not:
  - (i) Included in the skill level/category rates (e.g., the rates are not full wrap rates)?
  - (ii) Improper under the segment's cost accounting practices?
  - (iii) Prohibited by a contract term?

### VII. Internal Controls

**Compliance criterion:** [a] sound internal control environment, accounting framework, and organizational structure; . . .

DFARS § 252.242-7006(c)(1).

#### A. General Requirements

1. Does the segment have appropriate written policies and procedures?
  - a. Is an individual within each function responsible for ensuring that adequate written policies and procedures are prepared?
  - b. Is an individual within each function responsible for ensuring that written policies and procedures remain current?
2. Does the segment's overall control environment demonstrate:
  - a. Integrity and ethical values?
  - b. Commitment to competence?

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- c. Active participation by the Board of Directors and Audit Committee?
  - d. Sound management philosophy and operating style?
  - e. Functional organizational structure?
  - f. Clear assignment of authority and responsibility?
  - g. Establishment, enforcement, and communication of human resources policies and practices?
  - h. Financial capability?
3. Does management consistently and effectively convey, through words and actions, a commitment to high ethical standards (e.g., in written memoranda, required trainings, etc.)?
4. Does the segment have a written code of business ethics and conduct that complies with FAR § 52.203-13(b), when applicable to a contract, and addresses:
  - a. Conflicts of interest, illegal or other improper payments, anti-competitive guidelines, and insider trading issues?
  - b. Statutory and regulatory requirements for procurement integrity, classified information, and recruiting and employment of former government personnel?
  - c. Statutory and regulatory guidelines on giving, receiving, and/or soliciting gifts, bribes, gratuities and other things of value in connection with government contracts?
  - d. Requirements for segment employees to periodically acknowledge written codes?
  - e. Clear delineation of acceptable and unacceptable behavior, as well as procedures for reporting suspected violations under the Code of Conduct?
  - f. Potential consequences and processes for evaluating, investigating and resolving potential violations under the Code of Conduct?

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5. Has the segment developed an employee business ethics and compliance training program that includes scheduled (e.g., annual or bi-annual) and mandatory compliance training sessions on topics covered in the segment's Code of Conduct?
  - a. Is the training recorded in personnel records and reviewed annually to ensure that it is current and compliant?
  - b. Does the segment periodically review and revise its training materials and program to account for changes in statute, regulation or contract requirements?
  
6. Does the segment maintain internal controls that facilitate timely discovery and disclosure of improper conduct in connection with government contracts, including:
  - a. Assignment of overall responsibility for the segment's business ethics and awareness program to an individual situated in a sufficiently high-ranking corporate position (e.g., Vice President or Chief Financial Officer)?
  - b. Allocation of resources adequate to ensure effectiveness of the business ethics and compliance program?
  - c. Procedures requiring reasonable efforts so that individuals who have previously violated the segment's Code of Conduct are not appointed to business ethics and awareness oversight positions?
  - d. Periodic evaluations or audits (i.e., at least annually) of the business ethics and compliance program that are aimed at evaluating the effectiveness of the program, identifying weaknesses in the segment's internal control systems and assessing the risk of criminal conduct?
  - e. Procedures for developing and implementing corrective actions in a prompt and effective manner?
  - f. Disciplinary actions for employees who fail to take reasonable steps to identify or take prompt action to prevent or to resolve improper conduct?



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- a. Is the form and nature of the organization well defined, including clear assignment of specific responsibilities, management functions, reporting relationships, and authority?
- b. Are formal organization charts maintained that clearly define the lines of authority and responsibility?
- c. Are written policies and procedures maintained that clearly address the circumstances under which authority and/or responsibility for particular tasks may be delegated?
- d. Are responsibilities and expectations for the entity's business activities clearly communicated to the executive in charge of those activities?
- e. Do departments providing critical services (e.g., Information Technology and Human Resources) report to a sufficiently high level within the organization to avoid undue influence from other departments?
- f. Are the company's Board of Directors and Audit Committee sufficiently independent to challenge management's decisions, act effectively on external audit communications and recommendations and take an active role to ensure appropriate accountability at all levels of the organization?
- g. Does the Board of Directors have a significant number of members who are not employees of the company that owns the segment?
- h. Is the Board of Directors empowered to constructively challenge management's decisions and performance (e.g., on strategic initiatives, major transactions, financial results/earnings)?
- i. Is the Board of Directors informed of and actively involved in significant issues and decisions made by the company?
- j. Does the Board of Directors maintain a compensation committee that approves, for example, all management incentive plans?

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- k. Does the Audit Committee report to an individual within the company with sufficient power to ensure that audit findings are appropriately considered and that corrective measures are taken, where necessary?
  - l. Does the Audit Committee regularly communicate and participate in meetings with the Board of Directors and management?
  - m. Does the Audit Committee actively participate in the development, modification and implementation of any significant changes to the contractor's accounting and billing systems and procedures?
  - n. Does the company engage the services of an independent, external auditor who periodically prepares external Certified Public Accountant ("CPA") Management Letters on the contractor's internal controls?
  - o. Does the company promptly address and take corrective actions relating to any internal control weaknesses identified by external auditors?
9. Does company management periodically evaluate whether the company has adequate financial resources to perform its government contracts?
- a. Are accounts payable and accounts receivable reviewed regularly to ensure an effective cash flow for the organization?
  - b. Does the company assess regularly whether it is meeting timely its debt obligations?
  - c. Are short-term and long-term cash flow projections developed regularly to assess the financial capability of the company?
10. Is the company's accounting system reliable? And is it designed to accurately and consistently identify, assemble, analyze, classify, record, track and report the company's financial transactions, assets, and liabilities? For example, does the company maintain:

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- a. A current, accurate and complete chart of accounts?
- b. Flow charts, narrative descriptions or other explanations of how information is processed through the accounting system from initiation of transactions to reporting of the transactions in the financial records?
- c. A partially or fully automated cost accounting system with a defined transaction flow and identifiable data input, data processing, and data output requirements?
- d. Experienced, well-trained personnel who are responsible for preparing, reviewing, modifying, and approving accounting transactions?
- e. Policies and procedures that clearly define the situations and frequency of management intervention in the collection, processing, and reporting of accounting data and transactions, including the types of approvals and documentation that are required for particular types of transactions?
- f. Documented explanations of any deviations from written accounting policies and procedures?
- g. Periodic and mandatory training taught by knowledgeable individuals using current training materials regarding:
  - (i) Accounting requirements?
  - (ii) Prohibited costs?
  - (iii) Billings?
  - (iv) Accounting systems?

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### B. Systems

**Compliance criterion:** [r]econciliation of subsidiary cost ledgers and cost objectives to the general ledger; . . .

DFARS § 252.242-7006(c)(6).

1. Does the segment have written policies and procedures to implement this requirement?
2. Is the segment's accounting system configured to automatically and accurately reconcile subsidiary cost ledgers and cost objectives to the general ledger? If not, does the segment have a procedure for performing scheduled (e.g., on a monthly or quarterly basis) reconciliations of subsidiary cost ledgers and cost objectives to the general ledger?
3. Is the segment's accounting system configured so that any discrepancies between subsidiary cost ledgers and cost objectives and the general ledger can be readily identified, investigated and reconciled?
4. Are scheduled reconciliations performed by experienced accounting personnel who have been trained to perform reconciliations and to identify/investigate any discrepancies?
5. Does the segment have a procedure that requires management to approve the results of all scheduled reconciliations of subsidiary cost ledgers and cost objectives to the general ledger?
6. Does the segment have a procedure for determining when adjustments are required based on ledger reconciliations? Is the determination documented?
7. Does the segment have a procedure that requires management to approve any required adjustments? Is the approval documented?

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8. Does the segment have a procedure for implementing and documenting any required adjustments?
9. Does the segment have standard procedures for identifying, documenting, approving and issuing credits or making adjustments in accordance with the terms of its contract?

### C. Adjusting Entries

**Compliance criterion:** [a]pproval and documentation of adjusting entries; . . .

DFARS § 252.242-7006(c)(7).

1. Does the segment have written policies and procedures regarding adjusting entries, addressing when adjustments may be made, why they may be made, approvals and documentation?
2. Does the segment document the reasons for any adjustments to a ledger?
3. Does segment management approve each adjustment to a ledger in writing?
4. Are written approvals included in the contract file?
5. Does the segment have a standard procedure for notifying the government of any adjustments to the ledger, when necessary?
  - a. Does management approve all such notices sent to the government?
  - b. Is documentation of the notices and management approvals included the contract file?
6. Are adjusting entries reviewed for compliance with written policies and procedures?
7. In the event that an audit reveals a lack of documentation, does the segment have a procedure for preparing and ensuring the accuracy of any post-audit adjustment documentation?

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8. Does management review and approve any post-audit adjustment documentation? Is this documentation kept in the contract file?

### D. System Monitoring

**Compliance criterion:** [p]eriodic monitoring of the system; . . .

DFARS § 252.242-7006(c)(8).

1. Does the segment have written policies and procedures to implement this requirement?
2. Does the segment, or the company of which it is a part, periodically (i.e., at least annually) audit or evaluate the performance of its accounting system and internal controls?
  - a. Are there procedures for implementing and enforcing any required corrective measures following the identification of weakness in its system or internal controls?
  - b. Is there a procedure for checking the status of compliance at scheduled intervals (e.g., at three, six, nine months) after the implementation of corrective measures?
3. Does the segment, or the company of which it is a part, regularly hire external auditors to audit and prepare CPA Management Letters regarding accounting system and internal controls?
  - a. Are there procedures for implementing and enforcing any required corrective measures following the identification of weakness in its system or internal controls?
  - b. Are there procedures for checking the status of compliance at scheduled intervals (e.g., at three, six, nine months) after the implementation of corrective measures?
4. Does the segment, or the company of which it is a part, periodically review and revise its written accounting and internal controls policies and procedures? Is the Audit Committee actively involved or consulted in such reviews?

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5. Does the segment, or the company of which it is a part, periodically review and revise its training materials related to accounting and internal controls? Is the Audit Committee actively involved or consulted in such reviews?
6. Is the training conducted periodically and, when it occurs, is it recorded in personnel records?
7. Is there a process for identifying and evaluating necessary Information Technology upgrades to the accounting system?
  - a. Is there a procedure that requires management to review and approve any such upgrades?
  - b. Are appropriate consultants and/or subject matter experts consulted before any purchase decisions are made?

## CHAPTER 1: ACCOUNTING AND BILLING SYSTEMS

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### VIII. 2014 System Update

#### A. Areas of Emphasis

While the Business Systems Rule contemplates government audits of contractor cost accounting systems, to date, most accounting systems deficiencies are observed during other, more focused government audits and reported through ad hoc Statements of Conditions and Recommendations (“SOCARs”) or Audit Reports. As a result, rather than identifying systemic issues, many perceived significant deficiencies actually relate to the way in which a contractor has implemented its cost accounting practices under a particular contract or program. Such issues, while potentially serious, are not the type of systemic issues that should give rise to “significant deficiencies” under the Business Systems Rule.

Specific areas of emphasis in recent DCAA SOCARs and audit reports alleging violations of DFARS § 252.242-7006 include:

1. Subcontract management, including whether prime contractors verify that entities performing CAS-covered subcontractors maintain compliant cost accounting systems.
2. The manner in which subcontract labor is charged under time and material contracts.
3. Cost charging, including whether costs are identified with the appropriate contract line item numbers.
4. Labor mapping, including whether contractors can map individual labor categories identified in a particular contract to internal labor categories.
5. The ability to reconcile vouchered amounts to internal accounting information, including general ledgers.
6. The timeliness of contractor responses to auditor requests for additional information.
7. The inclusion of allegedly expressly unallowable costs in incurred cost submissions and related allegations of CAS 405 violations and assessments of penalties.

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8. The presence of sufficient internal controls to prevent the billing to the government of unallowable and expressly unallowable costs. While process controls are, in general, an area of emphasis during DCAA audits, even greater emphasis is being placed on the controls implemented in the area of contractor travel costs, including screening for unallowable costs, ensuring Fly America Act compliance, and ensuring compliance with FAR § 31.205-47.
9. Availability of documentation for costs, particularly travel and consultant costs.
10. Obtaining any necessary pre-approvals before incurring costs, specifically in the areas of direct consultants and direct travel.
11. Capitalization and depreciation practices, including the methods used and allowability of underlying costs.

### **B. Regulatory Developments**

1. The six-year statute of limitations begins to run when the government receives an ICS. *Raytheon Co.*, ASBCA No. 57576, 13-1 BCA ¶ 25,209.
2. The six-year statute of limitations is not suspended by or otherwise delayed until completion of an audit of the ICS. See *Sikorsky Aircraft Corp. v. United States*, 105 Fed. Cl. 657 (2012); *Raytheon Missile Systems*, ASBCA No. 58011, 13-1 BCA ¶ 35,241.
3. ICS updates do not restart the CDA statute of limitations so long as the initial submission contained information sufficient to make the government aware of the facts underlying the relevant claim. *Compare Raytheon Co., Space & Airborne Systems*, ASBCA No. 57801, 13-1 BCA ¶ 35,319 (“[c]laim accrual does not depend on the degree of detail provided, whether the contractor revises the calculations later, or whether the contractor characterizes the impact as ‘immaterial.’ It is enough that the government knows, or has reason to know, that some costs have been incurred, even if the amount is not finalized or a fuller analysis will follow.”) *with Sikorsky Aircraft Corp. v. United States*, 110 Fed.Cl. 210 (2013) (prior

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submissions by the contractor regarding the changed practices did not place the government on notice concerning the impact of the alleged CAS noncompliance because the contractor's submissions identified a net cost benefit to the government and, thus, did not indicate the existence of a government claim).

4. CAS violations, as distinguished from allowability issues, may be subject to the continuing claim doctrine. See *Fluor Corp.* ASBCA No. 57852, 14-1 BCA ¶ 35472. Under this doctrine, a claim accrues each time a party suffers some reoccurring harm. In the context of a CAS violation, a claim may accrue each time a contractor bills costs using a noncompliant cost accounting methodology and, therefore, related claims may remain timely, even if the harm began more than six years prior.

### C. DCAA Guidance

On April 24, 2012, DCAA issued Memorandum to Regional Directors (“MRD”) No. 12-PAS-012(R), “Audit Guidance on Auditing Contractor Business Systems and Contractor Compliance with DFARS § 252.242-7006”, Accounting System Administration (2012), <http://www.dcaa.mil/mmr/12-PAS-012.pdf>. Through this MRD, DCAA explained that contractor accounting system and control environment audits will be performed every third year and that billing audits will be performed every year.

Despite the title of MRD 12-PAS-012(R), most of the other guidance contained in the document is applicable to all DCAA business systems audits. This guidance is discussed in Chapter 7 below.

### D. Proposed Update to the DFARS Business Systems Rule

On July 15, 2014, DOD issued a proposed rule that would update the Business Systems Rule to require contractors to self-assess and report on estimating system, accounting system, and material management and accounting system compliance. 79 Fed. Reg. 41,172 (July 15, 2014). The proposed rule and its requirements are discussed in additional detail in Chapter 7 below.

## CHAPTER 2: PURCHASING SYSTEMS

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### I. Overview

The Business Systems Rule sets forth 24 criteria that must be present in all contractor purchasing systems subject to the Rule in order for a purchasing system to be “acceptable.” DFARS § 252.244-7001(a). If an ACO determines that a contractor’s purchasing system is significantly deficient in one of these 24 areas, and the contractor fails to cure the deficiency, the ACO will deem the system “unacceptable.” DFARS § 252.244-7001(d).

The Business Systems Rule defines a purchasing system as “the Contractor’s system or systems for purchasing and subcontracting, including make-or-buy decisions, the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administering of orders, and expediting delivery of materials.” DFARS § 252.244-7001(a). This definition applies to both purchases that result in direct costs, as well as those that result in indirect costs.

The criteria of the Business Systems Rule are in addition to other pre-existing FAR requirements relating to contractor purchasing systems, which sometime overlap or expand upon the 24 criteria set forth in DFARS Business Systems Rule. See DFARS § 244.305; FAR §§ 44.204, 52.244-2. For example, FAR provides that contractors performing flexibly priced contracts or unpriced, fixed-price contracts must obtain ACO consent prior to issuance of certain types of subcontracts, absent an “approved” purchasing system. FAR §§ 44.204, 52.244-2. FAR Subpart 44.2 sets forth the factors that the ACO is to consider when assessing a specific transaction and the types of transactions that ACOs may not approve. FAR § 44.202-2.

Further, under certain government contracts, the government may perform Contractor Purchasing System Reviews (“CPSRs”) to assess the health of a contractor’s purchasing system. FAR § 44.302. FAR Subpart 44.3 provides guidance concerning government approval of contractor purchasing systems, relying on, among other things, the considerations used for subcontract approvals and 10 enumerated considerations for special attention listed at FAR § 44.303. Importantly, unlike the Business Systems Rule, FAR does not provide for automatic withholds against government payments to the contractor in the event that the criteria of FAR Part 44 are not met. Instead, the FAR provides that the contractor must seek ACO consent prior to subcontracting as the consequence of a “disapproved” purchasing system.

## CHAPTER 2: PURCHASING SYSTEMS

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For these reasons, the fundamental compliance requirement for purchasing systems may be stated as follows:

**Compliance requirements:** when the DFARS Business Systems Rule applies, establish and maintain an “acceptable” purchasing system compliant with the 24 system criteria and the relevant FAR and DFARS purchasing system requirements.

DFARS § 252.244-7001(a). Accordingly, this chapter consolidates the Business Systems Rule criteria for purchasing systems with relevant FAR and DFARS requirements. After providing a discussion of relevant definitions, the chapter is organized generally to follow the procurement lifecycle, including contractor procurement policies, procurement planning, source selection and closeout.

### II. References

- DFARS § 252.244-7001
- DFARS § 244.305-70
- FAR Subpt. 15.4
- FAR Pt. 44
- FAR § 52.244-2
- FAR § 52.244-5
- FAR § 52.244-6
- DFARS Pt. 244

### III. Key Definitions

The following terms are used throughout this chapter.

1. **Purchasing System:** The contractor’s system or systems for purchasing and subcontracting, including make-or-buy decisions, the selection of vendors, analysis of quoted prices, negotiation of prices with vendors, placing and administering of orders, and expediting delivery of materials. DFARS § 252.244-7001(a).

## CHAPTER 2: PURCHASING SYSTEMS

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2. Acceptable Purchasing System: A purchasing system that complies with the system criteria in DFARS § 252.224-7001(c). DFARS § 252.224-7001(a).
3. Approved Purchasing System: A purchasing system that has been reviewed and approved in accordance with FAR Part 44. FAR § 44.101.
4. Contractor: The total contractor organization or a separate entity of it, such as an affiliate, division, or plant, that performs its own purchasing. FAR § 44.101.
5. Offeror: A generic term covering all entities that submit bids, proposals, or other offers for business opportunities in support of a government program.
6. Subcontract: Any contract (as defined in FAR Subpart 2.1) entered into by a subcontractor to furnish supplies or services for performance of a prime contract or a subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders. FAR § 44.101.
7. Subcontractor: Any supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime contractor or another subcontractor. FAR § 44.101.
8. Supplier: A generic term covering all entities that provide a contractor with goods or services that either directly or indirectly support a government program, including subcontractors, vendors, and affiliated business units. When appropriate, more specific terms are used throughout this section.

### IV. Purchasing System Elements

This section begins by discussing compliance requirements relevant to a contractor's general purchasing system policies. The section then discusses specific policies and compliance requirements that relate to each of the following stages of the procurement process: (a) procurement planning and market research; (b) prevention of conflicts of interest and procurement misconduct; (c) competitive purchasing; (d) negotiated procurements; (e) cost/price analysis; (f) source selection; (g) formation and content; (h) foreign purchases and performance; (i) procurement administration; and (j) procurement closeout.

## CHAPTER 2: PURCHASING SYSTEMS

### A. Purchasing System Policies

#### Compliance criteria:

- (1) Have an adequate system description including policies, procedures, and purchasing practices that comply with the [FAR] and [DFARS]; . . .
- (3) Maintain an organization plan that establishes clear lines of authority and responsibility;
- (4) Ensure all purchase orders are based on authorized requisitions and include a complete and accurate history of purchase transactions to support vendor selected, price paid, and document the subcontract/purchase order files which are subject to Government review;
- (5) Establish and maintain adequate documentation to provide a complete and accurate history of purchase transactions to support vendors selected and prices paid; . . .
- (18) Perform internal audits or management reviews, training, and maintain policies and procedures for the purchasing department to ensure the integrity of the purchasing system; . . .
- (20) Provide for an organizational and administrative structure that ensures effective and efficient procurement of required quality materials and parts at the best value from responsible and reliable sources . . .

DFARS § 252.244-7001(c); see FAR § 44.303(e)-(g).

1. Does the contractor have written systems descriptions, including policies, that are consistent with federal laws and regulations? DFARS § 252.244-7001(c)(1).
2. Does the contractor provide its procurement employees guidance and/or instructions (such as desk references) regarding the implementation of procurement policies?
3. Are procurement employees trained on the contractor's policies prior to commencing their duties? Is additional training provided on a regular basis and when the contractor materially changes its purchasing policies? DFARS § 252.244-7001(c)(18).

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4. Are appropriate management officials:
  - a. Aware of the policies of their purchasing organization?
  - b. Familiar with their key suppliers, including the basis for award, the type/structure of the agreement between the contractor and the supplier, and the effectiveness of purchases?
  - c. Responsive to operational problems in the purchasing area?
  
5. Does the contractor's purchasing organization have policies that provide clear lines of authority and allocations of responsibility (see DFARS § 252.244-7001(c)(3), (20)), including:
  - a. Limitations on the ability of employees to execute agreements on behalf of the contractor, including signature authority and contextual limitations?
  - b. Requirements that the same employee may not execute a requisition and conduct the associated procurement?
  - c. Mandatory management approval in certain circumstances, such as sole source awards?
  
6. Are policies in place to avoid unauthorized commitments resulting from procurement employees exceeding their authority?
  - a. Is approval authority established by designating who within the contractor must approve purchases at specific value levels?
  - b. Does an approval/ratification process exist if an unauthorized commitment occurs?
  
7. Do the contractor's policies generally require that all purchases be based on:
  - a. Authorized requisitions?
  - b. Source selection decisions that are fully supported and documented?

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8. Do the contractor's policies generally require a written agreement before a supplier begins performance?
  - a. Do the contractor's policies permit suppliers to begin work prior to execution of an agreement in urgent and/or emergency situations?
  - b. If so, do the policies require prompt definitization and other safeguards?
9. Do the contractor's policies generally require maintenance of one discrete and centralized file for each procurement that:
  - a. Is current?
  - b. Documents vendor selection and prices paid by providing a complete and accurate history of the transaction? DFARS § 252.244-7001(c)(5).
  - c. Contains a complete history of the transaction, including all documents necessary to support the vendor selected and price paid? DFARS § 252.244-7001(c)(4).
  - d. Contains all documentation required by the contractor's procurement policies and relevant regulations?
10. Do the contractor's procurement policies require use of a checklist to ensure that each procurement file contains all necessary documents?
11. Do the contractor's procurement policies address transactions with affiliated entities? FAR § 44.303(e).
  - a. Do the policies ensure that such entities are not favored?
  - b. Does the contractor recover from the government fees paid to affiliates under common control only when appropriate? FAR § 31.205-26(e).
12. Does the contractor have policies for contracting with small business and other socioeconomically disadvantaged entities that are consistent with FAR (e.g., FAR Pts. 19, 26)? FAR §§ 44.202-2(a)(4)(i), 44.303(f).

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13. Do the contractor's policies require internal audits or assessments of the contractor's purchasing systems? DFARS § 252.244-7001(c)(18).
  - a. Do contractor audits and/or reviews of specific purchases spend appropriate time and resources on the planning, award, and post-award management of major subcontract programs? FAR § 44.303(g).
14. If a CPSR has been conducted recently, did the contractor correct any deficiencies and/or weaknesses timely and appropriately?
15. Does the contractor maintain a file documenting all audit responses and determinations that require corrective action and/or company response?
16. Are employees subject to discipline for failing to follow procedures?
  - a. Is the manner and/or degree of discipline commensurate with the significance of the employee's failure?
  - b. Is a file maintained for employee disciplinary actions?

### B. Procurement Planning and Market Research

#### **Compliance criteria:**

- (6) Apply a consistent make-or-buy policy that is in the best interest of the Government; . . .
- (13) Ensure proper type of contract selection and prohibit issuance of cost-plus-a-percentage-of-cost subcontracts; . . .

DFARS § 252.244-7001(c); see FAR § 44.303(a), (d), (i).

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1. As part of the procurement planning process, do buyers interact regularly with other functions of the organization to ensure that the procurement is conducted in a reasonably efficient, effective and logical manner?
  - a. Are specifications developed by, or in conjunction with, program and technical personnel?
  - b. Can the contractor meet relevant needs from inventory or otherwise supply the needs in-house?
  - c. Does the contractor require consolidation of requirements for the same item to obtain economic ordering quantities and use procedures that ensure that consolidations will occur?
2. For materials acquired on an order point or “min-max” basis, are the criteria used to establish and maintain order point or min/max reviewed periodically?
3. Does the contractor consider whether an item is available from the government prior to purchasing an item? FAR § 44.202-2(a)(2).
4. Are buyers required to conduct market research prior to beginning the procurement process to determine (see FAR §§ 44.303(a), (i)):
  - a. The availability and approximate number of potential suppliers?
  - b. Whether commercial items are appropriate?
  - c. Distribution and support capabilities of suppliers?
  - d. The ability of small or disadvantaged businesses to meet the relevant needs? FAR § 44.202-2(a)(4)(i); FAR § 44.303(f).
  - e. The availability of items from nonprofit agencies designated by the Committee for Purchase From People Who Are Blind or Severely Disabled? FAR § 44.202-2(a)(4)(ii).
  - f. The availability of items from FAR Part 26 programs, such as historically black colleges and universities?

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5. Does the contractor perform best value procurements? If so, do the contractor's policies:
  - a. State when such procurements are appropriate?
  - b. Provide guidance regarding what evaluation factors should be used?
  - c. Require that cost/price be considered as a factor?
6. Does the contractor ensure consistent and defensible make-or-buy decisions that are in the government's best interest? FAR § 44.202-2(a)(1); DFARS § 252.244-7001(c)(6).
7. Does the contractor provide guidance or considerations for procurement personnel when determining the proper form of procurement and resulting agreement? FAR § 44.202-2(a)(9).
  - a. Are FFP contracts or otherwise appropriate forms of agreements used when acquiring commercial items (see FAR Pts. 2 and 12) or when acquiring other supplies or services on the basis of reasonably definite functional or detailed specifications (see FAR Pt. 11) that allow for the determination of fair and reasonable prices at the outset (see FAR § 16.202-2), such as when:
    - (i) There is adequate price competition?
    - (ii) There are reasonable price comparisons with prior purchases of the same or similar supplies or services made on a competitive basis or supported by valid certified cost or pricing data?
    - (iii) Available cost or pricing information permits realistic estimates of the probable costs of performance?
    - (iv) Performance uncertainties can be identified and reasonable estimates of their cost impact can be made, and the supplier is willing to accept an FFP agreement and assume the risks involved?

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- b. Are FPI agreements used when an FFP agreement is not appropriate and the required supplies or services can be acquired at lower costs and, in certain instances, with improved delivery or technical performance, by relating the amount of profit or fee payable under the contract to the contractor's performance? FAR § 16.401.
  - c. Are T&M and/or labor hours agreements used only when it is not possible at the time of award to accurately estimate the extent or duration of the work or to anticipate costs with any reasonable degree of confidence? FAR § 16.601.
  - d. Are cost reimbursement agreements used only when (see FAR § 16.301-2):
    - (i) Circumstances do not allow the contractor to define its requirements sufficiently to allow for a fixed-price type agreement?
    - (ii) Uncertainties involved in performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price agreement?
8. When cost reimbursement agreements are used, is a written justification for using this type of agreement required? FAR § 16.301-2(b).
9. Do contractor policies prohibit inappropriate/unadvisable agreement types, such as:
- a. Cost-plus-percentage-of-cost agreements? FAR § 44.203(b)(2); DFARS § 252.244-7001(c)(13).
  - b. Cost-type agreements under fixed-price prime contracts?
  - c. Cost reimbursement agreements if the fee exceeds the fee limitations of FAR Subpart 15.4? FAR § 44.203(b)(1).
  - d. Agreements obligating the government to deal directly with the supplier? FAR § 44.203(b)(3).

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- e. Agreements that purport to make the results of arbitration, judicial determination, or voluntary settlement between the prime contractor and supplier binding on the government? FAR § 44.203(b)(4).
  - f. Repetitive or unduly protracted use of cost reimbursement, T&M, or labor-hour agreements? FAR § 44.203(b)(5).
10. Does the contractor's procurement policy favor the use of commercial item components, when possible? FAR § 52.244-6. Are buyers required to document their determination that an item is commercial in nature?
11. Does the contractor require that all offerors complete and return standard representations and certifications with offers? Do these representations and certifications provide the contractor with information necessary to the source selection process, such as small business status, etc.?

### C. Prevention of Conflicts of Interest and Procurement Misconduct

**Compliance criteria:** [e]nforce adequate policies on conflict of interest, gifts, and gratuities, including the requirements of the Anti-Kickback Act; . . .

DFARS § 252.244-7001(c); see FAR § 52.203-13(c)(1)(ii).

- 1. Do contractor policies prohibit improper kickbacks, gifts and gratuities? Anti-Kickback Act of 1986 (41 U.S.C. §§ 51-58); FAR Pt. 3; FAR § 52.203-7; DFARS § 252.244-7001(c)(17).
  - a. Does the contractor have rules prohibiting improper kickbacks, gifts and gratuities by suppliers? Are employees aware of these rules and trained to identify improper conduct?

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- b. Does the contractor have procedures to minimize the opportunity for improper kickbacks, gifts, and gratuities to the purchasing function, including:
    - (i) Mandatory competition of procurements for commercial items?
    - (ii) Management-level review of major purchases?
    - (iii) Periodic rotation of purchasing employees?
    - (iv) Identification and review of frequent suppliers for improper behavior?
  - c. Does the contractor require suppliers to certify they have not paid improper kickbacks, gifts and gratuities?
  - d. Does the contractor have educational programs for new employees and suppliers explaining company policies against improper kickbacks, gifts and gratuities and the consequences of violating these policies?
  - e. Does the contractor have procedures to report improper kickbacks, gifts and gratuities to management and to law enforcement officials, if appropriate?
2. Do contractor policies guard against conflicts of interest?
- a. Are employees required to disclose prior and current relationships with suppliers (including both employment relationships and other relations, such as through a spouse)?
  - b. Are employees prohibited from working for other entities while employed by the contractor? If not, are employees required to disclose employment relationships with other companies?
  - c. Are buyers required to disclose whether they have ownership positions in potential suppliers? Are buyers prohibited from directly doing business with entities in which the buyer has an ownership interest or otherwise controls?

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- d. Do company policies require management approval before an employee can conduct business with an entity with which the employee has or had any ownership intent?
3. If the prime contract is subject to FAR § 52.203-13 (Contractor Code of Business Ethics and Conduct), does the contractor provide training on its ethics policies to supplier employees, as appropriate? FAR § 52.203-13(c)(1)(ii).
4. Does the contractor require annual declarations from employees that they have violated no company ethics rules?
5. Does the company perform a background credit check on all buyers and purchasing agents before they are hired?

### D. Competitive Purchasing

#### Compliance criteria:

- (7) Use competitive sourcing to the maximum extent practicable, and ensure debarred or suspended contractors are properly excluded from contract award; . . .
- (9) Require management level justification and adequate cost or price analysis, as applicable, for any sole or single source award; . . .

DFARS § 252.244-7001(c); see FAR § 44.303(b).

1. Does the contractor require buyers to use competitive sourcing to the maximum extent practicable? FAR §§ 44.202-2(a)(5), 44.303(b), 52.244-5; DFARS § 252.244-7001(c)(7).
2. Are competitive bids monitored for indications of collusion or other procurement improprieties?
3. Are procurements awarded without full and open competition only in specific situations where full and open competition cannot be obtained because (see FAR § 6.302):

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- a. Only one responsible source exists and no other supplies or services will satisfy contractor needs?
  - b. Unusual or compelling urgency exists?
  - c. Use of a particular source is required by international agreement?
  - d. Use of a particular source is required by statute?
  - e. The government has determined that national security or the public interest requires the use of a specific supplier?
  - f. The government has otherwise directed the contractor to use a particular supplier in the public interest?
  - g. Other circumstances that justify a sole source or limited competition award?
4. Is management-level justification and adequate cost or price analysis required for sole source procurements? FAR § 44.202-2(a)(8)-(9), (b)(3); FAR § 44.303(b); DFARS § 252.244-7001(c)(9). Does this justification include the following information (see FAR § 6.303):
- a. The reason for purchasing without full and open competition?
  - b. The government prime contract under which the justification is sought?
  - c. The nature and/or description of the action being approved?
  - d. A description of the supplies or services required to meet the contractor's needs (including the estimated value)?
  - e. A demonstration that the proposed contractor's unique qualifications or the nature of the acquisition requires a sole source procurement under company policy?
  - f. A description of efforts made to ensure that offers are solicited from as many potential sources as is practicable, including whether a notice was or will be publicized?
  - g. A determination by the relevant procurement official that the anticipated cost or price will be fair and reasonable?

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- h. A description of the market research conducted (see FAR Pt. 10) and the results of the research or a statement of the reason why market research was not conducted?
- i. Any other facts supporting the use of other than full and open competition, such as:
  - (i) Explanation of why technical data packages, specifications, engineering descriptions, statements of work, or purchase descriptions suitable for full and open competition have not been developed or are not available?
  - (ii) In the context of a follow-on acquisition, an estimate of the cost/price that would be duplicated and how the estimate was derived?
- j. A listing of the sources, if any, that expressed, in writing, an interest in the acquisition?
- k. A statement of the actions, if any, the contractor may take to remove or overcome any barriers to competition before any subsequent acquisition for the supplies or services required?
- l. Certification that the justification is accurate and complete to the best of the knowledge and belief of the individual responsible for the procurement?

### E. Negotiated Procurements

**Compliance criteria:** [d]ocument negotiations in accordance with [FAR requirements for negotiation memoranda] . . .

DFARS § 252.244-7001(c); see FAR § 44.303(c).

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1. When negotiated procurements occur, does the contractor require a negotiation memorandum that is certified by the negotiator? DFARS § 252.244-7001(c)(11).
2. If a negotiation memorandum is required, does it contain the following information (see FAR §§ 15.406-3, 52.244-2(e)(1)):
  - a. The purpose of the negotiation?
  - b. A description of the acquisition, including appropriate identifying numbers (e.g., the RFP number)?
  - c. The name, position, and organization of each person representing the contractor and the offeror in the negotiation?
  - d. The current status of any offeror business systems, to the extent they affected and were considered in the negotiation? Is special attention given to offeror accounting and purchasing systems?
  - e. If certified cost or pricing data (see Ch. 2, § IV.F.) were not required in the case of any price negotiation exceeding the certified cost or pricing data threshold, the exception used and the basis for it?
  - f. If certified cost or pricing data (see Ch. 2, § IV.F.) were required, the extent to which the negotiator:
    - (i) Relied on the certified cost or pricing data submitted and used them in negotiating the price;
    - (ii) Recognized as inaccurate, incomplete, or noncurrent any certified cost or pricing data submitted; the action taken by the contractor and the offeror as a result; and the effect of the defective data on the price negotiated; or
    - (iii) Determined that an exception applied after the data were submitted and, therefore, considered not to be certified cost or pricing data?

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- g. A summary of the subcontractor's proposal, any field pricing assistance recommendations, including the reasons for any pertinent variances from them, the contractor's negotiation objective and the outcome of the negotiations:
    - (i) When the determination of a fair and reasonable price is based on cost analysis (see Ch. 2, § IV.F.4), does the summary address each major cost element?
    - (ii) When the determination of a fair and reasonable price is based on price analysis (see Ch. 2, § IV.F.4), does the summary include the source and type of data used to support the determination?
  - h. The most significant facts or considerations controlling the establishment of the prenegotiation objectives and the negotiated agreement, including explanation of any significant differences between the two positions?
  - i. To the extent such direction has a significant effect on the action, a discussion and quantification of the impact of direction given by Congress, other agencies, and higher-level officials (i.e., officials who would not normally exercise authority during the award and review process for the instant contract action)?
  - j. The basis for the profit or fee prenegotiation objective and the profit or fee negotiated?
  - k. Documentation of fair and reasonable pricing (see Ch. 2, § IV.F.4).
3. May offerors submit alternate proposals? Are such proposals adequately assessed by contracting personnel (see FAR § 44.202-2(a)(6))?

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### F. Cost or Pricing Data and Price Reasonableness

#### Compliance criteria:

- (8) Evaluate price, quality, delivery, technical capabilities, and financial capabilities of competing vendors to ensure fair and reasonable prices; . . .
- (10) Perform timely and adequate cost or price analysis and technical evaluation for each subcontractor and supplier proposal or quote to ensure fair and reasonable subcontract prices; . . .
- (11) Document negotiations in accordance with FAR 15.406-3; . . .
- (12) Seek, take, and document economically feasible purchase discounts, including cash discounts, trade discounts, quantity discounts, rebates, freight allowances, and company-wide volume discounts; . . .
- (22) Establish and maintain procedures to ensure performance of adequate price or cost analysis on purchasing actions . . .

DFARS § 252.244-7001(c); see FAR § 44.303(c).

1. Is offeror cost or pricing data required, when appropriate?  
FAR §§ 44.303(c); 52.215-12, -13.
  - a. Is cost or pricing data obtained from an offeror when required under FAR Subpart 15.4, or when requested by the customer?
  - b. If cost or pricing data is required from offerors, does the contractor require that offerors provide such data with sufficient time to permit the contractor to disclose the information to the government as part of the contractor's certified cost or pricing data?
  - c. When cost or pricing data is required, does the contractor ensure that the data is consistent with FAR Table 15-2?

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- d. Is offeror cost or pricing data reviewed to ensure its accuracy, completeness and currency?
  - e. Is the purchasing function required to furnish the estimating organization copies of current offeror quotes and negotiated price data in a timely manner for use in the prime contract proposal preparation?
  - f. Is the purchasing function required to furnish to the negotiating organization updates and revisions to offeror quotes and negotiated price data as soon as possible during the fact-finding phase?
  - g. Does the purchasing function have policies that ensure the most current, accurate and complete cost or pricing data has been or will be provided to the negotiating organization?
  - h. Do procedures exist to ensure that an offeror submits the required certificate of current cost or pricing data?
  - i. Is work outside the requirements of the contract monitored by the purchasing function, and are approved changes in excess of \$700,000 negotiated in accordance with TINA? 10 U.S.C. § 2306a.
  - j. In the event that an offeror fails to provide certified cost or pricing data, does the contractor:
    - (i) Require the offeror to provide notice in writing?
    - (ii) Notify the government of the offeror's position?
2. Does contractor policy require that a buyer conduct cost or price analysis to determine that the price offered is fair and reasonable? FAR § 44.202-2(a)(8); DFARS § 252.244-7001(c)(8), (10), (22).
  3. Does the contractor provide guidance as to when cost analysis is appropriate and when price analysis is appropriate? FAR Subpt. 15.4; DFARS § 252.244-7001(c)(22).

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- a. When certified cost or pricing data is not required, is price analysis used to determine price reasonableness? FAR §§ 15.404-1, -3.
  - b. When certified cost or pricing data is required, is cost analysis used to evaluate the reasonableness of individual cost elements? FAR § 15.404-1. Is price analysis used to verify that the overall price offered is fair and reasonable? *Id.*
  - c. Is cost analysis used to evaluate data other than certified cost or pricing data to determine cost reasonableness or cost realism when a fair and reasonable price cannot be determined through price analysis alone for commercial or non-commercial items? *Id.*
4. Are appropriate methods of cost and price analysis identified in the contractor's policies or related guidance?
- a. Does the contractor perform price analysis by (see FAR § 15.404-1(b)):
    - (i) Comparison of proposed prices received in response to the solicitation?
    - (ii) Comparison of the proposed prices to historical prices paid for the same or similar items?
    - (iii) Use of parametric estimating methods/application of rough yardsticks (such as dollars per pound or per horsepower, or other units) to highlight significant inconsistencies that warrant additional pricing inquiry?
    - (iv) Comparison with competitive published price lists, published market prices of commodities, similar indexes, and discount or rebate arrangements?
    - (v) Comparison of proposed prices with independent cost estimates?

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- (vi) Comparison of proposed prices with prices obtained through market research for the same or similar items?
- (vii) Analysis of data other than certified cost or pricing data provided by the offeror?
- b. Are the first two methods of price analysis (see previous subsection) preferred? FAR § 15.404-1(b)(3).
- c. Does the contractor perform cost analysis by (see FAR § 15.404-1(c)):
  - (i) Verification of cost data or pricing data and evaluation of cost elements, including:
    - (a) The necessity for, and reasonableness of, proposed costs, including allowances for contingencies?
    - (b) Projection of the offeror's cost trends, on the basis of current and historical cost or pricing data?
    - (c) Reasonableness of estimates generated by appropriately calibrated and validated parametric models or cost-estimating relationships?
    - (d) The application of audited or negotiated indirect cost rates, labor rates, cost of money or other factors?
  - (ii) Evaluating the effect of the offeror's current practices on future costs?
  - (iii) Comparing costs proposed by the offeror for individual cost elements with:
    - (a) Actual costs previously incurred by the same offeror?
    - (b) Previous cost estimates from the offeror or from other offerors for the same or similar items?

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- (c) Other cost estimates received in response to the contractor's request?
    - (d) Independent cost estimates by technical personnel?
    - (e) Forecasts of planned expenditures?
  - (iv) Verification that the offeror's cost submissions are in accordance with the cost principles and procedures in FAR Part 31 and, when applicable, the requirements and procedures in 48 C.F.R. Chapter 99 (Cost Accounting Standards)?
  - (v) Review to determine whether any cost or pricing data, necessary to make the offeror's proposal suitable for negotiation, have not been either submitted or identified in writing by the offeror?
  - (vi) Analysis of the results of any make-or-buy program reviews in evaluating second-tier subcontract costs (FAR § 15.407-2)?
5. Does the contractor encourage buyers to seek assistance from other contractor organizations when performing price or cost analysis? From government organizations?
  6. Are all price and cost reasonableness and cost realism determinations documented in the procurement file?
  7. Does the contractor seek, take and document economically feasible purchase discounts, including cash discounts, trade discounts, quantity discounts, rebates, freight allowances and company-wide volume discounts? DFARS § 252.244-7001(c) (12).
  8. If supplier performance will involve the use of government-furnished property, does the supplier's price reflect cost savings associated with the use of this property (FAR § 44.202-2(a)(10))?

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### G. Source Selection

#### **Compliance criteria:**

- (7) Use competitive sourcing to the maximum extent practicable, and ensure debarred or suspended contractors are properly excluded from contract award; . . .
- (8) Evaluate price, quality, delivery, technical capabilities, and financial capabilities of competing vendors to ensure fair and reasonable prices; . . .
- (21) Establish and maintain selection processes to ensure the most responsive and responsible sources for furnishing required quality parts and materials and to promote competitive sourcing among dependable suppliers so that purchases are reasonably priced and from sources that meet contractor quality requirements; . . .

DFARS § 252.244-7001(c); see FAR § 44.303(d).

1. Does the contractor provide guidance to buyers regarding source selection, including the appropriate considerations when conducting cost-technical trade-offs and determining best value? DFARS § 252.244-7001(c)(21).
2. Does the contractor review all specifications and other requirements to minimize unnecessary restrictions on competition?
3. Prior to award, are potential suppliers screened against a list of parties suspended or debarred from contracting? FAR §§ 44.202-2(a)(13), 44.303(d), 52.209-6; DFARS § 252.244-7001(c)(7).
4. Do buyers make a responsibility determination prior to subcontract award? FAR §§ 44.202-2(a)(7), 44.303(d); DFARS § 252.244-7001(c)(21). As a part of this determination, does the contractor ensure that a prospective subcontractor (see FAR § 9.104-1):

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- a. Has adequate financial resources to perform the contract, or the ability to obtain them (see FAR § 9.104-3(a))?
  - b. Is able to comply with the required or proposed delivery or performance schedule, taking into consideration all existing commercial and governmental business commitments?
  - c. Has a satisfactory performance record (see FAR § 9.104-3(b); FAR Subpt. 42.15)?
  - d. Has a satisfactory record of integrity and business ethics (see FAR Subpt. 42.15)?
  - e. Has the necessary organization, experience, accounting and operational controls and technical skills, or the ability to obtain them (including, as appropriate, such elements as production control procedures, property control systems, quality assurance measures, and safety programs applicable to materials to be produced or services to be performed by the prospective contractor and subcontractors) (see FAR § 9.104-3(a))?
  - f. Has the necessary production, construction, and technical equipment and facilities, or the ability to obtain them (see FAR § 9.104-3(a))?
  - g. Is otherwise qualified and eligible to receive an award under applicable laws and regulations (see FAR § 9.108 (inverted domestic corporation prohibition))?
5. Is a finding that the price offered is fair and reasonable made before award? DFARS § 252.244-7001(c)(8), (21).
  6. Are all awards justified in writing?
    - a. Are the reasons for awards to other than the lowest price bidder justified in writing?
    - b. Is technical justification for an award documented? FAR § 44.202-2(a)(3).

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### H. Formation and Content

#### **Compliance criteria:**

- (2) Ensure that all applicable purchase orders and subcontracts contain all flowdown clauses, including terms and conditions and any other clauses needed to carry out the requirements of the prime contract; . . .
- (16) Notify the Government of the award of all subcontracts that contain the FAR and DFARS flowdown clauses that allow for Government audit of those subcontracts, and ensure the performance of audits of those subcontracts; . . .
- (19) Establish and maintain policies and procedures to ensure purchase orders and subcontracts contain mandatory and applicable flowdown clauses, as required by the FAR and DFARS, including terms and conditions required by the prime contract and any clauses required to carry out the requirements of the prime contract; . . .

DFARS § 252.244-7001(c); see FAR § 44.303(h).

1. Do the contractor's policies require advance notice to the government of subcontract award and government consent, when required by the prime contract?
  - a. Is such notice given and consent received?
  - b. Are the contractor's buyers aware of the status of the contractor's purchasing system (i.e., approved or unapproved) and the implications that status has on advance government notice and consent? FAR § 52.244-2.
  - c. Do the contractor's policies require the buyer to review the terms of the prime contract prior to subcontract award to determine whether advance notice and government consent are required? FAR § 52.244-2.

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2. Does the contractor require the individual signing an agreement on behalf of a supplier to demonstrate his or her authority to execute agreements on behalf of the supplier?
3. Does the contractor have standard terms and conditions that are used whenever making a purchase under a government prime contract or subcontract that:
  - a. Provide a mechanism for the contractor to obtain additional information from the supplier to meet reporting requirements, as necessary?
  - b. Obtain intellectual property rights consistent with statutory and regulatory requirements?
  - c. Permit the level of surveillance and quality assurance necessary to ensure compliance under the prime contract?
  - d. Contain dispute resolution provisions that are in the contractor's best interest and treat contracting officer final decisions as binding on the supplier?
  - e. Do not inappropriately restrict a supplier's right to do business with the government? FAR § 52.203-6.
4. Does the contractor ensure that specific agreements have all terms necessary to implement and carry out the requirements of the related prime contract? DFARS § 252.244-7001(c)(2), (19).
  - a. Are technical requirements consistent with the requirements of the prime contract? FAR § 44.202-2(a)(11).
  - b. Are prime contracts reviewed to ensure that all mandatory flowdown clauses are included in subcontracts?
  - c. Does the contractor include provisions that, while not mandatory, may be essential to ensuring compliance, including:
    - (i) Termination for convenience and default?
    - (ii) Progress payments?
    - (iii) Disputes?

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- (iv) Limitation of costs or limitation of funds provisions?
  - (v) Defective pricing liability?
  - (vi) Obligations under the Defense Priorities System or the Defense Materials System?
  - (vii) Warranty obligations?
  - (viii) Technical data rights?
  - (ix) Changes?
  - (x) Assignment of claims?
  - (xi) Domestic source rules (Buy American Act/Trade Agreements Act)?
  - (xii) Prohibitions on gratuities and other non-mandatory ethics-related clauses?
  - (xiii) Government property?
  - (xiv) Technical data?
  - (xv) Subcontractor cost or pricing data?
  - (xvi) Stop work orders?
- d. Are all agreements reviewed to eliminate clauses that will conflict with provisions in the prime contract?
5. Are subcontracts for commercial items consistent with the requirements of FAR Part 12?
- a. Do commercial item subcontracts contain all required flowdown clauses? FAR § 52.244-6; DFARS § 252.244-7000.
  - b. Does the prime contractor only include in commercial item subcontracts “a minimal number of additional clauses necessary to satisfy its contractual obligations?” FAR § 52.244-6.

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6. Are all agreements that are executed under terms other than the contractor's standard government contract terms and conditions reviewed by individuals with sufficient knowledge and authority to determine whether the terms of the agreement are consistent with government contract requirements?
7. If the contractor's relevant government contract is subject to FAR § 52.203-13 (Contractor Code of Business Ethics and Conduct), are suppliers required to notify the contractor of reportable events under the clause to facilitate timely disclosure to the government? FAR § 52.203-13(c)(2)(ii)(F).
8. Does the contractor notify the government when it awards a subcontract that contains FAR and DFARS flowdown clauses that allow for government audit of those subcontracts, and ensure the performance of audits of those subcontracts? DFARS § 252.244-7001(c)(16).
9. When a subcontract is subject to CAS, does the contractor take appropriate actions (see FAR §§ 44.202-2(a)(12), 44.303(h), 52.230-6(l)-(n)), including:
  - a. Stating that the subcontract is subject to CAS in the body of the subcontract?
  - b. Flowing down the appropriate CAS clause(s)?
  - c. Notifying the government of the award?
  - d. Obtaining a subcontractor's CAS Disclosure Statement or a certification that the subcontractor has submitted a CAS Disclosure Statement to the government?
  - e. Notifying the government of any changes to a subcontractor's cost accounting practices?
10. Does the contractor engage in teaming agreements when seeking government contracts? If so:
  - a. Does the teaming agreement bind the subcontractor to prices agreed to between the contractor and the government?

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- b. Does the teaming agreement ensure that only fair and reasonable prices will be offered and that, if needed, the subcontractor will support its prices with cost or pricing data?
- c. Does the teaming agreement ensure that the contractor controls all contact with the government and negotiation of the subcontract?
- d. Does the teaming agreement provide that resulting agreements/arrangements made pursuant to the teaming agreement may be subject to government approval under FAR Subparts 9.6 and 44.2?
- e. Does the teaming agreement make clear the division of work under the work statement for the subcontract?

### I. Foreign Purchases and Performance

#### **Compliance criteria:**

1. Contractors must comply with all relevant domestic preference requirements.
2. Export control regulations must be complied with.
3. Contractors must not execute agreements with prohibited parties.

FAR Pt. 25, § 52.225; DFARS Pt. 225, § 252.225.

1. Does the contractor monitor the content of items (or construction) to ensure compliance with domestic preference requirements? FAR §§ 52.225-1, *et seq.*; DFARS §§ 252.225-7000, *et seq.*
  - a. Do contracting personnel know what domestic preference requirements are contained in the relevant prime contracts? FAR §§ 52.225-1, -5, -9, -11; DFARS §§ 252.225-7001, -7021.

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- b. Are specialty metals procured only from acceptable sources under contracts with the DOD?  
DFARS §§ 252.225-7008, -7009, -7010.
    - c. Are procurement personnel able to identify prohibited sources for content under government contracts?
    - d. Does the contractor require suppliers to provide information regarding location of performance and country of origin of supplies?
    - e. If required by contract provisions implementing the Buy American Act or the Trade Agreements Act, or other specialty domestic content requirements, does the contractor monitor the content of end items (or construction) that will be delivered to the government to ensure compliance with domestic preference requirements?
    - f. Does the contractor have a mechanism for requesting waivers from the government prior to the acquisition of foreign components (or construction materials) or, if necessary, when inappropriate materials are included in end products (or construction) that will be delivered to the government?
  2. If goods or information of any sort are transferred to suppliers as a part of the procurement process, does the contractor ensure compliance with export laws and regulations?
    - a. Does the contractor have an export control system with an empowered official that reviews all exports (including those performed as part of the procurement process) to ensure export compliance?
    - b. Are procurement personnel aware that providing technical data to foreign nationals or foreign entities, including specifications or other information that may be necessary to the procurement process, may be considered an export?

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- c. If a procurement will involve export controlled information, are foreign national employees prevented from supporting the procurement? If not, does the contractor obtain an export license prior to providing the employees any export controlled information?
      - d. Do procurement personnel work in conjunction with the contractor's export control group and/or legal organization to ensure that such exports comply with applicable laws and regulations?
      - e. If the contractor will provide foreign suppliers with material or other goods as part of performance, are such activities coordinated with contractor's export control group and/or legal organization to ensure that such exports comply with applicable laws and regulations?
      - f. Does the contractor require that suppliers comply with all export control laws and regulations?
3. When purchasing from foreign parties, does the contractor comply with all relevant import laws and regulations?
4. Does the contractor have a mechanism to prevent it from doing business with foreign entities prohibited under federal laws or regulations? FAR § 52.225-13.
  - a. Does the contractor monitor and comply with all U.S. sanctions and trade restrictions?
  - b. Prior to contracting with a foreign entity, does the contractor review various government lists of foreign parties with which it may not conduct business?
5. Does the contractor ensure that its suppliers take into account other considerations for foreign transactions such as:
  - a. Whether the ACO has authorized duty-free entry of the product?

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- b. Whether the supplier has been evaluated for Foreign Corrupt Practices Act (“FCPA”) compliance and inclusion of prohibitions against violation of the FCPA?
- c. Responsibility for taxes and duties?
- d. In what currency will payment be made? Is an exchange rate specified?
- e. Does the contract indicate what law will apply to the contract? Is a procedure in place to resolve contract disputes?

### J. Procurement Administration

#### **Compliance criteria:**

- (14) Maintain subcontract surveillance to ensure timely delivery of an acceptable product and procedures to notify the Government of potential subcontract problems that may impact delivery, quantity, or price; . . .
- (15) Document and justify reasons for subcontract changes that affect cost or price; . . .
- (23) Establish and maintain procedures to ensure that proper types of subcontracts are selected, and that there are controls over subcontracting, including oversight and surveillance of subcontracted effort; and
- (24) Establish and maintain procedures to timely notify the Contracting Officer, in writing [of excessive pass-through concerns] . . .

DFARS § 252.244-7001(c); see FAR § 44.303(j).

- 1. Does the contractor maintain an effective surveillance mechanism to ensure that suppliers are on-schedule and deliver products that comply with contractual requirements?

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2. Does the contractor notify the government when it experiences supplier problems that may impact delivery, quantity or price? DFARS § 252.244-7001(c)(14), (23).
3. Does the contractor document and justify all significant supplier actions, including changes that affect cost/price or schedule? DFARS § 252.244-7001(c)(15).
4. Does the contractor ensure that supplier invoices include all necessary documentation?
5. Are supplier invoices monitored for accuracy and completeness and to ensure that only permitted and allowable amounts are claimed? FAR § 44.303(j).
6. Does the contractor monitor subcontractor performance to ensure that the contractor complies with excessive pass-through requirements? DFARS § 252.244-7001(c)(24).
  - a. When planning procurements, does the contractor ensure that less than 70% of work will be performed by subcontractors? If not, is notice provided to the government? FAR § 52.215-23.
  - b. If work under the contract is modified (either at the contract or subcontract level), does the contractor re-assess contract performance to ensure that subcontractors still perform 70% or less of the work under the contract? Do procedures exist to provide the government with notice if subcontractors perform more than 70% of the work? FAR § 52.215-23.
  - c. Does the contractor require subcontractors to monitor lower-tier subcontract performance to ensure that lower-tier subcontractors do not perform more than 70% of subcontract work? Must subcontractors notify the contractor if second tier subcontractors perform more than 70% of work? FAR § 52.215-23.

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### K. Procurement Closeout

**Compliance criteria:** prior to closeout, the contractor must ensure that performance is complete and consistent with the terms of the subcontract; and a release of claims should be obtained from subcontractors prior to final payment.

FAR § 4.804.

1. Prior to paying the final invoice of a supplier, does the contractor ensure that all items or services to be delivered or services to be rendered have:
  - a. Been provided?
  - b. Been inspected?
  - c. Passed inspection?
2. Prior to paying the final invoice of a supplier, does the contractor ensure that the supplier has been paid in accordance with the subcontract?
3. Does the contractor obtain a release of claims from a supplier prior to making final payment?
4. Is contract closeout documented? Is this documentation contained in the procurement file?
5. Does the contractor have a process for closing out procurement files after a procurement is completed?

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### V. Counterfeit Electronic Parts

#### A. Applicability

The DOD counterfeit parts rule, DFARS § 252.246-7007, applies to CAS-covered contracts where the prime contractor supplies electronic parts, as well as subcontracts issued under that prime contract. Electronic parts are defined as “an integrated circuit, a discrete electronic component (including, but not limited to, a transistor, capacitor, resistor, or diode), or a circuit assembly . . . [and] includes any embedded software or firmware.”

1. Is the DOD contract CAS-covered?
2. Does the contractor supply electronic parts or products that include electronic parts?
3. If acting as a sub-tier supplier, is the clause included in a subcontract as a flowdown?

DFARS § 252.246-7007.

#### B. Training and Policies and Procedures

##### **Compliance criteria:**

- (1) Training of personnel;
- (3) Processes to abolish counterfeit parts proliferation;
- (10) Processes for keeping continually informed of current counterfeiting information and trends;
- (11) Processes for screening GIDEP reports and other credible sources of counterfeiting information to avoid the purchase or use of counterfeit electronic parts.

DFARS § 252.246-7007(c).

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1. Does the contractor have periodic training for contractor personnel to ensure compliance with, and understanding of, the counterfeit electronic parts requirements?
  - a. Does the receiving and inspection policy require training in detecting and avoiding counterfeit parts?
  - b. Does the purchasing and subcontract management policy require training in detecting and avoiding counterfeit parts?
2. Does the contractor maintain adequate and documented purchasing and subcontract management policies to avoid the introduction of counterfeit parts into the supply chain?
  - a. Is there evidence that the contractor's policies are implemented?
3. Do the policies and procedures require that the contractor document the detection, verification and control of suspect counterfeit parts? (a) Is contract closeout documented? (b) Is this documentation contained in the procurement file?
4. Do the policies and procedures include a designated individual to report issues associated with counterfeit and suspect counterfeit parts?
5. Does the contractor have a designated individual responsible for keeping continually informed of current counterfeiting information and trends through email alerts, industry focus groups and/or independent research?

### **C. Identifying a Procurement Need and Structuring a Procurement, Including Flowdowns**

#### **Compliance criteria:**

- (9) Flowdown of counterfeit detection and avoidance requirements, including applicable system criteria . . . to subcontractors at all levels in the supply chain that are responsible for buying or selling electronic parts or assemblies containing electronic parts, or for performing authentication testing.

DFARS § 252.246.-7007(c).

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1. Does the contractor flowdown DFARS § 252.246-7007 to all suppliers who supply electronic parts?
2. Does the contractor specify the flowdown of applicable engineering and manufacturing requirements to all sub-tier suppliers including commercial item suppliers?
3. Do the subcontract terms include quality control processes and requirements to minimize the risk of procuring counterfeit parts?
4. Do the subcontract terms notify a sub-tier supplier of the tests and inspection requirements to assure product authenticity?
5. Do the subcontract terms notify a sub-tier supplier that it may be liable for remedial costs associated with providing a counterfeit product?
6. Do the subcontract terms notify a sub-tier supplier of the requirements to provide clear documentation?
7. Do the subcontract terms notify a sub-tier supplier of the potential federal penalties associated with fraud and falsification?
8. Does the contractor have a designated individual to screen Government-Industry Data Exchange Program (GIDEP) reports and other credible sources of counterfeiting information to identify specific electronic parts, which may be at a higher risk of being counterfeit?
9. Are high risk procurements identified as such so that the contractor can more strictly scrutinize the procurement to identify, detect and avoid counterfeit electronic parts in the supply chain?
10. Does the process require a sub-tier supplier to report counterfeit parts to the contractor, GIDEP and industry reporting programs?

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### D. Identifying Suppliers

#### Compliance criteria:

- (5) Use of suppliers that are the original manufacturer, or sources with the express written authority of the original manufacturer or current design activity, including an authorized aftermarket manufacturer or suppliers that obtain parts exclusively from one or more of these sources.

DFARS § 252.246-7007(c).

1. Does the contractor require the assessment of potential sources/contractors to determine the risk of receiving counterfeit parts?
2. Does the contractor maintain a list of approved sub-tier suppliers and the scope of that approval?
3. Does the contractor review the sub-tier supplier's Quality Management System?
4. Does the contractor specify a preference to procure from the Original Chip Manufacturers/Original manufacturers ("OCM/OM") or OCM/OM supply chain when available?
5. Does the contractor verify the accuracy of authorized OCM/OM distributor lists?
6. Does the contractor verify that an authorized distributor is authorized to sell the specific electronic part that the contractor seeks to purchase?
7. Does the contractor require periodic monitoring of approved sources of supply to assure that they are maintaining an effective process for mitigating the risks of counterfeits?
8. Does the contractor assess and mitigate the risk of procuring counterfeit parts from sources that are not OCM/OM and OCM/OM authorized suppliers?

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9. Does the contractor maintain supply chain traceability to the OCM/OM or aftermarket manufacturer and identify the name and location of all the supply chain intermediaries?
10. Does this process require supplier Certificates of Quality Conformance?
11. Does the contractor designate an individual to screen GIDEP reports and other credible sources of counterfeiting information to identify suppliers that may have previously provided counterfeit parts and notify the purchasing department of any related supplier concerns?

### **E. Receiving, Inspection, Tracking, Detection and Identification**

#### **Compliance criteria:**

- (2) The inspection and testing of electronic parts, including criteria for acceptance and rejection;
- (4) Processes for maintaining electronic part traceability that enable tracking of the supply chain back to the original manufacturer, whether the electronic parts are supplied as discrete electronic parts or are contained in assemblies;
- (7) Methodologies to identify suspect counterfeit parts and to rapidly determine if a suspect counterfeit part is, in fact, counterfeit;
- (8) Design, operation, and maintenance of systems to detect and avoid counterfeit electronic parts and suspect counterfeit electronic parts;
- (12) Control of obsolete electronic parts to maximize the availability and use of authentic, originally designed, and qualified electronic parts throughout the product's life cycle.

DFARS § 252.246-7007(c).

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1. Does the contractor inspect electronic parts in an attempt to identify counterfeit material prior to formal acceptance?
2. Does the process require inspection for evidence of remarking or resurfacing, if applicable?
3. Does the contractor require detailed inspection of documentation or packaging?
4. Does the contractor test the part prior to formal acceptance?
5. Does the contractor perform a visual inspection to IDEA-STD-1010, Acceptability of Electronic Components Distributed in the Open Market?
6. Is x-ray inspection required, if applicable?
7. Is x-ray florescence inspection required, if applicable?
8. Is destructive physical analysis required, if applicable?
9. Does the contractor document traceability and authenticity of electronic parts?
10. If traceability or authenticity cannot be verified, does the contractor place restrictions on the use of the electronic parts in DOD contracts and document such restrictions?
11. Does the contractor have a process, as appropriate, for ensuring long-term availability of parts that may be obsolete?
12. Does the contractor require increased testing for obsolete parts?

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### F. Reporting and Ensuring the Supply Stream Is Free of Counterfeit Parts

#### **Compliance criteria:**

- (6) Reporting and quarantining of counterfeit electronic parts and suspect counterfeit electronic parts.

DFARS § 252.246-7007(c).

1. Does the contractor have a designated individual who company employees can report incidents of identification of counterfeit and suspect counterfeit parts to and who is responsible for formal reporting?
2. Does the contractor require that the occurrences of counterfeit parts be reported as required to GIDEP and industry supported reporting programs?
3. If a contractor has certain parts that satisfy the DOD counterfeit parts restrictions and others that do not, does the contractor specifically designate the compliant parts as such through a DOD status product line?
4. Does the contractor quarantine counterfeit and suspect counterfeit parts?

## CHAPTER 2: PURCHASING SYSTEMS

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### VI. 2014 System Update

#### A. Areas of Emphasis

Contractors have experienced compliance issues during system reviews conducted pursuant to DFARS § 252.244-7001 in the following purchasing system areas:

1. Lack of or inadequate cost or price analysis.
2. Lack of competition without justification and/or failure to properly document single and sole source awards.
3. Lack of commercial item determinations for all procurements above the micro-purchase threshold, including procurements below the Truth in Negotiations Act (“TINA”) threshold.
4. Inadequate policies and procedures.
5. Failure to obtain subcontractor certifications regarding federal lobbying in accordance with FAR § 52.203-12.
6. Failure to comply with Defense Priorities and Allocations System requirements.
7. Lack of adequate procurement file documentation and failure to properly document negotiations.
8. Failure to properly verify vendor eligibility in compliance with FAR § 52.209-6.
9. Failure to ensure POs and subcontracts contain mandatory flow downs.
10. Improperly handling small dollar awards/micro-purchases.
11. Failure to obtain an adequate small business subcontracting plan.
12. Lack of Equal Employment Opportunity (“EEO”) clearance prior to award.
13. Failure to ensure current certified cost or pricing data for subcontracts subject to TINA is obtained and failure to seek price reductions when defective cost or pricing data has been submitted.

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14. Failure to properly administer CAS-covered subcontracts.
15. Failure to ensure that letter contract actions are timely definitized.
16. Lack of properly implemented long term agreements.
17. Deficiencies related to intercompany transfers.

### **B. Regulatory Developments - Counterfeit Electronic Parts Detection and Avoidance**

On May 6, 2014, DOD issued a final rule on counterfeit electronic parts. The fundamental requirements of the rule are that contractors performing CAS-covered contracts are required to maintain a counterfeit electronic parts detection and avoidance system as part of their purchasing system that meets the criteria set out in section V above. In addition, the final rule provides that costs associated with counterfeit electronic parts and any related rework or corrective action are unallowable. These requirements are implemented through a new DFARS contract clause, revisions to the DFARS purchasing system clause, and a new DFARS cost principle. See DFARS §§ 246.870-3, 252.244-7001.

#### **1. Definitions**

The final rule applies to “counterfeit electronic parts” and “suspect counterfeit electronic parts,” both of which are defined terms. Counterfeit electronic parts are defined as:

[A]n unlawful or unauthorized reproduction, substitution, or alteration that has been knowingly mismarked, misidentified, or otherwise misrepresented to be an authentic, unmodified electronic part from the original manufacturer, or a source with the express written authority of the original manufacturer or current design activity, including an authorized aftermarket manufacturer. Unlawful or unauthorized substitution includes used electronic parts represented as new, or the false identification of grade, serial number, lot number, date code, or performance characteristics.

Similarly, suspect counterfeit electronic parts are defined as electronic parts for which “credible evidence . . . provides reasonable doubt that the electronic part is authentic.” The final rule’s incorporation of the term

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“credible evidence” is significant because it should provide contractors the ability to conduct an investigation to determine whether a part might be a suspect counterfeit part before the reporting or cost disallowance provisions of the rule are triggered. If the initial investigation were to reveal that the part is authentic, then there is no prohibition against the contractor recovering the costs of the part and the investigation.

### **2. Purchasing System Criteria**

The most significant impact on defense contractors subject to the new counterfeit electronic parts rule is the substantial new purchasing system requirement. Specifically, contractors now must maintain an adequate counterfeit electronic parts detection and avoidance system. DFARS § 246.870-2. The rule sets forth 12 criteria for an adequate system, which are described above in section V. Notably, many of these specific criteria are vague and undefined, making it important for contractors to interpret these criteria in policies and procedures that reflect the contractor’s business and to comply with these policies and procedures.

The rule requires that contractors adopt a “risk based approach” that takes into account: (1) the likelihood that a particular part is counterfeit; (2) the potential consequences of a counterfeit; and (3) the likelihood that a counterfeit will be detected through inspection and testing. DFARS § 246.870-2.

### **3. Unallowable Costs**

Under the new rule, all costs associated with counterfeit parts, including the cost of the parts and any required rework or corrective action, are unallowable under government contracts except where a three part safe-harbor test is satisfied. Notably, while the counterfeit parts rule and associated system requirements are limited in applicability to CAS-covered contracts, the DFARS cost principle at DFARS § 231.205-71 applies to all DOD contracts.

1. If costs are associated with counterfeit parts, do they meet the safe harbor test:
  - a. Does the contractor have a DOD-approved counterfeit electronic parts detection and avoidance system;

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- b. Was the counterfeit or suspect counterfeit part at issue provided to the contractor as government furnished property in accordance with FAR Part 45; and
    - c. Did the contractor provide timely notice to the government?
  2. If costs are associated with counterfeit parts and do not satisfy the safe-harbor test, are all such costs, including costs of parts and any required rework or corrective action, excluded from any direct or indirect billings under government contracts?

### C. DCMA Guidance

On November 28, 2012, DCMA issued a “Contractor Purchasing System Reviews” instruction, which it updated on January 9, 2014. DCMA-INST 109. This instruction provides an overview of the new CPSR process and superseded both: (a) the previous DCMA CPSR instruction “Consent to Subcontract/Contractor Purchasing System Review;” and (b) the former instruction’s Appendix B, which was a broad-ranging 55 question checklist formerly used to assess a contractor’s purchasing system. DCMA-INST 109 canceled that 55 question checklist and now, instead, mirrors the 24 purchasing system requirements discussed above and found at DFARS § 252.244-7001. DCMA-INST 109 is a stand-alone purchasing system evaluation document used as guidance for DCMA CPSR auditors. Appendix A to the instruction contains a lengthy CPSR process flowchart, which describes DCMA’s process in detail.

The new instruction states that DCMA’s policy is to determine if a contractor meets the regulatory requirements identified in FAR § 44.302(a) and included in DFARS § 252.244-7001. It provides that an ACO shall initiate a review of a contractor’s purchasing system and determine whether significant deficiencies exist. If any significant deficiency exists, the ACO must issue a decision to disapprove the contractor’s purchasing system. Before doing so, however, the ACO is required to obtain higher level review from the Contractor Business Systems Review Panel in accordance with DCMA-INST 131, “Contractor Business Systems,” as must occur for any ACO decision to disapprove any contractor business system.

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The instruction also provides that the “ACO must maintain a sufficient level of annual surveillance,” which includes making a written determination regarding whether an additional CPSR is necessary every three years after an initial determination. An increase in surveillance may indicate that DCMA is considering conducting a CPSR in the near future.

According to the instruction, once an ACO has determined that a CPSR is necessary, a CPSR Procurement Analyst Group will be assigned to the review. The Group will assign a Procurement Analyst who will act as the team captain for the review. The team captain will be the primary contact for both the ACO and the contractor to establish the schedule and lead the CPSR. The instruction requires that contractors receive a set of pre-review questionnaires at least eight weeks prior to the review and that the team captain consider the following factors in defining the scope of the review:

1. Whether the past review resulted in significant deficiencies requiring corrective action;
2. Whether there was a major change in the contractor’s purchasing policies, procedures, or key personnel since the last review; and
3. Whether there was a major change in plant workload or type of work.

DCMA’s instruction also provides that following the CPSR, the team captain is to submit a complete report of the review to the ACO within 30 days of the review. At that point, standard business systems review procedures, described in Chapter 7, apply.

## CHAPTER 3: ESTIMATING SYSTEMS

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### I. Overview

The Business Systems Rule builds upon and expands the previous DFARS requirements relating to contractor estimating systems. As did its predecessor, the Business Systems Rule requires that the contractor establish, maintain and comply with an “acceptable estimating system.” DFARS § 252.215-7002(b). The underlying policy is that an approved and acceptable estimating system benefits both the contractor and the government because it ensures reliable and accurate proposals that provide the basis for negotiation of a fair and reasonable price. See FAR § 15.407-5.

The Business Systems Rule regarding estimating systems applies to “large” contractors that, in their preceding fiscal year, received DOD prime contracts or subcontracts totaling \$50 million or more for which certified cost or pricing data were required. The Business Systems Rule also may apply to contractors that received DOD prime contracts or subcontracts totaling \$10 million or more (but less than \$50 million) for which cost or pricing data were required, where the procurement contracting officer (“PCO”), with concurrence from, or at the request of, the ACO, determines that application of the Rule would be in the best interest of the government (e.g., significant estimating problems are believed to exist or the contractor’s sales are predominantly to the government). DFARS § 215.407-5-70(b)-(c).

The Business Systems Rule defines “estimating system” to mean the contractor’s policies, procedures and practices for budgeting and planning controls, and for generating estimates of costs and other data included in proposals submitted to customers in the expectation of receiving contract awards. The Business Systems Rule requires that the contractor’s estimating system include the following five components: (a) an organizational structure; (b) established lines of authority, duties, and responsibilities; (c) internal controls and managerial reviews; (d) flow of work, coordination and communication; and (e) budgeting, planning, estimating methods, techniques, accumulation of historical costs and other analyses used to generate cost estimates. DFARS § 252.215-7002(a).

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The Business Systems Rule defines an “acceptable” estimating system as an estimating system incorporating the above five components that results in meeting the following compliance requirements:

**Compliance requirements:** the system:

- (1) Is maintained, reliable, and consistently applied;
- (2) Produces verifiable, supportable, documented, and timely cost estimates that are an acceptable basis for negotiation of fair and reasonable prices;
- (3) Is consistent with and integrated with the Contractor’s related management systems [e.g., accounting system]; and
- (4) Is subject to applicable financial control systems.

DFARS § 252.215-7002(a).

The Business Systems Rule also sets forth the following four system requirements necessary to meet the stated compliance requirements.

**System requirements:**

- (1) The Contractor shall disclose its estimating system to the [ACO], in writing. . . .
- (2) An estimating system disclosure is acceptable when the Contractor has provided the ACO with documentation that—
  - (i) Accurately describes those policies, procedures, and practices that the Contractor currently uses in preparing cost proposals; and
  - (ii) Provides sufficient detail for the Government to reasonably make an informed judgment regarding the acceptability of the Contractor’s estimating practices.

## CHAPTER 3: ESTIMATING SYSTEMS

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- (3) The Contractor shall—
  - (i) Comply with its disclosed estimating system; and
  - (ii) Disclose significant changes to the cost estimating system to the ACO on a timely basis.
- (4) The Contractor's estimating system shall provide for the use of appropriate source data, utilize sound estimating techniques and good judgment, maintain a consistent approach, and adhere to established policies and procedures. An acceptable estimating system shall accomplish the following [17] functions . . . .

DFARS § 252.215-7002(d).

The Business Systems Rule identifies 17 estimating functions that the contractor must perform. These “function criteria” do not prescribe any specific result because the intent is that the performance of these functions will result in meeting the system requirements that are, in turn, essential to complying with the system compliance requirements.

The compliance focus for estimating systems is upon the ability of the contractor's organization, internal controls and processes to generate acceptable and accurate proposals. Thus, and perhaps uniquely, the Business Systems Rule confers broad discretion on the contractor regarding the details of its estimating system design so long as that design results in meeting the compliance requirements listed above, including the 17 function criteria. This discretion, however, is tempered by the other Business Systems Rule requirements.

First, the Business Systems Rule requires that the contractor: (a) disclose in writing to the ACO its estimating system; (b) comply with its disclosed system; and (c) timely disclose to the ACO any significant changes to the estimating system. DFARS § 252.215-7002(d)(1), (d)(3). And second, the Business Systems Rule requires that the means of disclosure and the contents of the disclosure should permit the ACO to accept the system and then rely upon it, much as is done for accounting systems subject to CAS.

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The considerations set forth below for assessing whether the contractor is maintaining an adequate estimating system recognize that the Business Systems Rule's compliance and system requirements and function criteria often overlap. These considerations, therefore, take the Rule's compliance and system requirements and function criteria and supplement them with requirements found in TINA and CAS. These considerations are organized into the following logical groupings that reflect one or more related compliance or system requirements and/or function criteria:

1. Preparing and supporting an acceptable proposal.
2. Estimating system designed to meet requirements.
3. Use of sound data/integration of other systems.
4. Estimating methods/techniques.
5. Internal controls to ensure system compliance.

### II. References

- DFARS § 215.407-5-70(b)-(c)
- DFARS § 252.215-7002(a)-(g)
- FAR § 15.403
- FAR § 15.407-5
- FAR § 15.408
- FAR § 31.205-26
- 48 C.F.R. § 9904.401-20
- 10 U.S.C. § 2306a

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### III. Compliance Requirements

#### A. Preparation of an Acceptable Proposal in Accordance with the Solicitation and Regulations

**Compliance requirement:** the preparation of “verifiable, supportable, documented, and timely cost estimates that are an acceptable basis for negotiation of fair and reasonable prices; . . .

DFARS § 252.215-7002(a)(2).

#### “Function” criteria:

- (xiv) Provide procedures to update cost estimates and notify the Contracting Officer in a timely manner throughout the negotiation process;
- (xv) Provide procedures that ensure subcontract prices are reasonable based on a documented review and analysis provided with the prime proposal when practicable; . . .
- (xvii) Have an adequate system description, including policies, procedures, and estimating and budgeting practices that comply with the FAR and DFARS.

DFARS § 252.215-7002(d)(4).

1. Do the contractor’s estimating and budgeting systems generate sound proposals that are compliant with the solicitation, and produce a fair and reasonable price, because the systems:
  - a. Provide for management reviews:
    - (i) Independent of the proposal team?

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- (ii) At the appropriate level based upon a matrix of authority?
    - (iii) That ensure the estimate is within proper scope based on the solicitation?
  - b. Provide for inclusion of and reliance on the appropriate technical experts (i.e., subject matter experts) in preparing bases of estimate?
  - c. Integrate appropriate data from accounting, budgeting and purchasing systems?
  - d. Use accurate historical data for similar efforts and deliverables, including labor hours and purchases of services and materials?
  - e. Use current labor and indirect rates?
  - f. Use current bills of material (“BOMs”) and master production schedules (“MPSs”)?
- 2. Do the systems ensure application of the processes set forth in paragraphs 1.a. through 1.f. above, in controls to modifications, priced changes, requests for equitable adjustment, termination proposals and other proposals?
- 3. Do the contractor’s estimating and budgeting systems result in prices that are “certifiable” (current, accurate and complete) for purposes of TINA requirements, where applicable? See FAR § 15.403.
  - a. Does the contractor properly determine that TINA applies to a government contract or modification and that certified cost or pricing data must be submitted, because the proposal is submitted to obtain:
    - (i) The award of any negotiated contract (except for undefinitized actions such as letter contracts) expected to exceed the \$700,000 threshold?

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- (ii) The award of a subcontract at any tier expected to exceed \$700,000, if the contractor and each higher tier subcontractor were required to furnish cost or pricing data?
  - (iii) The modification of any sealed bid or negotiated contract expected to exceed the \$700,000 threshold for an existing contract, or the threshold stated in an existing contract?
  - (iv) A modification expected to exceed \$700,000 for a subcontract for which cost or pricing data initially were required?
- b. Does the contractor confirm that an exception to TINA applies and cost or pricing data is not required because:
- (i) The acquisition is “at or below” the simplified acquisition threshold of \$100,000?
  - (ii) There is “adequate price competition” as defined by TINA?
  - (iii) The prices are set by law or regulation?
  - (iv) It is an acquisition of a commercial item as defined by FAR (including modifications that do not transform a commercial item to a noncommercial item)?
  - (v) There is a TINA waiver?
- c. Does the contractor meaningfully disclose to the government all relevant information, meaning information that reasonable persons would expect to impact price negotiations significantly?
- d. Do contractor personnel responsible for submission of data under TINA understand the difference between facts and judgment and apply that understanding to the contractor’s submissions?

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- e. Is the responsibility to ensure the accuracy of the TINA certification assigned to a designated individual with adequate experience, training and responsibility?
  - f. Does the contractor have in place an effective “sweep” mechanism to ensure the data it provides from throughout the contractor’s organization is current, accurate and complete?
  - g. Does the contractor have in place a mechanism to disclose results of its “sweep” prior to agreement on price?
  - h. Are updates to the contractor’s disclosures required to be memorialized in writing?
  - i. Does the contractor ensure that its policies and procedures cover the circumstances under which TINA would apply to subcontracts, modifications and priced changes?
4. When TINA applies to a solicitation:
- a. Do the contractor’s procedures comply with FAR § 15.408, Table 15-2, reporting requirements for cost or price proposals when cost or pricing data are required, including cost breakdowns for the following cost elements:
    - (i) Materials and services?
    - (ii) Direct labor?
    - (iii) Indirect costs?
    - (iv) Other direct costs, including travel?
    - (v) Royalties?
    - (vi) Facility capital cost of money?
    - (vii) Profit and/or fee?
  - b. Does the contractor ensure that proposal adequacy checklists, if required, are accurate and consistently submitted?

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5. With regard to subcontractors and lower tier subcontractors:
  - a. When TINA applies to a solicitation, does the contractor ensure that, where required, its subcontractors and the applicable lower tier subcontractors submit cost or pricing data that is current, accurate and complete in accordance with FAR Subpart 15.4? See para. 3.a above.
  - b. Does the contractor ensure that subcontractor certified cost or pricing data is submitted in the format provided in Table 15-2 of FAR § 15.408 or the alternate format specified in the solicitation?
  - c. Does the contractor ensure that, prior to final agreement on the price of a prime contract, updated subcontractor cost or pricing data has been obtained and disclosed to the government?
  - d. Does the contractor conduct appropriate cost/price analysis and submit the results of such analysis to the government?
  - e. Does the contractor submit subcontractor certified cost or pricing data to the government as part of its own certified cost or pricing data when required by FAR § 15.404-3(b)(3) and (c), including:
    - (i) When the contractor is required by FAR § 15.404-3(c) to obtain and analyze certified cost or pricing data before awarding any subcontract, purchase order or modification expected to exceed the certified cost or pricing data threshold unless an exception applies? See paras. 3.a.-b. above.
    - (ii) When the subcontract is in an amount that exceeds the lower of either: (a) \$12.5 million or more; or (b) both more than the certified cost or pricing data threshold and more than 10% of the prime contractor's proposed price, unless the PCO believes such submission is unnecessary?
  - f. Does the contractor update subcontractor data as appropriate during source selection and negotiations?

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- g. Does the contractor ensure that subcontract prices are reasonable?
    - (i) Is the contractor's purchasing system approved? See Ch. 2.
    - (ii) Is the contractor's purchasing system integrated with its estimating system?
  - h. Does the contractor ensure that it flows down FAR §§ 52.215-12 and -13 to its subcontractors, as required by FAR § 15.408(d) through (e), when it is contemplated that certified cost or pricing data will be required for negotiated contract awards or modifications?
  - i. Does the contractor ensure that its subcontractors flow down TINA requirements to lower-tier subcontractors where required? See para. 3.a above.
6. Are the contractor's cost accounting practices used for estimating costs in pricing the related proposal consistent with its cost accounting practices used for accumulating and reporting actual costs as of the date of agreement on price? 48 C.F.R. § 9904.401-40.

### **B. Estimating System Designed to Meet the Requirements**

**Compliance requirements:** the system:

- (1) Is maintained, reliable, and consistently applied; . . .
- (3) Is consistent with and integrated with the Contractor's related management systems [e.g., accounting system]; . . .

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DFARS § 252.215-7002(a).

**“Function” criteria:**

- (i) Establish clear responsibility for preparation, review, and approval of cost estimates and budgets;
- (ii) Provide a written description of the organization and duties of the personnel responsible for preparing, reviewing, and approving cost estimates and budgets; . . .
- (v) Provide for adequate supervision throughout the estimating and budgeting process; . . .
- (xii) Require management review, including verification of the company’s estimating and budgeting policies, procedures, and practices;
- (xiii) Provide for internal review of, and accountability for, the acceptability of the estimating system, including the budgetary data supporting indirect cost estimates and comparisons of projected results to actual results, and an analysis of any differences; . . .
- (xvi) Provide estimating and budgeting procedures that consistently generate sound proposals that are compliant with the provisions of the solicitation and are adequate to serve as a basis to reach a fair and reasonable price; . . .

DFARS § 252.215-7002(d)(4).

1. Does the contractor have an estimating system organizational structure with clear lines of responsibility?
  - a. Has the contractor clearly defined and assigned the responsibilities for each component of the proposal preparation process, including:
    - (i) Preparation?
    - (ii) Review?
    - (iii) Approval?

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- b. Does the contractor's organizational structure identify contracts and technical personnel designated to define the required proposal scope:
  - (i) Based on WBSs?
  - (ii) Based on directed change?
  - (iii) Based upon constructive change?
- c. Does the contractor's organizational structure include engineering or other pertinent technical personnel who will provide relevant estimates of hour and material requirements?
- d. Does the contractor's organizational structure include purchasing personnel tasked to provide the most recent and accurate vendor quotes and/or historical purchase data?
- e. Does the contractor's organizational structure include accounting personnel tasked to provide historical labor and other cost data where required?
- f. Does the contractor's organizational structure include budgeting personnel tasked to provide corporate budgeting projections as necessary for forward pricing proposals and applicable TINA disclosures?
- g. Does the contractor's organizational structure include management personnel at the executive level with adequate authority and approval rights for proposals generated by the system pursuant to a matrix of authority?
- h. Does the contractor's organizational structure provide for independent review and approval of proposals by an appropriate level of management?
- i. Does the contractor's organizational structure provide for the reliance on technical experts (such as subject matter experts), where required by the solicitation?
- j. Does the contractor have a process for periodic review and improvement of its organizational structure to ensure it meets the requirements?

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### C. Use of Sound Data/Integration of Other Systems

#### **“Function” criteria:**

- (iv) Identify and document the sources of data and the estimating methods and rationale used in developing cost estimates and budgets; . . .
- (vii) Provide for detection and timely correction of errors;
- (viii) Protect against cost duplication and omissions;
- (ix) Provide for the use of historical experience, including historical vendor pricing information, where appropriate; . . .
- (xi) Integrate information available from other management systems; . . .
- (xiii) Provide for internal review of, and accountability for, the acceptability of the estimating system, including the budgetary data supporting indirect cost estimates and comparisons of projected results to actual results, and an analysis of any differences; . . .

DFARS § 252.215-7002(d)(4).

1. Do the contractor’s procedures require that estimates document the specific source of data used?
2. Does the contractor have in place appropriate processes under which the contractor is able to access and integrate data from other applicable management systems (notably accounting, budgeting and planning, purchasing and material management) into the preparation of the proposal?
  - a. Is the accounting system approved?
  - b. Is the budgeting and planning system approved?
  - c. Is the purchasing system approved?

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- d. Is the material management and accounting system (“MMAS”) approved?
    - e. When a system is not approved, does the contractor have internal controls to ensure the integrity of data obtained?
  3. Does the contractor have an organized and integrated system that enables responsible personnel to identify and document the following when required by the estimating approach and scope:
    - a. Current labor rates?
    - b. Historical labor hours by job?
    - c. Proposed and historical material costs?
    - d. Current vendor quotes?
    - e. Historical purchase costs?
    - f. Other direct costs, including:
      - (i) Travel and relocation costs?
      - (ii) Special tooling and test equipment costs?
      - (iii) Information technology costs?
    - g. Facility capital cost of money rates?
    - h. The status of approved indirect cost rates, such as overhead and G&A versus actual performance to date?
    - i. Profit and/or fee?
    - j. Planned capital expenditures?
    - k. Budget projections?
  4. Does the contractor’s system provide for independent management review and approval of the data which forms the basis for the estimate, including, but not limited to all of the above in Section III.C.3, by either the proposal manager or other designated personnel not involved in preparing the estimates?

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5. Does the contractor require supervisory or peer review of estimates specifically to ensure accuracy of data and to eliminate:
  - a. Duplication of costs?
  - b. Incorrect indirect cost rates?
  - c. Inaccurate labor rates?
  - d. Transfer at price of materials and services between companies under “common control?”  
See FAR § 31.205-26.
  - e. Improper application of profit and/or fee?
  - f. Other mechanical and clerical errors?
  
6. Is the contractor’s estimating system able to obtain and rely upon additional necessary data to include:
  - a. Does the contractor keep records of its preproduction work and special tooling?
  - b. Does the contractor keep records of prototypes, static test models or mock-ups?
  - c. Does the contractor keep production records by individual production centers, departments, or operations, as well as by components, lots, batches, runs or time periods?
  - d. Does the contractor keep engineering records by major task?
  - e. Does the contractor keep records of each contract line item number (“CLIN”) to be separately priced?
  - f. Does the contractor keep records of scrap, rework, spoilage, excess material, and obsolete items resulting from engineering changes?
  - g. Does the contractor keep records of packaging and crating when substantial?
  - h. Does the contractor keep records of other nonrecurring or other direct cost items requiring separate treatment?

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7. Is the information that the contractor is relying upon to develop cost estimates relevant?

### D. Estimating Methods/Techniques

#### **“Function” criteria:**

- (iv) Identify and document the sources of data and the estimating methods and rationale used in developing cost estimates and budgets; . . .
- (vi) Provide for consistent application of estimating and budgeting techniques; . . .
- (x) Require use of appropriate analytical methods; . . .

DFARS § 252.215-7002(d)(4).

1. Does the contractor require that proposal preparers use sound judgment in determining which particular estimating technique is most suitable, including, but not limited to, the following techniques?
  - a. Detailed method, where the contractor accumulates detailed information to arrive at estimated costs. When utilizing this method, in addition to the requirements set forth in Section III.C above, does the contractor rely on the following resources as applicable:
    - (i) Specifications?
    - (ii) Drawings?
    - (iii) BOMs?
    - (iv) Quantities and rates?
    - (v) Machine and work-station workloads?
    - (vi) Manufacturing processes?
    - (vii) Material scrap, waste and spoilage?

## CHAPTER 3: ESTIMATING SYSTEMS

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- b. Comparison method, where specifications for the item being requested are similar to other items already produced or currently in production. When utilizing this method, in addition to the requirements set forth in Section III.C above, does the contractor:
  - (i) Compare requirements for the new item with those for a past or current item?
  - (ii) Isolate differences and ensure that cost elements applicable to the differences are deleted from or added to the experienced costs?
  - (iii) Make adjustments for possible upward or downward trends?
  
- c. Roundtable method, where a new item is involved and representatives from the engineering, manufacturing, purchasing, and accounting departments develop cost estimates by exchanging views and making judgments based on knowledge and experience. When utilizing this method, in addition to the requirements set forth in Section III.C above, does the contractor:
  - (i) Ensure that the relevant subject matter experts participate?
  - (ii) Ensure that current and accurate rates and historical purchasing information are available?
  
- d. Parametric analysis method, where cost data are derived from a key cost driver factor (e.g., product weight) and a statistical relationship is developed between historical costs and program characteristics. When utilizing this method, in addition to the requirements set forth in Section III.C above, does the contractor:
  - (i) Select a valid cost driver for the basis of the comparison?
  - (ii) Ensure that the historical data used in the comparison is accurate and relevant?

## CHAPTER 3: ESTIMATING SYSTEMS

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2. Does the contractor require that proposal preparers document their estimating techniques and the reason(s) for using these estimating techniques in the basis of estimate or similar document?
3. Does the contractor consistently apply estimating techniques or justify any inconsistency?
4. Does the contractor require management supervision and review of estimates to ensure:
  - a. Accuracy of data?
  - b. Consistency in methodology?
5. Are designated estimating personnel trained in the use of estimating techniques, including, but not limited to, those described in paragraph 1 above?

### IV. Internal Controls To Ensure System Compliance

**Compliance requirement:** the system “[i]s subject to applicable financial control systems.”

DFARS § 252.215-7002(a)(4).

#### A. Training

**“Function” criteria:** [e]nsure that relevant personnel have sufficient training, experience, and guidance to perform estimating and budgeting tasks in accordance with the contractor’s established procedures; . . .

DFARS § 252.215-7002(d)(4)(iii).

## CHAPTER 3: ESTIMATING SYSTEMS

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1. Does the contractor require periodic training of estimating personnel, at a minimum, in:
  - a. TINA requirements?
  - b. FAR requirements (including FAR §15.408; Table 15-2)?
  - c. DFARS requirements (including the Business Systems Rule)?
  - d. Estimating techniques/analysis?
  - e. Budgeting techniques?
  - f. Price reasonableness analysis techniques?
2. Does the contractor document the training required by paragraph 1 above?
3. Does the contractor include appropriate experience and training requirements in job descriptions of estimating personnel?
4. Does the contractor employ only trained and experienced personnel in management and supervisory positions?

### B. Internal Review

#### **“Function” criteria:**

- (xii) Require management review, including verification of the company’s estimating and budgeting policies, procedures, and practices;
- (xiii) Provide for internal review of, and accountability for, the acceptability of the estimating system, including the budgetary data supporting indirect cost estimates and comparisons of projected results to actual results, and an analysis of any differences; . . .

DFARS § 252.215-7002(d)(4).

## CHAPTER 3: ESTIMATING SYSTEMS

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1. Does the contractor's estimating system require internal independent reviews of estimates by designated management personnel prior to submission of the proposal?
2. Does the contractor undertake independent reviews to assess the differences between estimated and actual costs? If so, are the results utilized to adjust the proposal, when appropriate?
3. Does the contractor undertake periodic (at a minimum annually) internal audits of the estimating system to ensure that estimates which it has prepared:
  - a. Use consistent estimating methods?
  - b. Rely upon sound data?
  - c. Are adequately integrated with other business systems?
  - d. Comply with FAR and DFARS?
  - e. Have been reasonably consistent with actual costs over time?
4. Does the contractor periodically (at a minimum annually) review and update its policies and procedures?
5. Does the contractor periodically (at a minimum annually) review and update its training requirements?

### C. Written Policies and Procedures

#### System requirements:

1. The contractor discloses its estimating system to the ACO in writing.
2. The contractor's disclosure accurately describes relevant policies, procedures and practices in sufficient detail to permit an informed government assessment and acceptance of the estimating system.
3. The contractor complies with its disclosed estimating system and discloses significant changes to the ACO timely.

DFARS § 252.215-7002(d).

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DFARS § 252.215-7002(d)(4)(ii).

**“Function” criteria:** [p]rovide a written description of the organization and duties of the personnel responsible for preparing, reviewing, and approving cost estimates and budgets; . . .

1. Does the contractor have in place written policies and procedures that establish uniform requirements for:
  - a. Proposal preparation?
  - b. Proposal review?
  - c. Proposal approval?
  - d. Compliance with TINA, CAS, FAR and DFARS?
2. Has the contractor provided a written description to the ACO of its estimating system in accord with DFARS § 252.215-7002(d) that accurately describes its:
  - a. Policies?
  - b. Procedures?
  - c. Practices?
3. Does the contractor review annually its practices and procedures to ensure adherence to all applicable requirements?
4. Does the contractor disclose to the ACO significant system changes on a timely basis?

## CHAPTER 3: ESTIMATING SYSTEMS

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### V. 2014 System Update

#### A. Areas of Emphasis

Areas of emphasis in recent estimating system reviews include:

1. Properly documented and complete estimating policies and procedures.
2. Preservation of records to support proposals submitted (e.g., proposal logs).
3. Labor rate support, including whether labor categories are being appropriately grouped, whether contractors have a reasonable basis for rate escalations, and whether labor rates are properly based on historical experience.
4. Internal reviews of estimates, through monitoring and tracking estimates against actual costs on a periodic basis.
5. Integration of purchasing and accounting system data with estimating systems.
6. Consistent and documented management review of proposals.
7. Periodic and comprehensive internal audits of estimating system and prompt implementation of corrective action.

#### B. Regulatory Developments

When promulgating the final DFARS Business Systems Rule in February 2012, DOD emphasized two estimating system requirements. First, DOD rejected a commentator's suggestion that integrating an estimating system with other systems was unnecessary. DOD said instead that an effective estimating system requires integration with other systems to ensure consistency in outputs across an enterprise. DOD used the example of an estimating system integrating with an accounting system to obtain historical cost information for direct materials to use in estimates. DOD reiterated that "[a]n estimating system that is disconnected to the other contractor business systems is a reflection of poor internal controls."

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Second, DOD rejected a commentator's attempt to base estimating system compliance on performance objectives and outcomes, rather than policies and procedures. DOD stated that effective internal control systems are "process oriented," rather than focused on outcomes alone. In practice, both adequate internal processes and controls and accurate system outputs are generally required for system approval.

On March 28, 2013, DOD amended the DFARS to add a proposal adequacy checklist for solicitations requiring certified cost or pricing data. This checklist contains 36 items pertaining to a contractor's cost proposal, many of which are drawn from FAR 15.408 Table 15-2. The rule requires contractors to cross-reference to proposal page numbers, or to explain why certain information is not provided. Notable checklist requirements include:

1. Does the proposal identify and explain CAS noncompliances and inconsistencies between a proposal and a contractor's disclosed practices or applicable CAS?
2. Does the proposal disclose "any other known activity that could materially impact the costs," including vendor quotations, nonrecurring costs, data supporting projections of business prospects, and "information on management decisions that could have a significant bearing on costs"?
3. Does the proposal disclose judgmental factors applied and methods used in the estimate?
4. Does the proposal include a time phased (i.e.; monthly, quarterly) breakdown of labor hours, rates and costs by category or skill level?
5. Does the proposal contain a price/cost analysis establishing the reasonableness of each of the proposed subcontracts included with the proposal? If not, does the proposal include a matrix identifying dates for receipt of a subcontractor proposal, completion of fact finding for purposes of price/cost analysis, and submission of the price/cost analysis?
6. Has the offeror submitted an exception to the submission of certified cost or pricing data for commercial items proposed either at the prime or subcontractor level, in accordance with provision 52.215-20?

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DCAA likely will review a contractor's proposal adequacy checklists as part of any estimating system review. Contractors should ensure that checklists are properly submitted and that submissions address each of the checklist requirements to the extent possible. Deviations from the checklist requirements should be minimized if at all possible, or properly explained to ensure that an inability to respond to a particular item is not used as evidence of a broad system issue. Contractors also should review checklists to ensure consistency across proposals. Repeated inadequacies, deviations, and inconsistencies in proposal checklist submissions could lead to an estimating system deficiency finding.

### **C. DCMA/DCAA Guidance**

DCMA updated its estimating system review guidance in February 2012. Pursuant to this updated guidance, the ACO is required to coordinate the estimating system review with DCAA to establish and manage a regular program for reviewing the contractor's estimating system. Estimating system reviews should be conducted every three years unless the ACO and DCAA agree to lengthen or shorten the review cycle based on a documented joint risk assessment.

### **D. Proposed Update to the DFARS Business Systems Rule**

On July 15, 2014, DOD issued a proposed rule that would update the Business Systems Rule to require contractors to self-assess and report on estimating system, accounting system, and material management and accounting system compliance. 79 Fed. Reg. 41,172 (July 15, 2014). The proposed rule and its requirements are discussed in additional detail in Chapter 7 below.

## CHAPTER 4: GOVERNMENT PROPERTY MANAGEMENT SYSTEM

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### I. Overview

The Business Systems Rule requires that contractors maintain an acceptable property management system. DFARS § 252.245-7003. This requirement applies to contracts containing the clause at FAR § 52.245-1, Government Property. FAR § 45.107(a)(1) requires that ACOs include the FAR § 52.245-1 clause in: (a) cost reimbursement, T&M and labor hour contracts; (b) fixed price contracts when the government will provide government property; and (c) FAR Part 12 contracts and modifications that exceed the simplified acquisition threshold when government property is furnished or the contractor is directed to acquire property that is titled to the government. The receipt of progress payments does not trigger the government property requirements discussed below, but does trigger the requirements found in FAR § 52.232-16(d) through (f).

A contractor property management system means any system(s) for managing and controlling government property. DFARS § 245.107.

An acceptable property management system means:

**Compliance requirement:** a system that meets the criteria in DFARS § 252.245-7003(c).

DFARS § 252.245-7003(a).

**Compliance requirement:** maintain a property management system in accordance with FAR § 52.245-1(f).

DFARS § 252.245-7003(c). Thus, the Business Systems Rule establishes the requirements of FAR § 52.245-1(f) as the baseline for withholds for an unacceptable system.

FAR § 52.245-1(f) requires contractors to establish and implement property management plans, systems, and procedures that include the basic components set forth in Section IV below at the contract, program, site or entity level. In addition, FAR § 52.245-1(f) requires that records of government property be readily available to authorized government personnel and that

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government property is appropriately safeguarded. Because DFARS § 252.242-7004, Material Management and Accounting System, addresses the government's objectives with regard to contractors receipt and use of material, this chapter focuses on government-furnished and contractor-acquired property.

### II. References

- DFARS § 245.105
- DFARS § 252.245-7003
- FAR § 45.101
- FAR § 45.107
- FAR § 52.232-16(d)-(f)
- FAR § 52.245-1
- DFARS § 252.242-7004

### III. Key Definitions

1. Contractor-acquired property: property acquired, fabricated, or otherwise provided by the contractor for performing a contract, and to which the government has title.
2. Equipment: a tangible item that is functionally complete for its intended purpose, durable, nonexpendable, and needed for the performance of a contract. Equipment is not intended for sale, and does not ordinarily lose its identity or become a component part of another article when put into use. Equipment does not include material, real property, special test equipment or special tooling.
3. Government-furnished property: property in the possession of, or directly acquired by, the government and subsequently furnished to the contractor for performance of a contract. Government-furnished property includes, but is not limited to, spares and property furnished for repair, maintenance, overhaul, or modification. Government-furnished property also includes contractor-acquired property if such property is a deliverable under a cost contract when accepted by the government for continued use under the contract.

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4. Government property: all property owned or leased by the government. Government property includes both government-furnished and contractor-acquired property. Government property includes material, equipment, special tooling, special test equipment, and real property. Government property does not include intellectual property and software.
5. Material: property that may be consumed or expended during the performance of a contract, component parts of a higher assembly, or items that lose their individual identify through incorporation into an end item. Material does not include equipment, special tooling, special test equipment or real property.
6. Property: all tangible objects of value, both real and personal.
7. Property records: the records created and maintained by the contractor in support of its stewardship responsibilities for the management of government property.
8. Provide: furnish, as in government-furnished property, or to acquire, as in contractor-acquired property.

See FAR §§ 45.101, 52.245-1(a).

### IV. Government Property System Elements

#### **A. Acquisition of Government Property (FAR § 52.245-1(f)(1)(i))**

1. Does the contractor identify when a property being acquired will be government-owned?
  - a. Do the individuals responsible for preparing and approving a purchase requisition under the contractor's purchasing system:
    - (i) Determine if the property, when acquired, will be government-owned based upon FAR § 52.245-1(e), consulting with contracts and/or legal personnel as needed?
    - (ii) Identify on the requisition that the acquired property will be government-owned under the contract identified on the requisition?

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- b. Do purchase orders identify acquired property as government-owned under an identified contract?
  - c. When property to be acquired will be government-owned, is there a designated responsible person for obtaining any required government pre-approval?
  - d. Is government approval obtained and documented?
2. Does the contractor acquire government property consistent with its engineering, production planning, and property control operations?
- a. When materials are acquired, is the acquisition in accordance with the contract's MMAS system?
  - b. For other than materials, is the acquisition
    - (i) Appropriately time phased based upon an accurate MPS?
    - (ii) In amounts supported by contract requirements based upon an accurate requirements document?
    - (iii) Properly approved using a standardized approval process involving the responsible employee?
    - (iv) Timely and accurately recorded in a standardized manner in the contractor's accounting system?
3. Does the contractor obtain government equipment only in appropriate circumstances, e.g., as part of contractual performance, and in the appropriate manner?

### **B. Receipt and Recording of Government Property (FAR § 52.245-1(f)(1)(ii), (iii))**

- 1. Does the contractor maintain a government property ledger/inventory system?
- 2. Does the contractor provide information to its receiving function that enables the function to determine that it is receiving government property identifiable with a specific contract?

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3. Upon receipt of government property, whether government-furnished or contractor-acquired, does the contractor document receipt, using a standardized format, and record the following information in its government property ledger/inventory system:
  - a. Name, part number and description, manufacturer, model number, and National Stock Number?
  - b. Quantity received (or fabricated), issued, and balance-on-hand?
  - c. Unit acquisition cost?
  - d. Unique-item identifier (if available)?
  - e. Unit of measure?
  - f. Condition at receipt?
  - g. Contract number?
  - h. Accountable contract number or equivalent code designation?
  - i. Location?
  - j. Disposition?
  - k. Posting reference and date of transaction?
  - l. Date placed in service?
4. Does the contractor identify, e.g., stamp, tag, mark or otherwise label, the property as government-owned in a manner appropriate to the type of property?
5. Does the contractor identify, document and manage any quantity, type or condition discrepancies identifiable upon receipt through comparison to documentation showing what was ordered?

### **C. Physical Inventory (FAR § 52.245-1(f)(1)(iv), (vi))**

1. Are there appropriate inventories by category of property (e.g., government-furnished property or contractor-acquired property and equipment, tooling and materials) in the contractor's possession?

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2. When not being used, is all property maintained in discrete physical inventories by category, unless commingling is approved by contract or approved property management systems procedures?
3. Does contractor management conduct an annual or more frequent inventory of government property using, if practicable, only employees who do not maintain records on, or have custody over, government property?
4. Does the contractor periodically record physical inventory results?
5. Are discrepancies identified as the result of a physical inventory:
  - a. Resolved timely in a manner appropriate to the type of property involved?
  - b. Resolved in a documented manner?
  - c. Approved by the government?
6. Does the contractor perform a final physical inventory upon contract completion or termination unless waived by the property administrator?
7. For government property, does the contractor have a process for creating and providing to the government, as required by FAR § 52.245-1(f)(1)(vi), reports of:
  - a. Discrepancies, loss, theft, damage or destruction identified through physical inventory results, audits and self-assessments?
  - b. Corrective actions taken?
  - c. Any other information as requested by the ACO?

### **D. Property Management (FAR § 52.245-1(f)(1)(ix))**

1. Does the contractor take reasonable steps to protect government property from theft, damage and loss?
2. Does the contractor have a process for performing normal and routine preventative maintenance?

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3. Does the contractor ensure that government property remains properly marked?
4. Does the contractor communicate to the government maintenance performed on government property?
5. Does the contractor obtain government approval prior to replacing or making capital improvements to government property?

### **E. Using Government Property and Subcontractor Control (FAR § 52.245-1(f)(1)(v), (viii))**

1. Does the contractor report to the relevant Property Administrator government property that is in excess or unused for contract performance and ensure proper disposal of such excess or unused items?
2. Does the system have a process to ensure government property is used on contracts only as permitted by the terms of the contract, including the payment of rent in accordance with FAR § 52.245-9?
  - a. Is there a person responsible for ensuring that only approved use occurs?
  - b. Is there a person responsible for ensuring that required rent is paid?
3. Does the contractor award subcontracts that permit the use of government property and, if so:
  - a. Is any required government approval for subcontractor use obtained before the subcontract is executed?
  - b. Do these subcontracts clearly identify the government property to be provided to the subcontractor, and the conditions of its use and any rent required?
  - c. Do these contracts include an appropriate flow down of contract terms and conditions, relating to government property furnished by the contractor to the subcontractor(s), that impose on the subcontractor the same obligations imposed on the contractor?

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- d. Does the system permit the contractor to conduct reviews periodically to determine the adequacy of the subcontractor's property management system?
  - e. Do these subcontracts obligate the subcontractor to provide the government with access to government property and government property records in the subcontractor's possession?
- 4. Does the contractor obtain ACO authorization before modifying, altering or cannibalizing government property? FAR § 52.245-1(c).
  - 5. Does the contractor's inventory system for government property identify when government property has been transferred to and returned by a subcontractor?
  - 6. When closing out subcontracts, does the contractor ensure subcontractor compliance with all government property requirements flowed down, including proper use, control and return?

### **F. Property Disposition (FAR § 52.245-1(f)(1)(vii), (x))**

- 1. Unless the contract provides otherwise, does the contractor maintain stewardship responsibility for government property until the property is:
  - a. Consumed or expended, reasonably and properly, or otherwise accounted for, in the performance of the contract?
  - b. Delivered or shipped from the contractor's plant, under government instructions, except when shipment is to a subcontractor or other location of the contractor?
  - c. Abandoned by the government in accordance with FAR § 52.245-1(k)?
  - d. Disposed of in accordance with FAR § 52.245-1(j) so that:
    - (i) Contractor inventory is not dispositioned until authorized by the plant clearance officer pursuant to FAR § 52.245-1(j)?

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- (ii) Scrap is disposed of after meeting the notice, documentation and reporting requirements in FAR § 52.245-1(j)(1)?
  - (iii) Contractor-acquired property no longer needed for contract performance dispositioned in accordance with the order specified in FAR § 52.245-1(j)(2)(i) and documented appropriately on SF 1428?
  - (iv) Government-furnished property is identified on a SF 1428 in accordance with FAR § 52.245-1(j)(3), (5) and (6) within the time specified in FAR § 52.245-1(j)(4)?
  - (v) All property on SF 1428 is stored for 120 days after government acceptance of the Form 1428 submission, or longer, subject to an equitable adjustment?
  - (vi) Contractor disposition is in accordance with government instructions in FAR § 52.245-1(j)(8) and (9)?
  - (vii) Government property transferred to subcontracts is included in the above?
- e. Does the system have a mechanism to identify property in excess to the contractor's contractual performance needs?
- f. Property closeout (FAR § 52.245-1(f)(1)(x)):
- (i) Does the contractor report at the end of performance to the Property Administrator all losses, theft, damage or destruction cases of government-furnished and contractor-acquired property as well as permit a physical inventorying of all property?
  - (ii) Does the contractor perform a physical inventory of all government-furnished and contractor-acquired property at contract closeout, unless waived by the property administrator?

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### G. Internal Controls

1. Is the property management activity established at a level within the management organization so that it possesses the authority to enforce government property requirements?
2. Does the contractor adequately describe its property management system, in accordance with FAR § 52.245-1(f), in:
  - a. Written policies and procedures?
  - b. System descriptions that:
    - (i) Identify the interrelationship of information technology and other relevant systems?
    - (ii) Describe the physical and accounting transactional flow?
    - (iii) Identify approval points and authority levels?
3. Is compliance with the government property requirements, policies and procedures and proper system functions verified by periodic internal audits?
4. Is property management training performed on an annual basis?
5. Does the contractor permit government access to verify the contractor's property management system?
6. Are all Quality Deficiency Reports or other government audits/reviews regarding government equipment resolved timely to the satisfaction of the government?
7. Regarding subcontracts:
  - a. Does the contractor perform periodic audits of subcontractor compliance with government property requirements?
  - b. Does the contractor annually inform all subcontractors of their government property obligations?

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8. Is the contractor's property management system disclosed to the government property manager? FAR § 52.245-1(b).
9. Does the contractor disclose to the government property manager any significant system changes? FAR § 52.245-1(b).
10. Does the contractor ensure that, when the government abandons government property, it is not assuming liabilities associated with the property, especially environmental liabilities?
11. When government property is lost, stolen, damaged or destroyed, does the contractor ensure that it does not accept liability unless required to do so by FAR § 52.245-1(h) or other contract clause?

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### V. 2014 System Update

#### A. Areas of Emphasis

Contractors have recently encountered government property system compliance issues in the following areas:

1. Inadequate government property ledger/inventory (especially a failure to show complete history of government property, from receipt to disposal).
2. Inadequate designation, marking, and traceability of government property.
3. Improper disposal of government property.
4. Improper controls over subcontractor property, including a failure to obtain proper approvals for subcontractor use of government property, and clearly identify and impose limitations on use of government property provided to subcontractors and inadequate reviews of subcontractor property management system.

#### B. Regulatory Developments

Effective April 2, 2012, the FAR Council revised key provisions in FAR Part 45 and the “Government Property” clause at FAR § 52.245-1 in order to:

1. Add the definition of “surplus property” and update the definition of “loss of Government property” to include loss, damage, destruction, and theft;
2. Clarify responsibilities of the contracting officer, property administrator, plant clearance officer, and contractor; and
3. Reorganize and clarify procedures and responsibility for Government property disposal.

In issuing the final rule, the FAR Council provided an interpretation of “materiality” in the context of government property system reviews. The Council stated that “[i]f the Government determines that deficiencies in a contractor’s property management system are significant enough to warrant a correction letter, then the contractor should treat those deficiencies

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as material.” 77 Fed. Reg. 12,937 (Mar. 2, 2012) (emphasis added). While materiality in this context relates to notifications of deficiencies under FAR Subpt. 45.1, it is likely possible the government may rely on this rationale to conclude that any deficiency is “material” for purposes of the Business Systems Rule as well.

Effective August 29, 2012, DOD also revised relevant DFARS clauses to revise and standardize the reporting requirements for government-furnished property to include in the Item Unique Identification (IUID) Registry items that are both uniquely and non-uniquely identified, and to include in the IUID (beginning in 2014) all serialized government-furnished property, not only items over \$5,000, as under the prior version of the clause.

The relevant Business System clause at DFARS § 252.245-7003(c) incorporates the contract requirements of the Government Property clause at FAR § 52.245-1, not government property-related DFARS clauses. Contractors should resist government attempts to rely on any DFARS government property requirements to support significant deficiency findings in this area.

### C. DCMA Guidance

On February 1, 2013, DCMA released DCMA Instruction 124 (DCMA-INST 124), which reissued and updated the previous November 2011 DCMA guidance for Contract Property Management. More recent clarifications and changes were added in March of 2014. The guidance describes the review process and the role of Property Administrators in evaluating property management systems.

The guidance clarifies that, although contractual non-compliances may form the basis for a significant deficiency under DFARS § 252.245-7003(c), “[o]nly the Contracting Officer can determine a contractual noncompliance to be a significant deficiency.” The guidance notes, however, that the [Property Administrator]’s preliminary judgment is crucial to mission success.” DCMA-INST 124 ¶ 3.14. Thus, despite the clarification that property administrators are charged with identifying contractual non-compliances and not with making system determinations, a contracting officer will still likely place great weight upon a Property Administrator’s recommendations and initial determinations. Contractors accordingly should attempt to engage with the property administrator during the audit and exit conference to address concerns before they are submitted to the contracting officer.

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DCMA's guidance discusses the flow of a Property Management System Analysis conducted by Property Administrators, and outlines the process for issuing Corrective Action Requests in connection with system reviews. The guidance explicitly encourages Property Administrators to focus on the results of prior Property Management System Analyses when reviewing property management systems. DCMA-INST 124 ¶ 3.7.2. Repeated instances of similar non-compliances may create grounds for more significant deficiencies. DCMA-INST 124 ¶ 3.14.

## CHAPTER 5: MATERIAL MANAGEMENT AND ACCOUNTING SYSTEM

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### I. Overview

The Business Systems Rule requires that contractors, in certain circumstances, maintain an acceptable MMAS. An MMAS is the contractor's system or systems for planning, controlling and accounting for the acquisition, use, issuance and disposition of material. The MMAS may be manual or automated and stand-alone or integrated with other systems. DFARS § 252.242-7004(a)(1). An acceptable MMAS means a system that meets the following requirements:

#### **Compliance requirements:**

- (b)(1) Maintain an MMAS that—
  - (i) Reasonably forecasts material requirements;
  - (ii) Ensures that costs of purchased and fabricated material charged or allocated to a contract are based on valid time-phased requirements; and
  - (iii) Maintains a consistent, equitable, and unbiased logic for costing of material transactions; and
- (2) Assess its MMAS and take reasonable action to comply with the MMAS [compliance criteria]; . . .
- (c)(1) Have policies, procedures, and operating instructions that adequately describe its MMAS;
  - (2) Provide to the Administrative Contracting Officer (ACO), upon request, the results of internal reviews that it has conducted to ensure compliance with established MMAS policies, procedures, and operating instructions; and
  - (3) Disclose significant changes in its MMAS to the ACO at least 30 days prior to implementation.

DFARS § 252.242-7004.

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To meet these compliance requirements, the Business Systems Rule imposes a number of system criteria. DFARS § 252.242-7004(d). These system criteria essentially restate the MMAS requirements that DFARS has listed for years. The discussions below focus, therefore, on each criterion and are not grouped by compliance requirement as occurs in other chapters. The discussions below, however, reference the compliance requirement(s) to which the criterion relates.

The obligation to maintain an acceptable MMAS exists under cost reimbursement or fixed price progress payment prime contracts with DOD exceeding the simplified acquisition threshold. DFARS § 242.7200(b)(1). The MMAS obligation does not apply to small businesses, educational institutions or nonprofits. DFARS § 242.7200(b)(2). DOD will conduct a system review when the contractor has \$40 million in qualifying sales in the preceding fiscal year and a government risk assessment establishes that an MMAS review is needed. DFARS § 242.7203(a).

### II. References

- DFARS Subpt. 242.72
- DFARS § 252.242-7004
- FAR § 31.205-26
- 48 C.F.R. § 9904.411

### III. Key Definitions

1. Bill of materials or BOMs: the list of materials and quantities required to manufacture an assembly or product.
2. Common inventories: inventories not assigned to a particular contract until withdrawal for use to perform a contract and that are owned by the contractor.
3. Excess material: any material not needed to perform the contract for which the inventory was acquired.
4. Item: depending upon the context, a piece part, a subassembly, a subcomponent, a component or a product.

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5. Loan/payback: what occurs when a part purchased or fabricated for one final cost objective is assigned or used on another final cost objective without a corresponding transfer of cost, and the borrowed part is replaced by the lending cost objective in a reasonable time. A loan/payback typically is caused by the borrowing final cost objective's need for a particular part arising earlier than the lending final cost objective's need.
6. Master production schedule or MPS: a schedule that details what and how much material, labor and capacity is required and when those resources are needed to produce an item.
7. Residual material: any material remaining after completion of a contract because of such things as minimum purchase requirements, unrealized attrition, contract changes, etc.
8. Transfer: what occurs when a part purchased or fabricated for one final cost objective is used on another final cost objective with a corresponding transfer of cost. A transfer typically is caused by the receiving final cost objective's need for a particular item and the lack of any requirement by the transferring final cost objective(s) because of situations such as changes or economic order quantity buys.
9. Valid time-phased requirements: material requirements that are: (a) needed to fulfill the production plan, including reasonable quantities for scrap, shrinkage, yield, etc.; and (b) properly charged/billed to contracts or other cost objectives within a reasonable time before, and in a manner consistent with, the need to fulfill the production plan.

### IV. MMAS Elements

#### A. System Description

**Compliance criterion:** [h]ave an adequate system description, including policies, procedures and operating instructions that comply with [FAR] and [DFARS]; . . .

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DFARS § 252.242-7004(d)(1); see DFARS § 252.242-7004(c)(1), (3) (compliance requirement for policies, procedures and operating instructions that adequately describe a contractor's MMAS and for disclosure of significant MMAS changes).

1. Are there appropriate written policies and procedures to ensure compliance with the remainder of the MMAS criteria described in Section IV?
2. Are the contractor's MMAS system and all of its component systems described in policies and procedures, including:
  - a. Narrative descriptions of each of the component systems and their interaction with one another, as well as detailed flowcharts for each of the component systems?
  - b. Identification of all MMAS-related transaction data, including tables, schedules, files and reports for each component system, as needed to ensure accuracy and proper accounting?
  - c. Descriptions of available historical data files, retention periods and storage format?
  - d. Operating instructions, including identification of programming languages used to implement, process and query the system?
3. Is the process for developing and maintaining accurate BOMs and MPSs described in the policies and procedures?
4. Are the following processes described in the policies and procedures:
  - a. Ordering materials based upon appropriate and approved purchase requisitions and purchase orders?  
See Ch. 2, Purchasing System.
  - b. Ordering and tracking materials to manage delivery time?
  - c. Recording receipt of materials upon arrival at the contractor's facility?

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- d. Recording the received material and related costs in the appropriate physical inventory account and in the proper account in the accounting system?
  - e. Placing received materials into the correct physical inventory?
  - f. Issuing materials for use on a final cost objective?
  - g. Charging costs of materials to the appropriate final cost objective?
  - h. Accounting for material costs when materials are transferred to or borrowed by a final cost objective other than the initial final cost objective originally charged for the cost of the material?
  - i. Disposing of scrap or residual materials during contract performance and at contract completion?
  - j. Billing of material costs to the government, including corrections and adjustments?
5. Has the contractor disclosed its policies and procedures to the ACO and documented the disclosure?
  6. Does the contractor disclose to the ACO significant changes to its MMAS at least 30 days prior to implementation of such changes and document the disclosure?

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### B. Development of Requirements for Material

**Compliance criterion:** [e]nsure that costs of purchased and fabricated material charged or allocated to a contract are based on valid, time-phased requirements as impacted by minimum/economic order quantity restrictions.

- (i) A 98 percent bill of material accuracy and a 95 percent master production schedule accuracy are desirable as a goal in order to ensure that requirements are both valid and time-phased.
- (ii) If systems have accuracy levels below these, the Contractor shall provide adequate evidence that—
  - (A) There is no material harm to the Government due to lower accuracy levels; and
  - (B) The cost to meet the accuracy goals is excessive in relation to the impact on the Government; . . .

DFARS § 252.242-7004(d)(2); see DFARS § 252.242-7004(b)(1)(i), (ii) (compliance requirement for reasonable forecasts of material requirements and for charging costs based on valid, time-phased requirements).

1. Are the contractor's BOMs at least 98% accurate?
  - a. Does the contractor have a BOM identifying the types and quantities of materials required to produce an item for each significant level of production (i.e., fabricated parts, subassemblies, assemblies, line replaceable units and final item)?
  - b. Is each BOM:
    - (i) Supported by and traceable to original contract or internal design requirements, including considerations for scrap, shrinkage, yield and other similar factors and subsequent contract changes?
    - (ii) Managed to ensure accurate conversions of engineering BOMs to manufacturing BOMs?

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- (iii) Controlled to ensure consistency between BOMs and actual requirements as affected by contract changes and engineering changes?
        - (iv) Dated to show initial release date and each subsequent release made to reflect changes?
        - (v) Prepared to include parameters on use of materials on an “as-required” basis?
        - (vi) Approved by an appropriate authority prior to initial release and prior to any subsequent release?
    - c. Does the contractor control and record the use of substitute materials to ensure that any substituted materials are: (1) appropriate; (2) documented; and (3) permitted by specifications, contract provisions or government approval?
    - d. Does the contractor verify that its BOMs are at least 98% accurate by:
      - (i) Assessing annually BOM accuracy through sample auditing designed to achieve a high confidence level that the 98% accuracy level is being maintained?
      - (ii) Assessing the BOMs within a sample for accuracy by, for example, comparing the BOMs to:
        - (a) Source data (e.g., drawings, manufacturing specifications, engineering changes and contract requirements)?
        - (b) The next lowest level of production?
        - (c) BOMs used to support material acquisitions, after taking into account the impact of changes?
2. Are the contractor’s MPSs at least 95% accurate?
  - a. Does the contractor maintain an MPS for each production effort that involves significant costs?

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- b. For each MPS:
  - (i) Does it include adequate planning time?
  - (ii) Does it reflect current and accurate lead and flow times consistent with documentation regarding:
    - (a) Acquisition lead times?
    - (b) The type and length of each process in the schedule?
    - (c) Actual shop floor practice?
  - (iii) Is each MPS adjusted, if appropriate, to reflect historical past due/late deliveries, including situations where unplanned effort was used to accelerate delivery?
  - (iv) Are contractor and subcontractor/vendor capacity constraints reasonably considered?
  - (v) Are changes processed timely?
  - (vi) Is it approved by a designated approving official based upon the above considerations prior to initial release and prior to any subsequent release?
- c. Is MPS accuracy measured using appropriate techniques, including the following:
  - (i) Assessing annually MPS accuracy through sample auditing designed to achieve a high confidence level that the 95% accuracy level is being maintained?
  - (ii) For accuracy of timing of performance:
    - (a) Comparing end item deliveries accomplished (i.e., actual production) versus end item deliveries planned (i.e. planned production) for a given time period?
    - (b) Comparing the number of end items that have accurate delivery dates in the MPS with the total number of contractual deliverable end items?

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- (c) Comparing actual completion dates for identified performance milestones with planned completion dates?
  - (iii) For accuracy of resource scheduling:
    - (a) Comparing actual resource loading, adjusted for changes, delays, etc., with planned resource loading?
    - (b) Verifying that resource scheduling has resulted in meeting committed-to contract milestones?
- 3. Does the contractor integrate into its BOMs and MPS processes appropriate consideration of planned product changes?
- 4. Regarding BOM/MPS changes, does the contractor:
  - a. Process changes timely?
  - b. Issue revised and updated BOMs or MPSs?
  - c. Provide changed BOM/MPS documents timely to the appropriate buyers, requisition approval authorities and production managers?
- 5. When a BOM or MPS does not meet the required level of accuracy, does the contractor:
  - a. Assess why, take actions to correct the deficiency and document its corrective actions; or
  - b. Document that the government is not materially harmed and the cost of compliance outweighs the harm to the government?

### C. System Monitoring

**Compliance criterion:** [p]rovide a mechanism to identify, report, and resolve system control weaknesses and manual override.

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DFARS § 252.242-7004(d)(3); see DFARS § 252.242-7004(b)(1) (compliance requirement to reasonably forecast needs for materials, charge contracts on a valid time-phased basis and properly account for cost transfers).

1. Does the contractor timely identify, resolve and document system issues, including:
  - a. Unauthorized changes to a BOM?
  - b. Unauthorized changes to an MPS?
  - c. An outdated BOM or MPS?
  - d. Materials charged to contracts in excess of or inconsistent with valid requirements?
  - e. Materials charged to contracts that are not properly time-phased because the charging occurs prior to planned delivery or production need dates?
  - f. Attrition, rework, scrap and lost/found material that differs materially from the norm?
  - g. Manual overrides of the system?
2. Does the contractor recognize operational exceptions and have procedures to address these exceptions, including:
  - a. Transfers (see Secs. IV.F.1 and IV.G.3 below)?
  - b. Loan/paybacks (see Secs. IV.F.2 and IV.G.4 below)?
  - c. Excess/residual inventory (see Secs. F.3 and G.5 below)?

### D. Audit Trail

**Compliance criterion:** [p]rovide audit trails and maintain records (manual and those in machine-readable form) necessary to evaluate system logic and to verify through transaction testing that the system is operating as desired; . . .

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DFARS § 252.242-7004(d)(4); see DFARS § 252.242-7004(b)(1), (2) (compliance requirement for an adequate MMAS and assessments of system adequacy).

1. Are all transactions to acquire or fabricate materials recorded in the MMAS to enable verification of system performance that materials are required based on valid, time-phased requirements?
2. Does the contractor document how both purchased and fabricated materials flow through its physical inventory system from receipt to use or disposition?
3. Does the contractor document how the costs of both purchased and fabricated materials flow through its accounting and billing systems?

### E. Physical Inventories

**Compliance criterion:** [e]stablish and maintain adequate levels of record accuracy, and include reconciliation of recorded inventory quantities to physical inventory by part number on a periodic basis. A 95 percent accuracy level is desirable. If systems have an accuracy level below 95 percent, the Contractor shall provide adequate evidence that—

- (i) There is no material harm to the Government due to lower accuracy levels; and
- (ii) The cost to meet the accuracy goal is excessive in relation to the impact on the Government; . . .

DFARS § 252.242-7004(d)(5); see DFARS § 252.242-7004(b)(1), (2) (compliance requirement for an adequate MMAS and assessments of system adequacy).

1. Does the contractor conduct physical inventories at the part level at least once per year?
2. Does the contractor have procedures prescribing how inventory record accuracy is verified as to quantity and location?

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3. Are results of physical inventories compared to inventory record information in the relevant systems?
4. Are physical inventory differences resolved appropriately and timely?
  - a. Are inventory records properly adjusted?
  - b. Are inventory costs properly adjusted?
  - c. Are contract costs, and billings for contracts that have not been closed out, properly adjusted to the extent that the inventory differences impact prior costs charged to the contracts and/or billed to the government?
5. When inventory accuracy at the part number level is not 95% accurate:
  - a. Does the contractor assess why, take actions to correct the deficiency and document its corrective actions; or
  - b. Does the contractor document that the government is not materially harmed and the cost of compliance outweighs the harm to the government?

### F. Transfers

**Compliance criterion:** [p]rovide detailed descriptions of circumstances that will result in manual or system generated transfers of parts; . . .

DFARS § 252.242-7004(d)(6); see DFARS § 252.242-7004(b)(1)(iii) (compliance requirement for appropriate physical control over transfers).

1. If the contractor's MMAS permits materials purchased for one contract to be transferred for use to perform another contract (see Sec. IV.G.3 below):
  - a. Do detailed, written descriptions exist of the circumstances that permit the transfer of materials from one cost objective to another, including the transfer of residual or excess materials and the transfer of materials to satisfy a more urgent need?

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- b. When a transfer occurs:
    - (i) Are the circumstances documented and recorded in the contractor's systems?
    - (ii) Are appropriate systems (inventory, accounting, purchasing, etc.) updated to ensure accurate inventory and are other performance records maintained?
    - (iii) Are appropriate internal approvals obtained?
  - c. Does the contractor have controls in place to ensure that the contractor identifies, reports and resolves, on a timely basis, material transfers that are inconsistent with the circumstances of an authorized transfer under the contractor's processes and procedures?
2. If the contractor permits loan/paybacks between contracts (see Sec. IV.G.4 below):
- a. Do detailed, written descriptions exist of the specific circumstances that permit a loan/payback, including urgent need?
  - b. When a loan/payback occurs:
    - (i) Are the circumstances documented and recorded in the contractor's system?
    - (ii) Is the loan and the payback documented?
    - (iii) Is there a mechanism to ensure that open loan/payback transactions are closed timely?
    - (iv) Are appropriate inventory and other transactions entered to ensure accurate inventory and performance records?
    - (v) Are appropriate internal approvals obtained?
    - (vi) If the loan/payback process is not pre-approved by the government, are loan/paybacks either forbidden or approved individually by the government, and do they otherwise meet the tracking criteria above?

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3. If the contractor has inventory not needed to perform the contract for which the inventory was acquired, rendering the inventory excess or residual inventory (see Sec. IV.G.5 below), does the contractor have procedures in place to ensure that:
  - a. Type and quantity are known as soon as practicable?
  - b. Type and quantity information is provided to the contractor's purchasing personnel as soon as possible?
  - c. Reasonable and consistent decisions regarding whether to transfer the inventory to a different inventory account or to a final cost objective are made?
  - d. All physical transfers are recorded accurately and in a timely manner?

### G. Costing of Material Transactions

**Compliance criterion:** [m]aintain a consistent, equitable, and unbiased logic for costing of material transactions . . .

DFARS § 252.242-7004(d)(7); see DFARS § 252.242-7004(b)(1)(iii) (compliance requirement for appropriate costing of material transactions).

1. Does the contractor have written policies and procedures measuring, assigning and allocating material costs, including interorganizational transfers? 48 C.F.R. § 9904.411-40(a); FAR § 31.205-26(e).
2. Regarding the cost of initial material acquisitions by purchase or fabrication:
  - a. Does the contractor use an actual or standard cost methodology, combined with any of the inventory costing methods in CAS § 411-50(b), consistently across all contract and customer types and from accounting period to accounting period?
  - b. Regarding the use of actual costs:
    - (i) When material costs are charged directly to a contract upon acquisition:

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- (a) Is the contract to be charged identified on the purchase order?
    - (b) If not, is the basis for the direct charge a clear identification to a contract based upon a specific and documented requirement for the materials or a reasonable allocation method? 48 C.F.R. § 9904.411-40(b); FAR § 31.205-26(d).
  - (ii) When material costs are charged directly to a contract upon requisition from inventory:
    - (a) If actual cost is used, does the accounting system permit determining the actual cost of the material(s) requisitioned?
    - (b) If an average cost is used, is the average cost calculated using an acceptable inventory method? 48 C.F.R. §§ 9904.411-40(d), -50(b); FAR § 31.205-26(d).
  - (iii) For materials purchased for and charged to indirect accounts during a fiscal year:
    - (a) Is the relevant cost measured consistently on an actual cost basis?
    - (b) When all such materials are not consumed during an accounting period, is the cost of any significant residual materials removed from the pool to which it was charged and carried as an asset? 48 C.F.R. §§ 9904.411-40(c), -50(d).
  - (iv) Does appropriate documentation exist to support material costs, including purchase requisitions, purchase orders, invoices and inventory requisitions?
- c. Regarding cost of material recorded at standard cost, see Ch. 1, § IV.A.15.

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3. Regarding transfers, including transfers of excess materials (see Secs. IV.F.1 and F.3 above):
  - a. Does the contractor maintain and disclose written policies describing its methodology for costing transfers?
  - b. Does the contractor maintain a consistent, unbiased methodology for costing material transfers between contracts (or final cost objectives) that measures the transferred cost based on actual cost, consistent application of an inventory costing practice permitted by CAS § 411-50 applied to actual costs, or standard costs?
    - (i) Is this methodology used for both government and commercial transfers?
    - (ii) Is this methodology used for both cost reimbursable and fixed price contracts?
  - c. Do transferred costs include value-added (labor and overhead, as appropriate) calculated on a consistent basis?
  - d. Does the contractor transfer costs in the same billing period, but no later than the next billing period, whenever possible?
4. Regarding loan/paybacks (see Sec. IV.F.2 above):
  - a. Does the contractor engage in “loan/payback” transactions?
  - b. Does the contractor maintain and disclose a written policy describing its loan/pay-back techniques?
  - c. When loan/payback is used, does the contractor have controls to:
    - (i) Ensure that parts are paid back expeditiously?
    - (ii) Prevent and correct any overbilling by, among other things:
      - (a) Ensuring that the cost of the loaned part is billed only under the loaning contract?

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- (b) Ensuring that, if delivery billing occurs under the borrowing contract, costs of the loaning contract are reduced for billing purposes by the cost of the loaned item?
        - (c) Making cost transfers when payback does not occur within a stated period, that reasonably minimizes the chance of material overbilling (e.g., 180 days)?
      - (iii) Identify outstanding loan/payback transactions monthly by contract to facilitate payback and a need for a cost transfer?
      - (iv) Ensure costs of replacement items are charged to the borrowing contract, including the reversal of any cost transfer that was made previously to ensure proper billing?
      - (v) If costs are transferred, are they measured using the same cost methodology as used for transfers (see Sec. IV.G.3)?
- 5. Regarding residual materials (see Sec. IV.F.3 above):
  - a. Are residual materials available after completion of a fixed price contract and the liquidation of all progress payments classified as contractor property and used to perform other contracts?
    - (i) If residual materials are transferred to another contract, is any cost or value transferred to the using contract?
      - (a) If so, is it an appropriate actual, average or standard cost?
      - (b) Is the transferred cost removed from the cost of the transferring contract?
      - (c) If costs are not transferred to the using contract, is the using contract not charged any cost/value for the materials transferred to it?

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- (ii) If residual materials are placed in common inventory, is any cost transferred to inventory?
      - (a) If so, is it an appropriate actual, average or standard cost?
      - (b) If not, does that inventory cost reflect a zero cost for the transferred materials?
  - b. Are residual materials associated with a cost contract retained by the contractor and used to perform other contracts?
    - (i) If residual materials are transferred to another contract, are credits taken against contract costs for these materials? If so, are these credits taken against contract costs using appropriate actual, average or standard cost?
    - (ii) If residual materials are placed in common inventory, are credits taken against contract costs for these materials? If so, are these credits taken against contract costs using appropriate actual, average or standard cost?
- 6. Regarding scrap:
  - a. Are procedures in place for obtaining the highest possible prices on items sold?
  - b. Are proceeds from the sale of scrap credited to the appropriate government contract(s) or other cost objective(s)?
- 7. Does the contractor conduct routine internal audits to review the accuracy of material charges?

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### H. Common Inventory Allocations

**Compliance criterion:** [w]here allocations from common inventory accounts are used, have controls . . . to ensure that—

- (i) Reallocations and any credit due are processed no less frequently than the routine billing cycle;
- (ii) Inventories retained for requirements that are not under contract are not allocated to contracts; and
- (iii) Algorithms are maintained based on valid and current data; . . .

DFARS § 252.242-7004(d)(8); see DFARS § 252.242-7004(b)(1)(iii) (compliance requirement for appropriate charging of material transactions).

1. Does the contractor have written procedures for the physical assignment of, and cost accounting for, common inventory items?
2. For materials placed into a common inventory:
  - a. Is a cost/value transferred to the inventory account based upon actual or standard cost?
  - b. Is the cost charged to the using (benefiting) contract to which common inventory is issued based upon the use of a consistently applied actual, average or standard inventory costing procedure? See 48 C.F.R. § 9904.411-50.
  - c. Are physical assignments and cost allocations to a contract based upon an inventory requisition that is consistent with valid, time-phased requirements found in the relevant MPS?
  - d. Does the contractor keep stock record cards or other records to provide information on the location, nomenclature, and quantities of items in common inventory?
3. When physical or cost allocations are not made reasonably close in time to required production dates or in excess of valid requirements, is there sufficient documented justification for the earlier allocations?

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4. Are allocations from common inventory accounts processed no less frequently than the routine billing cycle?
5. Are algorithms used to replenish common inventories updated when common inventory account allocations are processed?

### I. Commingled Inventories

**Compliance criteria:** [h]ave adequate controls to ensure that physically commingled inventories that may include material for which costs are charged or allocated to fixed-price, cost-reimbursement, and commercial contracts do not compromise requirements of any of the [MMAS compliance criteria]. Government-furnished material shall not be—

- (i) Physically commingled with other material; or
- (ii) Used on commercial work; . . .

DFARS § 252.242-7004(d)(9); see DFARS § 252.242-7004(b)(1)(iii) (compliance requirement for appropriate charging of material transactions).

1. Does the contractor maintain any physical inventory that holds received materials, the costs of which have been charged to two or more contracts? If so:
  - a. Does the contractor record accurately and timely the number of items added to a commingled inventory allocable to a particular contract?
  - b. Does the contractor accurately and timely record inventory requisitions so that the number of items in inventory allocable to a contract is tracked?
  - c. Does the contractor's physical inventory process (see Sec. IV.E above) adequately address issues related to any commingled inventory?
  - d. Does the contractor use a consistent method of developing a cost for each item in commingled inventory, whether it is actual cost, an appropriate average cost using a methodology listed in CAS § 411-50, or standard cost?

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- e. Does the contractor allocate inventory costs to contracts using the inventory cost developed under paragraph d. above?
  - f. Does the contractor assess monthly whether any previous assignment of commingled inventories to contracts remains appropriate by analyzing, among other things:
    - (i) BOM changes?
    - (ii) MPS changes?
    - (iii) Transfers?
    - (iv) Inventory discrepancies?
  - g. Are adjustments required by the monthly assessment reflected in billing for the next billing period?
2. Does the contractor maintain separate physical inventories for government-furnished materials?

### J. Internal Audits

**Compliance criterion:** [b]e subjected to periodic internal reviews to ensure compliance with established policies and procedures.

DFARS § 252.242-7004(d)(10); see DFARS § 252.242-7004(b)(2) (compliance requirement to assess the MMAS).

1. Is the MMAS reviewed periodically by internal audit or other independent reviewer(s)?
2. Do these reviews act as a mechanism to identify, report and resolve system control weaknesses and manual overrides?
3. Do the reviews confirm the existence of audit trails/records necessary to evaluate system logic and to verify through transaction testing that the system is operating as designed?
4. Are unfavorable comments addressed and resolved in a timely manner?

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5. Does the contractor have a clear and disclosed methodology for disclosing the results of internal audits to the government without disclosing the reports themselves?

### V. Supporting Best Practices

#### A. Material Receiving

1. Does the contractor have appropriate policies and procedures for the receipt and inspection of material that will support a compliant MMAS?
2. Does the contractor have a formalized receiving function, which meets the following criteria:
  - a. Is the receiving department independent from the purchasing, invoice processing, and shipping functions?
  - b. Is there central control of incoming material?
  - c. Is the flow of MMAS documentation, such as receiving forms, controlled by use of pre-numbered forms, batch transmittals and/or other appropriate means?
  - d. Are signed receiving reports prepared for all material received and a copy furnished to the accounting department?
  - e. Is the receiving department advised, by copy of the purchase order, of the type of material purchased?
  - f. Are material quantities received verified by actual count, weight, or measurement by the receiving department?
  - g. Is quality inspection of received materials evidenced by inspection reports, notations on receiving reports, or other acceptable records?
  - h. Are procedures in effect that control defective and damaged material, over-shipments, returned material, material received but not ordered, and claims against carriers and vendors?

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- i. Unless clearly justified by the circumstances, are government contracts not charged for the cost of rework when a contractor accepts and reworks defective vendor-furnished material instead of rejecting and returning it?
- j. Are material returns routed to the shipping department and controlled by authorized shipping forms or material releases?
- k. Are procedures in effect for controlling the distribution of material from the receiving area to stores or to production areas?

### **B. Storage/Inventory/Issuance of Material**

1. Does the contractor have written policies and procedures concerning the storage and issuance of material?
2. Is separate accountability maintained for each class of contractor-owned and government-owned materials?
3. Is material received delivered directly to the warehouse, storeroom, or production area, via an inspection area if appropriate?
4. When material is delivered directly to a production area, is there documentation and accounting control for that material?
5. Is excess stock, as defined by policies and procedures, prevented from accumulating in production areas?
6. Are inventory records maintained by employees functionally independent of storekeepers?
7. Are there adequate controls to prevent theft or diversion of material?
  - a. Are unauthorized persons denied access to storerooms?
  - b. Are there special safeguards for high dollar value material and material susceptible to personal use or sale?
8. Are materials stored to facilitate locating, withdrawing, handling, and counting?

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9. Do procedures provide for the timely reporting of slow moving, obsolete or overstocked material, such as electronic parts, automotive and truck parts, or copper, brass, or other high value metals or components?
10. Do procedures provide for the release of materials only upon the receipt of a properly approved requisition?
11. Are requisitions applicable to government-owned materials distinguishable from requisitions for contractor-owned materials?
12. Are procedures in effect to control and account for returnable items (e.g., reels, containers, skids, boxes, and barrels)?
13. Is the flow of accounting documentation controlled by use of pre-numbered forms, batch transmittals and/or other appropriate means?

### **C. Precious Metals**

1. Are appropriate safeguards exercised over precious metals, such as separation of responsibility for receiving, storing and issuing?
2. Does the contractor maintain perpetual inventory records for these materials?
3. Does the contractor safeguard scrap?

## CHAPTER 5: MATERIAL MANAGEMENT AND ACCOUNTING SYSTEM

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### VI. 2014 System Update

#### A. Areas of Emphasis

In 2013, the DOD Inspector General issued two reports, Report Nos. DOD IG-2013-082 and DOD IG-2014-002, addressing hotline allegations that DCAA failed to take appropriate actions to respond to certain contractor MMAS deficiencies. In these reports, the IG identified the MMAS deficiencies in the contractor systems. These deficiencies included:

1. Bills of Material creation and time-phasing of material requirements not adequately described in contractor policies.
2. Material transfers and diversions subject to inadequate controls and inconsistencies not properly identified and reported.
3. Employee access to manufacturing resources planning system not properly controlled.
4. MMAS audit trails inadequate.
5. Borrow/lend transactions not properly described in contractor policies.
6. MMAS internal reviews not documented.
7. Use of economic ordering quantities not adequately described in contractor policies.
8. Identification and reports of significant MMAS changes to CO not detailed in contractor policies.
9. 95% MPS accuracy not met due to contractor's premature purchase of material not needed in production for several months.

The DOD-IG reports criticized DCAA for failing to timely and adequately follow-up on these initial MMAS deficiency findings to ensure that the contractors had effectively implemented corrective action. Consistent with these IG recommendations, DCAA likely will seek to dedicate additional resources to monitoring and verifying corrective actions in response to significant deficiency findings.

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In addition to those MMAS compliance issues identified in the DOD-IG reports, other common MMAS system compliance issues include the following:

1. **Excess material:** Significant material on hand not charged and allocated to existing projects. This commonly results from improper requirements planning and a failure to timely disposition material and is identified as a system control weakness in the DFARS system criteria.
2. **Audit trails:** Inability to tie certain parts and materials to authorized demands or higher-level assemblies.
3. **Retained on floor inventory accuracy:** Inability to maintain 95% accuracy for non-stockroom inventory.
4. **Part Transfers:** Part transfers, including specifically for internally fabricated parts, were not properly documented.

### **B. DCMA/DCAA Guidance**

DCMA updated its MMAS review guidance in May 2012. Based on this updated guidance, ACOs are required to determine on an annual basis whether a contractor meets the \$40 million threshold of qualifying sales that triggers an MMAS review. If a contractor meets this threshold, the ACO must conduct a risk assessment, considering past corrective action requests, system modifications, and functional specialist risk reports. A contractor's MMAS that has never been reviewed or not reviewed in the past three years will be deemed "at risk" unless the contractor can produce evidence demonstrating that its system is adequate.

Per DCMA's guidance, MMAS system reviews will emphasize risk areas based on the system risk assessment, the contractor's past performance and other known system weaknesses. Government system reviews also will focus on areas of weakness identified during other business systems reviews and issues identified by contractors in internal audits. If a MMAS is disapproved, the ACO is directed to approve the system "as quickly as possible."

### **C. Proposed Update to the DFARS Business Systems Rule**

On July 15, 2014, DOD issued a proposed rule that would update the Business Systems Rule to require contractors to self-assess and report on estimating system, accounting system, and material management and accounting system compliance. 79 Fed. Reg. 41,172 (July 15, 2014). The proposed rule and its requirements are discussed in additional detail in Chapter 7 below.

## CHAPTER 6: EARNED VALUE MANAGEMENT SYSTEM

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### I. Overview

The Business Systems Rule sets forth requirements for contractors to establish and maintain a compliant earned value management system (“EVMS”). DFARS § 252.234-7002. The Business Systems Rule EVMS requirements supplement the existing FAR and DFARS EVMS requirements applicable to contractors performing certain high-value and complex, flexibly-priced development contracts. See FAR Subpt. 34.2; DFARS Subpt. 234.2.

FAR defines an EVMS as a project management tool that effectively integrates the project scope of work with cost, schedule and performance elements for optimum project planning and control. FAR § 2.101. The qualities and operating characteristics of a compliant EVMS are described in American National Standards Institute/Electronics Industries Alliance Standard 748 (“ANSI/EIA-748”), Earned Value Management Systems. DFARS § 252.234-7002.

An acceptable EVMS must meet the following compliance criteria:

#### **Compliance criteria:**

- (1) An Earned Value Management System (EVMS) that complies with the EVMS guidelines in the American National Standards Institute/Electronic Industries Alliance Standard 748, Earned Value Management Systems (ANSI/EIA-748); and
- (2) Management procedures that provide timely, reliable and verifiable information for the Contract Performance Report (CPR) and the Integrated Master Schedule (IMS) as required by the CPR and IMS data requirements of the contract.

DFARS § 252.234-7002(b).

The Business Systems Rule mandates compliance with these requirements for contracts valued at \$50 million or more. For these contracts, contractors are required to establish an EVMS that has been determined acceptable by the cognizant federal agency (“CFA”), likely a DCMA ACO. DFARS § 252.234-7002(c). For contracts that are less than \$50 million, the CFA will not make a formal determination that the contractor’s EVMS complies with the requirements. DFARS § 252.234-7002(d).

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Contractors must provide prior notice to the CFA of any proposed substantive changes to the EVMS and the impact of those changes. DFARS § 252.234-7002(e). If the contract has a value of \$50 million or more, the contractor must seek prior approval from the CFA for any proposed EVMS changes, unless a waiver is granted by the CFA. *Id.* If the CFA waives the advance approval requirements, the contractor must disclose proposed EVMS changes to the CFA at least 14 days before implementation of the change. *Id.*

Typically, a government review of the EVMS will occur near the commencement of contractor performance or after major contract actions as part of an integrated baseline review. DFARS § 252.234-7002(f). The contractor also is required to maintain pertinent records and to provide the government with access to such records during the performance of the contract to support intermittent government assessments of contractor EVMS compliance. DFARS § 252.234-7002(g).

The Business Systems Rule imposes withholds under a covered contract when the initial validation of the system is not completed within a timeframe approved by the ACO, or if the ACO determines that the contractor's system contains any deficiencies in the "high-risk" guidelines of ANSI/EIA-748 (Intent Guidelines 1, 3, 6-10, 12, 16, 21, 23, 26-28, 30 or 32). DFARS § 252.234-7002(i) (3)(iv). The ACO has the discretion to disapprove an EVMS when there are one or more deficiencies in the contractor's system with respect to any of the remaining 16 guidelines of ANSI/EIA-748 after receipt of input from functional government specialists and the relevant auditor. *Id.*

### II. References

- DFARS Subpt. 234.2
- DFARS § 252.234-7002
- FAR Subpt. 34.2
- DOD Instruction No. 5000.02 (Dec. 8, 2008)
- American National Standards Institute/Electronics Industries Alliance Standard-748-B, Earned Value Management Systems (June 2007)
- DOD Earned Value Management Implementation Guide (Oct. 2006)
- DCAA Contract Audit Manual, 11-200 (Dec. 31, 2010)
- National Defense Industrial Association (NDIA) Program Management Systems Committee (PMSC) Earned Value Management Systems Intent Guide (May 2011) ("NDIA PMSC ANSI/EIA-748-B Intent Guide")

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### III. Key Definitions

The following definitions are from the American National Standards Institute/ Electronics Industries Alliance Standard-748-B, Earned Value Management Systems and DOD Earned Value Management Implementation Guide.

1. Actual cost of work performed: the costs actually incurred and recorded in accomplishing work performed.
2. Budgeted cost for work performed (“BCWP”): the value of completed work expressed in terms of the budget assigned to that work, also referred to as earned value.
3. Contract Performance Report (“CPR”): a contractually required report, prepared by the contractor, containing performance information derived from the EVMS. The report provides the status of progress on the contract.
4. Control account: a management control point at which budgets (resource plans) and actual costs are accumulated and compared to earned value for management control purposes. A control account is a natural management point for planning and control since it represents the work assigned to one responsible organizational element on one program WBS element.
5. Cost variance: a metric for the cost performance on a program as of a specified date. It is the difference between earned value and actual cost (cost variance = earned value – actual cost). A positive value indicates a favorable position and a negative value indicates an unfavorable condition.
6. Earned value: the value of completed work expressed in terms of the budget assigned to that work, also referred to as BCWP.
7. Estimate at completion or EAC: the current estimated total cost for program authorized work. It equals actual cost to a point in time plus the estimated costs to completion.
8. Estimate to complete or ETC: estimate of costs to complete all work from a point in time to the end of the program.
9. Integrated master plan: an integrated plan identifying events, significant accomplishments, and criteria for the program.

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10. Integrated Master Schedule (“IMS”): an integrated schedule containing the networked, detailed tasks necessary to ensure successful program execution.
11. Level of effort: unmeasured effort of a general or supportive nature usually without a deliverable end product. Examples are supervision, program administration and contract administration.
12. Management reserve: an amount of the total budget withheld for management control purposes, from the amount designated for the accomplishment of a specific task or set of tasks.
13. Milestone: a schedule event marking the due date for accomplishment of a specified effort (work scope) or objective. A milestone may mark the start, an interim step, or the end of one or more activities.
14. Organization structure: the hierarchical arrangement of the management organization for a program, graphically depicting the reporting relationships. The organizational structure will be by work team, function, or other applicable units are used.
15. Over-target baseline: replanning actions involving establishment of cost and/or schedule objectives that exceed the desired or contractual objectives of the program. An over-target baseline is a new baseline for management when the original objectives cannot be met and new goals are needed for management purposes.
16. Performance measurement baseline: the total time-phased budget plan against which program performance is measured. It is the schedule for expenditure of the resources allocated to accomplish program scope and schedule objectives, and is formed by the budgets assigned to control accounts and applicable indirect budgets. The performance measurement baseline also includes budget for future effort assigned to higher level accounts, also referred to as summary level planning packages, plus any undistributed budget. Management reserve is not included in the baseline, as it is not yet designated for specific work scope.

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17. Planned value: the time-phased budget plan for work currently scheduled.
18. Planning package: a logical aggregation of work within a control account, usually future efforts that can be identified and budgeted, but which is not yet planned in detail at the work package or task level.
19. Program target cost: the program cost objective based on the negotiated contract target cost, or the management goal value of the authorized work, plus the estimated cost of authorized unpriced work.
20. Schedule: a plan that defines when specified work must be done to accomplish program objectives on time.
21. Schedule risk assessment: a process that uses statistical techniques to identify technical, programmatic, and schedule risks in a program and quantifies the impact of those risks on the program's schedule.
22. Schedule variance: a metric for the schedule performance on a program. It is the difference between earned value and the budget (schedule variance = earned value – planned value). A positive value is a favorable condition while a negative value is unfavorable.
23. Undistributed budget: budget associated with specific work scope or contract changes that have not been assigned to a control account or summary level planning package.
24. Work breakdown structure or "WBS": product-oriented division of program tasks depicting the breakdown of work scope for work authorization, tracking and reporting purposes.

### IV. EVMS Compliance with the Guidelines of ANSI/EIA-748

The guidelines of ANSI/EIA-748 are organized into five categories. The categories correlate to the series of steps necessary for a contractor to establish, implement and maintain an EVMS. Thus, in the discussions below, each of the ANSI/EIA-748's categories is followed by a recitation of the ANSI/EIA-748's guidelines (compliance requirements) and relevant considerations.

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### A. Organization (Intent Guidelines 1-5)

#### Compliance requirements:

- a) Define the authorized work elements for the program[/contract]. . . .
- b) Identify the program organizational structure, including the major subcontractors responsible for accomplishing the authorized work, and define the organizational elements in which work will be planned and controlled. . . .
- c) Provide for the integration of the company's planning, scheduling, budgeting, work authorization and cost accumulation processes with each other, and as appropriate, the program work breakdown structure and the program organizational structure. . . .
- d) Identify the company organization or function responsible for controlling overhead (indirect costs). . . .
- e) Provide for integration of the program work breakdown structure and the program organizational structure in a manner that permits cost and schedule performance measurement by elements of either or both structures as needed.

NDIA PMSC ANSI/EIA-748-B Intent Guide, pp. 3-7.

1. Does the contractor utilize a WBS?
2. Does each WBS contain all project work, including revisions for authorized changes and modifications?
3. Does the WBS identify all WBS elements specified for external reporting?
4. Does the WBS extend, at a minimum, to the level(s) at which control accounts are established?
5. Does the organizational breakdown structure ("OBS") identify the organization responsible for each segment of work, including subcontracted and intra-organizational effort?

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6. Does the assignment of lower-level work segments to responsible managers provide key control points for management purposes?
7. When an effort is subcontracted, is the applicable subcontractor identified with and related to the appropriate WBS element(s) and/or organization element charged with acquiring the subcontracted item?
8. Does the contractor identify the program organizational structure, including the major subcontractors responsible for accomplishing the authorized work, and define the organizational elements in which work will be planned and controlled? Does the contractor assign all authorized work to organizational elements?
9. Are all major subcontractor work efforts integrated into the program structure?
10. Are the work tasks assigned to a WBS and OBS, and are they traceable to the planning and budgeting system and the cost collection system?
11. Has the contractor established a coding structure that facilitates the linkage between the planning, scheduling, budgeting, work authorization, cost accumulation and performance measurement processes?
12. Does the contractor provide a logical framework that links the products of the management processes through common data elements? Examples include cross-references between the statement of work and WBS, the master schedule and performance measurement tasks, and the detail schedules and control account plans.
13. Does the contractor clearly identify managers who are assigned responsibility and authority for controlling indirect costs, including overhead, and G&A costs, and who have the authority to approve expenditure of resources?
14. Does the contractor have a documented process for management and control of indirect costs, including assignment of responsibility in the organization's approved accounting procedures?

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15. Has the contractor established multiple control accounts that reflect the scope of the management tasks, and considerations for planning and control of budgets, schedules, work assignments, progress assessment, problem identification and corrective actions?
16. Is the control account the primary point for work authorization, work performance management, and work performance measurement; i.e., where planned value is established, earned value is assessed, and actual costs are collected?
17. Has the contractor assigned each control account to a manager? Is the control account manager responsible for ensuring the accomplishment of work in his or her control account and the focal point for management control?
18. Are the control accounts visible at the intersection of the WBS and OBS?
19. Does the control account clearly identify any supporting activities?

### **B. Planning, Scheduling & Budgeting (Intent Guidelines 6-15)**

#### **Compliance requirements:**

- a) Schedule the authorized work in a manner which describes the sequence of work and identifies significant task interdependencies required to meet the requirements of the program. . . .
- b) Identify physical products, milestones, technical performance goals, or other indicators that will be used to measure progress. . . .
- c) Establish and maintain a time-phased budget baseline, at the control account level, against which program performance can be measured. . . .
- d) Establish budgets for authorized work with identification of significant cost elements (labor, material, etc.) as needed for internal management and for control of subcontractors. . . .

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- e) To the extent it is practicable, identify the authorized work in discrete work packages, establish budgets for this work in terms of dollars, hours, or other measurable units. Where the entire control account is not subdivided into work packages, identify the far term effort in larger planning packages for budget and scheduling purposes. . . .
- f) Provide that the sum of all work package budgets plus planning package budgets within a control account equals the control account budget. . . .
- g) Identify and control level of effort activity by time-phased budgets established for this purpose. . . .
- h) Establish overhead budgets for each significant organizational component of the company for expenses that will become indirect costs. Reflect in the program budgets, at the appropriate level, the amounts in overhead pool that are planned to be allocated to the program as indirect costs. . . .
- i) Identify management reserves and undistributed budget. . . .
- j) Provide that the program target cost goal is reconciled with the sum of all internal program budgets and management reserves.

NDIA PMSC ANSI/EIA-748-B Intent Guide, pp. 9-24.

1. Does the master schedule establish the top level schedule for accomplishment of program objectives? Is the master schedule supported by subordinating schedules adequate to effectively plan and manage the program, including procurement of subcontracts?
2. Does the schedule establish the time-phased sequence of discrete work to be accomplished?

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3. Does the schedule establish critical target dates, project milestones, contractual events and accomplishment criteria? Are project decision points identified and used to plan, status and monitor progress of the work?
4. Does the schedule identify the significant interdependencies that are indicative of the actual way the work is accomplished?
5. Is the schedule a reasonable baseline for achieving project requirements as demonstrated through schedule analysis techniques?
6. Do the schedule network relationships support the development of a critical path for development projects?
7. Does the contractor's performance measurement baseline reflect the work scope, time-phased at the control account level consistent with the schedule?
8. Does the contractor's performance measurement baseline reflect the budget value in all control accounts for the work scope and summary level planning packages?
9. Are the budgets for each control account reconcilable to the budget values shown on the work authorization documents?
10. Has the contractor established a responsibility assignment matrix which represents the complete project plan and budget?
11. Do the work packages incorporate objective indicators of progress?
12. Does the contractor's planning packages for long-term efforts reflect the manner in which the work is to be performed?
13. Does each control account manager have a budget with an assigned scope of work?
14. Do the contractor's budgets for level of effort activity have a sound basis of estimate and are the budgets time-phased to properly reflect when work will be accomplished?
15. Does the contractor's management reserve budget reflect the level of risk within the currently authorized work scope identified?

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### C. Accounting Considerations (Intent Guidelines 16-21)

#### Compliance requirements:

- a) Record direct costs in a manner consistent with the budgets in a formal system controlled by the general books of account. . . .
- b) When a work breakdown structure is used, summarize direct costs from control accounts into the work breakdown structure without allocation of a single control account to two or more work breakdown structure elements. . . .
- c) Summarize direct costs from the control accounts into the contractor's organizational elements without allocation of a single control account to two or more organizational elements. . . .
- d) Record all indirect costs that will be allocated to the program consistent with the overhead budgets. . . .
- e) Identify unit costs, equivalent unit costs, or lot costs when needed. . . .
- f) For EVMS, the material accounting system will provide for:
  - 1) Accurate cost accumulation and assignment of costs to control accounts in a manner consistent with the budgets using recognized, acceptable, costing techniques.
  - 2) Cost recorded for accomplishing work performed in the same period that earned value is measured and at the point in time most suitable for the category of material involved, but no earlier than the time of actual receipt of material.
  - 3) Full accountability of all material purchased for the program including the residual inventory.

NDIA PMSC ANSI/EIA-748-B Intent Guide, pp. 25-30.

1. See Ch. 1, Accounting and Billing Systems; Ch. 5, Material Management and Accounting System.
2. Does the EVMS utilize actual cost data from the contractor's accounting system?

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3. Does the contractor maintain an adequate accounting system?
4. Are the cost reporting requirements effectively flowed down to subcontractors, permitting accurate estimates of actual costs for work performed pending invoice receipt and payment?
5. Are costs reported in the accounting system and the timing of cost recognition consistent with the time phasing in the budgets?
6. Do the actual costs reported in the performance reports agree with the costs recorded in the general books of account (accounting system) and are any timing differences explained and reconciled?
7. At a minimum, are actual costs collected at the control account level to enable summarization of cost by both the WBS and OBS?
8. Are material costs recorded on an as-applied basis at the time material is applied to the work (and/or does an exception apply)?
9. Does the cost collection account structure show charge number hierarchy?
10. Does the WBS/cost collection mapping showing the relationship between charge numbers and control accounts and/or work packages?
11. Has the contractor established a cost charging structure that will ensure that actual costs are collected (roll-up scheme) so that direct comparison with associated budgets can be made at the appropriate WBS level(s)?
12. Does the contractor's OBS structure (roll-up scheme) mapping show the relationship of charge numbers to the OBS?
13. Has the contractor established a cost charging structure (roll-up scheme) to ensure that actual costs are collected so that direct comparison with associated budgets can be made at the appropriate organizational level(s)?

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### D. Analysis and Management Reports (Intent Guidelines 22-27)

#### Compliance requirements:

- a) At least on a monthly basis, generate the following information at the control account and other levels as necessary for management control using actual cost data from, or reconcilable with, the accounting system:
  - 1) Comparison of the amount of planned budget and the amount of budget earned for work accomplished. This comparison provides the schedule variance.
  - 2) Comparison of the amount of the budget earned and the actual (applied where appropriate) direct costs for the same work. This comparison provides the cost variance. . . .
- b) Identify, at least monthly, the significant differences between both planned and actual schedule performance and planned and actual cost performance, and provide the reasons for the variances in the detail needed by program management. . . .
- c) Identify budgeted and applied (or actual) indirect costs at the level and frequency needed by management for effective control, along with the reasons for any significant variances. . . .
- d) Summarize the data elements and associated variances through the program organization and/or work breakdown structure to support management needs and any customer reporting specified in the contract. . . .
- e) Implement managerial actions taken as the result of earned value information. . . .
- f) Develop revised estimates of cost at completion based on performance to date, commitment values for material, and estimates of future conditions.

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NDIA PMSC ANSI/EIA-748-B Intent Guide, pp. 32-39.

1. See Ch. 1, § VI.D.2, Accounting and Billing Systems, regarding EACs.
2. Does the contractor maintain appropriate and clear earning methodologies for discrete work efforts?
3. Is the earning methodology consistently applied?
4. Is apportioned-effort value earned consistent with the relevant base accounts?
5. Is level of effort work scope appropriately time-phased and earned consistent with the budget scheduled for each time period?
6. Does the monthly performance report contain reliable BCWP and actual cost of work performed comparison information for identifying the cost variance?
7. Does the monthly performance report contain reliable earned value (BCWP) and planned value comparison information for identifying the schedule variance?
8. Does the monthly performance report contain a narrative on variance analysis (root causes, impacts at completion, and management actions)?
9. Does the monthly performance report summarize performance measurement data from control account (at a minimum) through WBS/OBS hierarchy to the program level?
10. Does the responsible overhead manager identify root cause(s) (i.e., usage or price variance, change in business volume, or rate variance due to a change in the direct base)?
11. Does the contractor have management action plans that identify corrective action plans to reduce or eliminate variance?
12. Do the contractor's management action plans contain performance metrics?
13. Does the contractor make EVMS data available to managers on a timely basis and of sufficient quality to ensure that effective management decisions can be made as a result of its analysis?

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14. Do the contractor's internal reports and the reports forwarded to its customer indicate the overall cost and schedule impacts of issues identified on the project?
15. Does the contractor identify the corrective actions at the appropriate level and then track issues to resolution and closure?
16. Does a manager have sufficient authority and control over the resources to implement effectively the corrective action requirements?
17. Does the contractor conduct a follow-up of the implementation to confirm whether the corrective action was effectively implemented?
18. Does the contractor periodically reassess the remaining authorized requirements on the program and maintain the most likely ETC and document changes from previous ETC?
19. Does the contractor maintain the most likely EAC for all authorized program efforts and document changes from the previous EACs?

### **E. Revisions and Data Maintenance (Intent Guidelines 28-32)**

#### **Compliance requirements:**

- a) Incorporate authorized changes in a timely manner, recording the effects of such changes in budgets and schedules. . . .
- b) Reconcile current budgets to prior budgets in terms of changes to the authorized work and internal replanning in the detail needed by management for effective control. . . .
- c) Control retroactive changes to records pertaining to work performed that would change previously reported amounts for actual costs, earned value, or budgets. . . .
- d) Prevent revisions to the program budget except for authorized changes. . . .
- e) Document changes to the performance measurement baseline.

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NDIA PMSC ANSI/EIA-748-B Intent Guide, pp. 41-48.

1. Does the contractor have the ability to track budget values for changes to the performance measurement baseline from program start to completion?
2. Does the contractor's change control process define its policy regarding retroactive changes that include: (a) conditions for use; (b) prohibitions, approvals and justifications; and (c) evidence of discipline and control?
3. Does the contractor compare the current and previous periods' "dollarized," time-phased baseline plan to identify any differences and to verify that all changes have been identified and unidentified changes addressed?
4. Do the CPRs containing current period data reflect any retroactive changes and contain appropriate explanations?
5. Do the contractor's control account/work package/planning package plans reflect approved budget changes?
6. Do the work authorization documents support the budget changes?
7. Do the CPRs and other applicable management reports reflect changes to the contract?

### V. EVMS Requirement of Timely, Reliable and Verifiable Information

**Compliance requirements:** contractor must use an EVMS "that provide[s] for generation of timely, reliable, and verifiable information for the Contractor Performance Report (CPR) and the Integrated Master Schedule (IMS) as required by the CPR and IMS data items of the contract."

DFARS § 252.234-7002(b)(2).

1. Does the contractor's performance data objectively measure work progress?

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2. Does the contractor's performance data allow for informed decision making and corrective action?
3. Is the contractor's performance data valid, timely and auditable?
4. Does the contractor's performance data allow for statistical estimation of future costs?
5. Does the contractor's performance data supply managers at all levels with status information at the appropriate level of detail?
6. Does the contractor maintain program control logs to identify management reserves and undistributed budgets and document changes?

### A. CPR

**Compliance criteria:** [n]ormally, the CPR should be delivered monthly.

DOD Earned Value Management Implementation Guide, § 2.2.5.6.3.1.

1. Is the contractor timely delivering the relevant CPR the government elected for use under the contract, tailored to the contract type, value and risks?
2. CPR Format 1, "Work Breakdown Structure":
  - a. Is the data for the WBS elements for the current reporting period reliable and verifiable?
  - b. Is the cumulative to date data for the WBS elements reliable and verifiable?
  - c. Are the contractor's calculations for cost and schedule variances reliable and verifiable?
  - d. Can the contractor identify any reprogramming adjustment, budget at completion, EAC, and variance at completion by elements?
  - e. Can the contractor provide reliable and verifiable data on the management reserve and the undistributed budget?

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3. CPR Format 2, "Organizational Categories" (mandatory for contracts valued at \$50 million or more):
  - a. Does the contractor identify the relevant contractor functional labor categories, major subcontractors, and material?
  - b. Does analysis of the data in this format correlate with CPR Format 1?
4. CPR Format 3, "Baseline" (focuses on budgeted time-phased baseline costs to the end of the program):
  - a. Is the data for budgeted time-phased baseline costs reliable and verifiable?
  - b. Is the data for the contract budget basis reliable and verifiable?
  - c. Is the data for the total allocated baseline reliable and verifiable?
  - d. Are the completion dates accurate?
  - e. Is the data on the management reserve reliable and verifiable?
  - f. Does analysis of the data in this format correlate with CPR Formats 1 and 2?
5. CPR Format 4, "Staffing" (provides staffing forecasts in months by functional category until the end of the contract):
  - a. Is the staffing data reliable and verifiable?
  - b. Does the staffing data, plotted over time, correlate to major milestones and activities on the contract schedule and show accuracy of labor estimates?
  - c. Are the projected staffing levels consistent with scheduled activities?
  - d. Does analysis of the data in this format correlate with CPR Formats 1, 2 and 3?

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6. CPR Format 5, “Explanation and Problem Analyses” (a narrative explanation of key cost, schedule and variance at completion variances):
  - a. What are the overall contract variances?
  - b. What are the differences between each EAC?
  - c. What are the changes in undistributed budget?
  - d. What are the changes in the management reserve?
  - e. What are the significant time-phasing shifts in CPR Format 3 – Baseline?
  - f. What are the significant time-phasing shifts or overall changes in CPR Format 4 – Staffing?
  - g. Is there any over-target baseline and/or over-target schedule incorporation?
  - h. For each significant variance, answer the following questions:
    - (i) What is the type and magnitude of the variance?
    - (ii) What are the significant reasons for the variance?
    - (iii) What are the effects on the immediate task?
    - (iv) What are the effects on the total contract?
    - (v) What are the correct actions being taken or planned?
  - i. Does the data in this format correlate with CPR Formats 1, 2, 3 and 4?

### B. IMS

**Compliance criteria:** contractor must submit the IMS “on a monthly basis (as a minimum) . . . as tailored by the CDRL.”

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### DOD Earned Value Management Implementation Guide, § 2.2.5.7.4.3.

1. Does the IMS contain the contract milestones from contract award to the completion of the contract?
2. Does the IMS contain discrete tasks/activities (including planning packages where applicable) from contract award to the completion of the contract?
3. Is the IMS an integrated, logical network-based schedule?
4. Is the IMS vertically and horizontally traceable to the cost/schedule reporting instrument used to address variances such as the CPR (if applicable)?
5. Does the IMS have a numbering system that provides traceability to the integrated master plan (if applicable) and statement of work?
6. Does the IMS contain periodic analysis of progress to date?
7. Does the IMS include fields and data that enable the user to access the information by product, process, or organizational lines?
8. For contracts valued at \$50 million or more, does the IMS contain the Schedule Risk Assessment that predicts the probability of project completion by contractual dates?
  - a. Does the IMS contain three-point estimates for remaining durations of remaining tasks/activities that meet any of the following criteria:
    - (i) Critical path tasks/activities?
    - (ii) Near-critical path tasks/activities, as specified in the CDRL (not part of the schedule's critical path)?
    - (i) High risk tasks/activities in the program's risk management plan?
  - b. Do the estimates include the most likely, best case and worst case durations?

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- c. Is the criteria for estimated best and worst case durations applied consistently across the entire schedule and documented in the contractor's schedule notes and management plan?
  - (i) For the most likely estimate, are the schedule durations based on these estimates?
  - (ii) For the best and worst case estimates, does the contractor disclose all of its assumptions?
  - (iii) For the best and worst case estimates, does the contractor schedule risk assessment explain changes to the critical path, margin erosion and mitigation plans?
  - (iv) Are the best and worst case estimates incorporated into the contractor's program risk management process?

### VI. System Evaluation (ANSI/EIA-748)

ANSI/EIA-748, § 5.

**Compliance criteria:** contractor is "responsible for the evaluation of its system" to "provide[] for documented assurance that the [contractor's] program management system meets the full intentions of the guidelines presented in [the ANSI/EIA-748] standard."

#### A. Evaluation Process

- 1. Does the contractor perform self-evaluations of its EVMS?
  - a. Does the contractor use any of the following possible approaches to meet the needs of different organizations with different levels of earned valued management experience?
    - (i) Does the contractor perform the self-evaluation internally using its own resources?

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- (ii) Does the contractor perform the self-evaluation using a peer group from its own resources and/or other organizations?
    - (iii) Does the contractor engage an outside organization to assist them with the evaluation?
    - (iv) Does the contractor ask customer representatives to participate in the evaluation?
  - b. If the contractor enlists outside assistance in its self-evaluation, does the contractor retain system ownership and responsibility?
  - c. When the self-evaluation is complete, does the contractor document the process and the results?
- 2. Does the contractor document conformity with ANSI/EIA-748?
- 3. Does the contractor notify the government of its compliance with the guidelines in ANSI/EIA-748? Is the contractor's notification signed by the appropriate company official?

### **B. Prior System Acceptance (DFARS § 234.7002(c))**

- 1. Does the contractor provide documentation that its proposed EVMS complies with the guidelines in ANSI/EIA-748?
- 2. If the organization proposes to use a system that currently does not comply with the guidelines in ANSI/EIA-748, has the organization submitted its comprehensive plan for compliance?

### **C. System Surveillance**

- 1. Does the contractor have policies to monitor its EVMS to ensure continued implementation of an EVMS that meets the guidelines in ANSI/EIA-748?
- 2. Does the contractor notify the government of any significant changes in its EVMS? DFARS § 234.7002(e).

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### VII. 2014 System Update

#### A. Areas of Emphasis

Contractors are experiencing EVMS compliance issues in the following areas:

1. Although the DFARS clause at 252.234-7002 incorporates the ANSI/EIA-748 standards, these standards are general and vague. DCMA/DCAA are relying on the more illustrative NDIA Intent Guide in making system determinations. Contractors are encountering findings of significant deficiencies based upon noncompliance with the “typical attributes” of compliant systems specified in the Intent Guide that are not specifically binding on the contractor.
2. As in other system reviews, DCMA/DCAA is relying on the contractors’ internal EVMS policies and procedures and faulting contractors for minor deviations from company policy.
3. Non-routine present-period changes to baseline figures. ANSI/EIA guidelines specify that an EVMS should “[c]ontrol retroactive changes to records pertaining to work performed that would change previously reported” EVMS metrics. DCMA takes the position that present-period changes (and not merely retroactive changes) to baseline figures violate this requirement. Intent Guideline 30 of the NDIA Intent Guide indeed suggests that present-period changes may be improper, notwithstanding the language of the ANSI/EIA guideline above. As noted above, contractors should resist attempts by DCMA to impose the expanded requirements of the Intent Guide as opposed to the ANSI/EIA guidelines.
4. Using subcontractor cost/schedule reports as inputs to prime contractor’s EVMS:
  - a. If a contractor’s EVMS relies on cost/schedule reports provided by key subcontractors and the subcontractor’s reports are not EVMS-compliant, there is a risk the contractor’s system will be targeted as providing Contract Performance Reports (CPR) that are not “verifiable,” as required by the clause.

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- b. Contractors should either (1) flow down EVMS requirements to key subcontractors; or (2) rely on straightforward, objectively measurable and verifiable milestones in tracking earned value on work performed by subcontractors. Receiving EVMS-type data provided by a subcontractor that lacks a fully compliant EVMS and attempting to tailor such data to the prime contractor's own EVMS presents a risk of a government challenge.

### **B. NDIA EVMS Intent Guide Updates**

In August of 2012, NDIA published an update to its EVMS Intent Guide, used by contractors and the government in developing and testing EVMS compliance. Revisions were made to clarify Intent Guideline Nos. 8 and 30:

Intent Guideline 8 relates to the development of the Performance Measurement Baseline (PMB), a time-phased budget baseline, by assigning budgets to scheduled segments of work. Whenever budgets for remaining work fall below that necessary to complete performance, this results in an Over-Target Baseline (OTB). Intent Guideline 8 clarified that, if the customer does not approve the implementation of an OTB, the contractor can establish an internal Operating Budget, which requires an internal factoring of BCWS, BCWP and BAC values, so such values do not exceed the PMB.

Intent Guideline 30 relates to retroactive changes to records that would change previously reported amounts for actual costs, earned value and budget. Such changes should be controlled, although "routine" adjustments are permitted. However, the revised guideline specifies that "[t]he cumulative values for BCWS and BCWP will not be adjusted for routine direct and/or indirect cost rate increases or decreases," in order to ensure accuracy of performance measurement data.

In April of 2014, NDIA released an updated EVMS "Compliance Map Template," a useful tool for contractors developing a compliance map to relevant ANSI/EIA guidelines.

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### C. New NDIA Acceptance Guide

In March of 2013, NDIA's Integrated Program Management Division (IPMD) released the EVMS Acceptance Guide. The Acceptance Guide provides guidance and a standard framework to prepare contractors for effectively designing an EVMS in the first instance, thereby demonstrating that its EVMS complies with the ANSI/EIA-748 guidelines; and, most importantly, obtaining acceptance of an EVMS system from a reviewing authority.

### D. DCMA Guidance - EVMS Compliance Reviews

DCMA released the most recent version of DCMA-INST 208 on April 9, 2014. The guidance, which replaced the June 30, 2011 version, describes the EVMS compliance review process in detail. Importantly, it also adds a discussion of "materiality" in the context of EVMS system reviews and whether a deficiency is "significant" under the Business Systems Rule. DCMA will likely employ these guidelines in making EVMS system determinations in the near future.

The guidance specifies:

Significant Deficiency. Materiality considerations and impact statements documented in DRs [Discrepancy Reports] may support the COs determination of a significant deficiency. In accordance with DCMA-INST 1201 (IPC-1) . . . , the term significant deficiency is synonymous with noncompliance. . . . The [compliance review] Chief shall ensure that DRs do not contain the term "significant deficiency" but should focus on describing the materiality impacts. Identifying the discrepancy as a significant deficiency is the sole responsibility of the CO.

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Both the materiality and the impact of any discrepancies will therefore be guideposts for EVMS system determinations by contracting officers. These concepts are further discussed in the guidance:

Materiality. Materiality is a matter of professional judgment influenced by the perception of the needs of a reasonable person who relies on the performance measurement reports and financial statements. Materiality judgments consider surrounding circumstances and involve both quantitative and qualitative considerations including the number of discrepancies observed, the associated absolute dollar value impact, the importance of item(s) to the accomplishment of contract requirements, and the potential impact on any government funding. As the CR Director, the EVMID Division Director has the final responsibility and authority on all materiality judgments.

Impact Evaluation. When determining whether a control deficiency or combination of deficiencies is a material weakness, the CR Chief evaluates the magnitude of the potential misstatement considering the maximum amount or effect. To have a mitigating effect, the internal control should operate at a level of precision that would prevent or detect a misstatement that could be material. Indicators of material weaknesses in internal control over financial reporting include:

1. Restatement of previously issued financial statements to reflect the correction of a material misstatement.
2. Identification by the Functional Specialist of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting.
3. Ineffective oversight of the company's external financial reporting and internal control over financial and/or performance measurement reporting by the company's Project Controls Department.

See DCMA-INST 208 § 3.2.4.1.

## CHAPTER 7: ADMINISTRATION OF BUSINESS SYSTEMS REQUIREMENTS

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### I. Overview

The Business Systems Rule imposes system compliance requirements, discussed in Chapters 1 through 6, and administrative requirements relating to system review, system acceptance and payment withholds when a significant deficiency exists. These administrative requirements are found in DFARS §§ 242.7000 and 252.242-7005, and are discussed below.

### II. Significant Deficiency

The Business Systems Rule defines “significant deficiency” as “a shortcoming in the system that materially affects the ability of DOD officials to rely upon information produced by the System that is needed for management purposes.” This definition is the key to managing risk under the Business Systems Rule.

#### A. Meaning of Significant Deficiency

Currently, no case law defines a significant deficiency. Based upon its regulatory definition (included above), a significant deficiency requires that a deficiency exist and that the deficiency be: (1) systemic; (2) current; and (3) material.

1. **Systemic:** A deficiency is “systemic” when it impacts the entire business system at issue. Systemic deficiencies are distinguishable from other deficiencies that are present under only one or some contracts or arise from contractor/employee errors.
2. **Current:** A deficiency is “current” when it presently affects the ability of DOD officials to rely upon information produced by the system. Thus, a deficiency that only impacts past information cannot be significant because it does not impact the reliability of the information presently being produced by the system. Similarly, a deficiency that has only a hypothetical impact at a future point in time cannot be significant unless and until that deficiency begins to impact the present reliability of the information being produced by the system.

## CHAPTER 7: ADMINISTRATION OF BUSINESS SYSTEMS REQUIREMENTS

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3. **Material:** A deficiency is “material” when it undermines the creditability of information that DOD officials rely upon to make decisions. This means that, in order to constitute a “significant deficiency” under the Business Systems Rule, a deficiency must: (a) impact the information produced by the system; and (b) do so in a way that has an actual and material impact on the DOD’s ability to rely on this information for the purpose intended.

### **B. DCAA’s Understanding of “Significant Deficiencies”**

DCAA MRD 12-PAS-012(R) appears to conclude that significant deficiencies under the Business Systems Rule are the same as “material weaknesses,” which is a term that DCAA has used since before the creation of the Business Systems Rule. MRD 12-PAS-012(R) 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.” (Emphasis added). The MRD goes on to note that “[i]f there is a **reasonable possibility** that the identified noncompliance with the DFARS criteria [i.e., the Business Systems Rule] 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 added). Finally, the MRD highlights the following considerations when determining whether a non-compliance is material:

1. 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).
2. Whether the noncompliance with the DFARS criteria is material considering the nature of the compliance requirements.
3. The root cause of the noncompliance (understanding why the noncompliance occurred will help to determine if it is systemic and significant).
4. The effect of compensating controls.

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5. The possible future consequences of the noncompliance with the DFARS criteria.
6. Qualitative considerations, including the needs and expectations of the report's users, contractor histories of noncompliance, and whether the noncompliance implicates statutory compliance requirements.

The above DCAA guidance is helpful to the extent that it indicates DCAA's understanding of the term "significant deficiency" under the Business Systems Rule. This understanding, however, is flawed in that it expands the regulatory definition of the term. Specifically, as explained above, in order to constitute a "significant deficiency" under the Business Systems Rule, a deficiency must have an actual impact on the ability of DOD officials to rely upon information produced by the system. DCAA's guidance, however, expands upon this definition by including deficiencies that have a "reasonable possibility" of impacting a business system. Importantly, this DCAA guidance is not binding on contractors. Contractors, therefore, must ensure that DCAA, when conducting business systems audits, only identifies as a "significant deficiency" conduct that meets the regulatory definition of the term.

### **C. Practice Recommendations**

Based upon the above, when addressing the existence of a significant system deficiency, contractors should consider:

1. Whether the purported significant deficiency is supported by facts and/or evidence or whether the auditors have misunderstood the data that they assessed.
2. Whether arguments exist that the conduct at issue is not systemic because, among other things, the conduct stems from an isolated mistake that is the result of mere human error and not due to any deficiency in policies and procedures, system operation or compliance with policies and procedures.
3. Whether arguments exist that the conduct at issue is not current because, among other things, subsequent process improvements or other events have prevented its reoccurrence, meaning that no deficiency exists currently.

## CHAPTER 7: ADMINISTRATION OF BUSINESS SYSTEMS REQUIREMENTS

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4. Whether arguments exist that the conduct at issue is not material because, among other things:
  - a. The deficiency did not affect adversely information produced by the system because, for example, the system produces a rate and the rate was not affected or the system is self-correcting; and/or
  - b. The amount involved is small when compared to relevant numbers such as total costs incurred, total amounts allocated to a contract and/or total billings.

### III. Applicability of Business Systems Compliance and Administrative Requirements

The Business Systems Rule is applicable to each contract that contains DFARS § 252.242-7005. This clause is required when a contract: (a) is subject to CAS, whether full or modified CAS coverage, under 48 C.F.R. § 9903.201-1 (the final DFARS rule made the business systems clause self-deleting in the event CAS does not apply); and (b) contains any of the following DFARS clauses:

1. DFARS § 252.215-7002, Cost Estimating Systems Requirements;
2. DFARS § 252.234-7002, Earned Value Management System;
3. DFARS § 252.242-7004, Material Management and Accounting System;
4. DFARS § 252.242-7006, Accounting System Administration;
5. DFARS § 252.244-7001, Contractor Purchasing System Administration; or
6. DFARS § 252.245-7003, Contractor Property Management System Administration.

DFARS § 242.7001. The standards for when each of these clauses applies differ and are discussed in the chapter addressing a particular business system.

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### IV. Determination of System Acceptability

The Business Systems Rule sets out procedures, that are largely consistent for all six systems, for identifying and resolving significant deficiencies and payment withholds. DFARS §§ 242.7000; 252.242-7005. These procedures are described below.

#### A. System Review

1. At the request of the ACO, the auditor or functional specialist will audit a system and document findings and recommendations in a report provided to the ACO. The report is to describe in detail any significant deficiencies or conclude that no significant deficiency exists. See, e.g., DFARS § 242.7502(b)-(d)(1).
2. In practice, however, many alleged significant deficiencies are identified during other government audits of contractor proposals or billings. This is particularly true for allegedly significant deficiencies relating to accounting and estimating system issues, which very frequently relate to isolated observations made in the context of proposal, post-award, incurred cost, or voucher audits. The importance of alleged significant deficiencies based upon narrowly-focused government audits is that the alleged significant deficiencies identified typically relate to a contractor's implementation of a business system under a particular contract or program, and not truly systemic issues. While such government assertions are serious, they do not meet the definition of "significant deficiency" discussed above.

#### B. Initial ACO Determination

1. The ACO is to review the report and promptly notify the contractor that:
  - a. The reviewed system is acceptable and approved; or
  - b. Promptly notify the contractor that the ACO has made an initial determination that a significant deficiency exists, explaining the ACO's reasoning in sufficient detail for the contractor to understand the deficiency. See, e.g., DFARS §§ 242.7502(d)(2); 252.242-7006(d).

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2. When a contractor has been notified of an initial determination that a significant deficiency exists, the contractor must respond in writing within 30 days from receipt of the initial determination. DFARS § 252.242-7005(c); e.g., DFARS 252.242-7006(d).
3. The ACO will evaluate the contractor's response, in consultation with the auditor or functional specialist, and make a final determination. *Id.*
4. Practice Recommendations
  - a. Systems Reviews
    - (i) Attempt to resolve any issue the auditor identifies before the auditor places it in a report.
    - (ii) When the issue cannot be resolved with the auditor and an audit report contains a finding of a significant deficiency, provide to the auditor with a written position and request that the auditor include this position in the audit report. This will help frame the issue for the ACO from the beginning and prevent the ACO's initial determination from being based solely on the auditor's opinion.
  - b. Initial Determinations
    - (i) To the extent possible, address with the ACO any alleged audit deficiencies, implement any corrective actions and communicate to the ACO the results of the corrective action prior to the issuance of any ACO initial determination.
    - (ii) Provide a written response to any initial determination of a significant deficiency within 30 days of receipt, if at all possible. The existence of even an initial determination of a significant deficiency may result in disapproval of the relevant system and impact the contractor's competitive posture and/or negotiation of contract and change order prices. Also, because the written response will be in the record of the cognizant ACO responsible for contractor business systems compliance, it may be given to PCOs to assist in negotiations.

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- (iii) Ensure that the written response is as complete as possible, because this is the contractor's last opportunity to avoid a finding of a significant deficiency, the need for corrective action and withholds. Furthermore, the initial determination often represents a contractor's last practical opportunity to rebut allegations of a significant deficiency before entering the disputes process. While contractors can submit a substantive response to final determinations, by that point, government positions will be solidified and difficult to change.
- (iv) To the extent that the contractor agrees that a significant deficiency exists, the contractor's response should include a corrective action plan to eliminate the deficiency. This may avoid a withhold or, at least, shorten its duration.
- (v) To the extent that the contractor disagrees that a significant deficiency exists, the contractor needs to weigh the advantages and disadvantages of proposing a corrective action plan. Proposing a corrective action plan may weaken the position that no significant deficiency exists, but such a plan positions the contractor to avoid or minimize withholds. The key discriminators for choosing whether to propose a corrective action plan are:
  - (a) The importance to the contractor of the practice(s) identified as a significant deficiency;
  - (b) The likelihood the ACO can be persuaded that no significant deficiency exists;
  - (c) The cost in time and money of any corrective action plan; and
  - (d) Pending proposal opportunities for which a corrective action plan may create a stronger competitive or negotiation position.

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- (vi) Regardless of the path chosen, ensure that the ACO has the best information and understanding possible regarding why no significant deficiency exists or why the corrective action plan is appropriate and, if supported, complete. When the ACO is considering whether a significant deficiency exists, DCAA or DCMA technical specialists already will have taken the position that such a deficiency exists. The ACO, therefore, will reject the position of DCAA or DCMA only if the facts and relevant requirements clearly established that no significant deficiency exists or that the deficiency has been corrected. Moreover, the ACO may have to defend his or her position before review boards designed to ensure that the ACO is not accommodating the contractor in the interest of contract performance or ongoing relationships. **In-person discussions and ACO system walk-throughs can be critical to ensuring that the ACO and the team of individuals supporting him or her have the best understanding possible of the issue and any proposed solution.**

### **C. Final ACO Determination**

1. After the contractor has responded to an initial determination, the ACO is required to make a final determination and provide notice to the contractor and take other actions. DFARS § 252.242-7005(c)-(d); e.g., DFARS § 252.242-7006(d)(3).
2. Notice of final determination is required to inform the contractor that either:
  - a. The system is accepted and approved (or re-approved) because no significant deficiencies remain; or
  - b. One or more significant deficiencies remain and any proposed or completed corrective action plan is inadequate; and
  - c. A corrective action plan or submission of an adequate corrective action plan is required within 45 days.

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3. Final determinations disapproving a contractor's business system must be reviewed and approved by an internal DCMA panel. DCMA INST 131 § 3.4 (Nov. 6, 2013). The purpose of this panel is to "to ensure significant deficiencies identified in the CO's initial determination notification and the contractor's response have been fully evaluated and discussed by the CO and functional specialist or auditor, and CMO contracts director or director of the CACO/DACO division of the Cost and Pricing Center" and to "make certain the consistent application of business system criteria and policy requirements." *Id.* at 3.4.3.
4. The other actions the ACO will take when the system is not accepted are:
  - a. Disapprove the system under FAR Subpart 44.3.
  - b. Institute withholds under contracts containing DFARS § 252.242-7005.
  - c. Monitor the contractor's corrective action plan and, if complete, correction of significant deficiencies. DFARS § 242.7000(c).
  - d. Promptly approve a previously disapproved system when no significant deficiencies remain and notify the contractor of system acceptability and approval. DFARS § 242.7000(d).
  - e. Issue a Level III or Level IV corrective action request, as appropriate. DCMA-INST 131 § 3.1.2.2.1. (Nov. 6, 2013).
5. Practice Recommendations
  - a. Once the ACO has issued a final determination of system disapproval, and absent an agreed resolution with the ACO, the contractor is essentially presented with a choice of: (1) disputing the existence of a significant deficiency; or (2) correcting the deficiency. Alternatively, in appropriate circumstances, the contractor can attempt to implement corrective action, eliminating the alleged deficiency, while the contractor simultaneously disputes the existence of any deficiency.

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- b. The contractor's action is a function of the circumstances, including:
  - (i) If the contractor does not agree that a significant deficiency exists and believes that no corrective action is appropriate, then the contractor needs to dispute the final determination that a significant deficiency exists under the Contract Disputes Act's ("CDA") dispute clause or in a bid protest.
  - (ii) If the contractor accepts the existence of a significant deficiency, but disagrees that the deficiency has not already been corrected, the contractor may challenge the final determination under the CDA's disputes clause or in a bid protest.
  - (iii) If the contractor accepts the existence of a significant deficiency and agrees that corrective action must be implemented, the corrective action plan should be implemented, documented and reported to the ACO as soon as possible. The report to the ACO should include a request for the elimination, or at least a reduction in, payment withholds (as discussed below).

### V. Payment Withholds and Other Government Actions

The Business Systems Rule requires that ACOs implement payment withholds whenever a final determination of an uncorrected significant deficiency is issued. DFARS §§ 242.7000(b); 252.242-7005(d). The Rule addresses the timing and amount of withholds. The Rule also provides for other actions that ACOs may take when there are unacceptable accounting/billing or purchasing systems.

#### A. Payment Withholds

The Business Systems Rule relies on government withholding of payments to contractors as the primary method of forcing contractors to comply with relevant systems requirements. This subsection addresses the administrative requirements of these withholds.

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1. Payments subject to withholds: When a final determination imposes payment withholds, the withholds will be imposed under any or all contracts that contain DFARS § 252.242-7005 (DFARS §§ 242.7000(b)(1); 252.242-7005(d)(4)) and that provide for:
  - a. Progress payments;
  - b. Interim payments under cost reimbursement, incentive, T&M or labor hour contracts; or
  - c. Performance-based payments.
2. Amount and Length of Withhold
  - a. Five percent of all relevant payments under each contract containing DFARS § 252.242-7005 for each unacceptable business system, up to a maximum of 10% for two or more unacceptable business systems, until paragraph b. below occurs or the withholds are discontinued. DFARS §§ 242.7000(b)(1); 252.242-7005(d).
  - b. Two percent of all relevant payments when the contractor submits a corrective action plan within 45 days of a final determination, and the ACO has accepted the corrective plan and determined, in consultation with the auditor or functional specialist, that the corrective action plan is being implemented, until withholds are discontinued. DFARS § 252.242-7005(d)(2).
  - c. The percentage of withholds must be reduced so that Business Systems Rule withholds plus prior withholds for the significant deficiency do not exceed the percentages above. DFARS § 252.242-7005(d)(3)(ii).

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3. Withhold Discontinuance
  - a. Upon contractor written notice that a corrective action for each significant deficiency in a system has been completed, the ACO will request that the relevant auditor or functional specialist review the contractor system and confirm that the significant deficiency no longer exists. DFARS §§ 242.7000(d), 252.242-7005(d)(4). Such reviews are often delayed for a substantial period of time due to auditor workload.
  - b. Once the ACO has received verification that the significant deficiency no longer exists, the ACO will discontinue withholds for the relevant business system. DFARS §§ 242.7000(d); 252.242-7005(e).
  - c. When a withhold is discontinued, the government will pay a contractor any withheld sums, without interest. DFARS § 242.7000(d). DCMA notes that “[w]hen discontinuing withholds taken against payments, the CO shall issue a notice of discontinuance of payment withholding to the contractor (see DFARS PGI 242.7000 (Reference (r))) and authorize the contractor to bill the Government for the released amount using the same type of invoice on which the withhold was originally taken. The CO’s notice shall identify the amount previously withheld and the amount the contractor is authorized to bill.” DCMA INST 131.
  - d. Withholds also may be discontinued when (DCMA INST 131 § 3.7):
    - (i) A contract is physically complete and all necessary closeout actions are accomplished. Withholds may not be “transferred” between contracts.
    - (ii) Withheld funds are due to expire.
  - e. If the ACO fails to make a determination regarding the discontinuance of withholds within 90 days of receipt of the contractor’s notice of completed corrective action, the ACO must reduce, by at least 50%, all withholdings directly related to the significant deficiencies that the contractor asserts have been corrected. DFARS §§ 242.7000(d), 252.242-7005(e).

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4. Practice Recommendation
  - a. If the government institutes a withhold as the result of an ACO's finding of a significant deficiency, develop and submit a corrective action plan as quickly as possible (if such a plan has not already been submitted). Ideally, this corrective action plan should show that all corrective actions have been completed. If showing only completed corrective actions is not practical, the corrective action plan should provide specific dates by which the corrective actions will be completed.
  - b. Keep channels of communication with the ACO open. Inform the ACO of progress made towards the resolution of any significant deficiencies and ensure that the ACO is comfortable with the proposed resolution.
  - c. Document the resolution of a significant deficiency and provide the ACO with notice of such a resolution immediately.

### **B. Risk Mitigation Actions by the Government**

DFARS §§ 242.7502(g) and 244.305-70(f) permit the government to take certain actions when an accounting or purchasing system has significant deficiencies to mitigate the government's risk under a specific proposal. The PCO, relying on field audit results, is required to assess whether the significant deficiency will impact negotiations. A conclusion that an impact will occur requires that the PCO decide how to mitigate the government's risk by considering, among other things, nine identified alternatives.

Surprisingly, the estimating systems rule does not contain a similar requirement. As a practical matter, however, contractors should expect that PCOs will take similar risk mitigation steps when an estimating system has a significant deficiency.

The above suggests that, when a contractor has an unacceptable system, the contractor should explain in its proposal how the contractor has mitigated the government's risk. Otherwise, the PCO will take unilateral mitigation steps.

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### VI. 2014 System Update

#### **A. System Review Results**

According to relevant information available as of the end of 2013, payment withholdings have been imposed against at least fourteen companies, with withholds totaling hundreds of millions of dollars. This information is based on a snapshot of system withholds from DCMA and likely constitutes a small percentage of the total systems challenged. Also, it is likely that many other contractor systems are awaiting review due to a significant system review backlog.

To date, business system reviews without significant deficiencies have been the exception, rather than commonplace. Contractors, however, have had success responding to initial significant deficiency findings by providing complete responses that address the factual and legal inadequacies of DOD's significant deficiency findings, and that provide detailed and fully implemented corrective action plans addressing each of the government's significant deficiency findings.

#### **B. DCMA and DCAA Guidance**

Due to the structure of this chapter, the updated DCMA and DCAA guidance relating to the administration of the business systems clause has been incorporated directly into the relevant sections in this chapter.

#### **C. Proposed Update to the DFARS Business Systems Rule**

On July 15, 2014, DOD issued a proposed rule that would update the Business Systems Rule to require contractors to self-assess and report on estimating system, accounting system, and material management and accounting system compliance. 79 Fed. Reg. 41172 (July 15, 2014). The purpose of the proposed rule appears to be to relieve DCAA of business system audit responsibilities it has been unable to meet and to require that contractors disclose to the government internal documentation supporting the contractor's business systems that the government is often unable to obtain in connection with system reviews.

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The proposed rule's changes would apply only to accounting, estimating, and material management and accounting systems ("MMAS"), discussed earlier in this guidebook, used by contractors performing DOD CAS-covered contracts containing the relevant business system clauses. Contractors subject to the rule would be required to provide a report on compliance with the relevant system criteria within six months after the end of the contractor's fiscal year. For accounting and estimating systems, this report would be made annually, beginning with the first fiscal year after the effective date. MMAS reporting would be required when the government conducts an MMAS review, which is required at least every three years.

The required compliance report for these three systems would include:

1. A statement that the contractor has evaluated each system's compliance with the relevant system criteria;
2. The contractor's self-assessment of each system's compliance, including a statement as to whether or not the system complies "in all material respects," as well as a disclosure of any "significant deficiencies" as defined in the rule;
3. The status of any disclosed significant deficiencies, including a corrective action plan with milestones and actions to eliminate any significant deficiencies that have not been corrected as of the date of the report; and
4. A signature from an employee at or above the vice president or chief financial officer level of the reporting business segment.

In addition to the self-reporting requirement, a contractor's covered systems would be subject to a triennial audit by an independent and qualified contractor-selected Certified Public Accountant ("CPA") to assess the contractor's compliance with the applicable system criteria. Additionally, the government could also require contractors to submit a more frequent CPA audit report based on a government risk assessment of the contractor's past experience and current vulnerability.

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Under the proposed rule, no favorable credit or “safe harbor” would be given for disclosures made in the contractor’s report. The government would not be required to rely on a contractor/CPA audit findings. The government, therefore, would still be permitted to conduct reviews of contractor systems and to challenge contractor/CPA internal findings and withhold payments from contractors on the basis of significant deficiencies identified in contractor systems whether or not self-disclosed.

Under the proposed rule, contractors also would be required to make available to the government certain information supporting their report and CPA audit. Specifically, the rule requires contractors to provide to the government an annual assessment of each system’s compliance with applicable system criteria, and to make available to the government documentation “to provide reasonable support for” the system assessment, including “the results of internal or external reviews or monitoring that have been conducted to ensure compliance” with relevant system criteria and contractor policies and procedures.

The rule’s documentation requirements appear to circumvent existing decisional law and statutory authority. In *United States v. Newport News Shipbuilding and Dry Dock Co.*, the Fourth Circuit found that the Defense Contract Audit Agency (“DCAA”) does not have the right to demand access to or subpoena contractor internal audit material. 837 F.2d 162, 170 (4th Cir. 1988). The proposed rule, by requiring contractors to make available documentation supporting system assessments, including the results of internal “reviews” or “monitoring,” could be potentially interpreted by the government to require the disclosure of a contractor’s internal audit reports, contrary to existing law.

The rule’s documentation requirements are also inconsistent with the intent of the 2013 National Defense Authorization Act (“NDAA”), which specifically considered but did not include a requirement that contractors disclose internal audit reports as a condition of contractor business system approval. This information would include information “to provide reasonable support” for the contractor’s system assessment, as well as information related to the contractor’s selection of its CPA and working papers supporting the triennial CPA audit.

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In addition to the disclosure of system assessments and supporting documentation, contractors also would be required to disclose certain information related to the contractor's selection of its CPA and working papers supporting its triennial CPA audit. Contractors with more than \$100 million in qualifying sales during a given fiscal year or that receive a government request also would be required to disclose their CPA's "audit strategy, risk assessment, and audit plan" to the government.

If adopted, the proposed DOD rule would impose a significant obligation on contractors both to adequately and accurately self-assess and report on business system compliance for three major systems and to obtain an independent review of system compliance, increasing contractor costs. A contractor's failure to comply with the applicable reporting and audit requirements also would result in system disapproval and potential withholding. Because DCAA would retain the ability to review contractor-reviewed systems, contractors also would incur significant costs associated with responding to DCAA reviews. Inadequate contractor system reviews or inaccurate reporting of system compliance also could result in negative past performance evaluations, cost disallowances, inability to receive contracts and potential False Claims Act liability.

The proposed rule, however, also could present opportunities for existing firms. The proposed rule would provide contractors waiting for delayed system reviews an opportunity to have systems approved without government involvement. Contractors that have already conducted internal system reviews would also be given an opportunity to leverage that existing work and have a compliant system. Upfront costs of internal reviews and CPA reviews may be significant at the outset, but would likely require only minor updating for subsequent reviews. The costs of self-assessments and CPA audits for system compliance likely would be allowable.

As of publication, the update to the Business Systems Rule has not been issued in final form. If the past history of the Business Systems Rule is any indication, however, DOD, may issue the proposed rule in final form with minimal substantive changes. Contractors should begin to take steps to ensure compliance with these system requirements.

## CHAPTER 8: FUTURE BUSINESS SYSTEMS RULE DEVELOPMENTS

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### I. Overview

Since the Department of Defense's ("DOD") issuance of the Business Systems Rule on May 18, 2011, the government has steadily attempted to expand the scope of the rule. This chapter will discuss the Department of Energy's ("DOE") proposed adoption of a business systems rule largely identical to the DOD business systems rule as well as potential business systems requirements related to cybersecurity.

### II. The DOE Business Systems Rule

DOE has adopted a business systems rule borrowing in large part from DOD's rule. DOE's business systems rule was first issued through DOE Acquisition Letter 2013-11, issued in August 2013 and revised in February 2014, and then through an April 1, 2014 DOE notice of proposed rulemaking to amend the DOE Acquisition Regulation (DEAR). Although DOE's notice of proposed rulemaking is not yet final, DOE's Acquisition Letter became effective when issued. DOE's Acquisition Letter and notice of proposed rulemaking are substantively similar and collectively referred to herein as the "DOE business systems rule." The DOE business systems rule will be included in future covered DOE contracts, and COs will be negotiating bilaterally with affected contractors to incorporate the rule into existing contracts, which contractors should resist.

The DOE business systems rule applies to contracts for capital asset projects or for non-capital asset projects. It does not apply to Management and Operating ("M&O") contracts, small business contracts, or certain service contracts. DOE intends to separately publish a business systems rule applicable to M&O contracts.

The DOE business systems rule clauses are included in DOE contracts exceeding \$50 million, or contracts of \$10 million or more when the contracting officer determines it to be in the best interest of the Government. The EVMS rule has a separate threshold, which applies to cost or incentive contracts and subcontracts exceeding \$20 million. The business systems rule clauses apply to CAS-covered contracts, as well as fixed price contracts awarded on the basis of adequate price competition without submission of cost or pricing data (a CAS exemption).

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The DOE business systems rule requires compliance with five of the six DOD business systems – accounting, estimating, purchasing, EVMS, and property. MMAS is excluded. The substantive system criteria in DOE's rule are in large part identical to the DOD system criteria. Like the DOD rule, the DOE business systems rule permits the government to withhold 5% of payments for significant deficiencies in a single business system and 10% for significant deficiencies in multiple systems. Withholding may be reduced to 2% upon implementation of an acceptable corrective action plan.

The DOE business systems rule differs from the current DOD business systems rule in one significant respect. Within 60 days after award of a contract subject to the rule, a DOE contractor is required to provide the CO with written documentation that each business system meets the relevant system criteria. DOE contractors, in other words, are required to police their own compliance with the system criteria and provide the government with documentation of system compliance. This requirement is similar to the requirement in the proposed DOD business systems rule that contractors self-assess and report on system compliance. DOE contractors subject to the rule will need to carefully assess their business systems to ensure that each system complies with relevant criteria before making any representations to DOE.

### III. Cybersecurity - The Next Frontier

Cybersecurity may become a business system requirement in the future. A string of recent developments highlights DOD's increased emphasis on cybersecurity. Most significantly, on November 18, 2013, DOD issued a final DFARS rule imposing heightened security safeguards and mandatory reporting requirements on DOD contractors handling unclassified controlled technical information ("UCTI"). 78 Fed. Reg. 69273 (Nov. 18, 2013). Pursuant to the new clause, DFARS 252.204-7012, contractors are required to implement over 50 information system security controls for information systems containing UCTI, to report any cyber incidents involving UCTI to DOD, and to flowdown these safeguarding and reporting requirements to suppliers. DOD is also permitted to conduct a damage assessment into any cyber incident.

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Section 941 of the FY 2013 National Defense Authorization Act imposes reporting obligations on certain DOD contractors for cyber breaches. Specifically, Section 941 requires “cleared defense contractors” to provide “rapid reporting” of successful penetration of contractor networks. Cleared defense contractors are private entities with clearance to access, receive or store classified information in support of DOD programs. A DFARS rule is being drafted to address Section 941, but it has not yet been issued.

In January 2014, GSA and DOD also issued a report to the President titled *Improving Cybersecurity and Resilience Through Acquisition*. The Joint Working Group’s final report made a number of recommendations concerning the use of cybersecurity standards in federal acquisitions. Most significantly, these recommendations included a recommendation to create a federal acquisition cyber risk management strategy, including the development of security control overlays for particular types of acquisitions. GSA and DOD also recommended that contractors purchase from original equipment manufacturers, their authorized resellers, or other “trusted” sources, whenever available, in appropriate acquisitions. GSA and DOD recommended that government accountability be increased for cyber risk management.

The parallels between cybersecurity and business systems are clear. The DFARS UCTI rule mandates a number of system controls that DOD could use as a baseline to conduct system reviews. The GSA/DOD “overlays” recommendation, when implemented, would likely contain many of the same controls. Section 941 reporting will likely be used to identify system weaknesses and highlight contractor noncompliances with system requirements. The GSA/DOD recommendation that the government purchase certain information technology from “trusted sources” is similar to the counterfeit parts requirement that is part of the business systems rule. The GSA/DOD emphasis on government accountability could result in contractors being forced to self-assess system compliance and report accordingly.

Ultimately, whether the government feels it needs to enforce cybersecurity compliance using the withholding mechanism of the business systems rule may depend on how effectively contractors comply with applicable requirements. If high-profile breaches continue and contractors fail to comply with mandatory security controls, cybersecurity may soon be in the crosshairs of the government’s continued expansion of the Business Systems Rule.

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