OFFICE OF THE UNDER SECRETARY OF DEFENSE

WASHINGTON, DC 20301-3000

ACQUISITION

August 30, 1991

DP(DARS)

MEMORANDUM FOR LTCOL MICHAEL RILEY, OASD(PA)(DFOI & SR)

SUBJECT: DAR CASE 91-004, CONTRACTOR ACCOUNTING CONTROLS

Attached is a matrix of 13 respondents and public comments received from those respondents on the proposed rule of subject case published in the Federal Register on June 10, 1991 (56FR26645). This case involves revisions to DFARS Parts 209, Contractor Qualifications and 242, Contract Administration.

These comments are provided for the public's review or request for copies. Our case manager is Mrs. Barbara Young, at 697-7266.

Linda E. Greene

LINDA E. GREENE
Deputy Director
Defense Acquisition Regulations Council

PUBLIC COMMENTORS

COMMENTORS	DATE OF LETTER
(1) TEXAS INSTRUMENTS	JULY 5, 1991
(2) DOD INSPECTOR GENERAL	JULY 1, 1991
(3) ALLIED-SIGNAL AEROSPACE COMPANY	JULY 22, 1991
(4) FMC CORPORATION	JULY 25, 1991
(5) DELCO ELECTRONICS	JULY 25, 1991
(6) HUGHES ELECTRONICS	JULY 29, 1991
(7) AEROSPACE INDUSTRIES ASSOCIATION	JULY 31, 1991
(8) NATIONAL SECURITY INDUSTRIAL ASSOCIATION	JULY 31, 1991
(9) AMERICAN CONSULTING ENGINEERS COUNCIL	AUGUST 1, 1991
(10) AMERICAN BAR ASSOCIATION	AUGUST 1, 1991
(11) SHIPBUILDERS COUNCIL OF AMERICA	AUGUST 1, 1991
(12) COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS	AUGUST 1, 1991
(13) ROCKWELL INTERNATIONAL	AUGUST 1, 1991

91-004

#1

TEXAS INSTRUMENTS

5 July 1991

In reply refer to:
200-313-075
Mail Station 3137

Ms. Barbara J. Young
Procurement Analyst
Defense Acquisition Regulations Council
OUSD(A)DP(DARS), Room 3D139
The Pentagon, Washington, DC 20301-3000

REFERENCE (a) DAR Case 91-004

ENCLOSURE (1) Comments on Proposed Rule on Contractor Accounting Controls

Dear Ms. Young:

The enclosed comments on the proposed rule on Contractor Accounting Controls are being forwarded for your consideration. The comments provide additional definitional clarification that is designed to minimize potential disagreement concerning interpretation of the rule.

In addition, we believe there will be situations where it is difficult for DCAA or the contractor to estimate the cost impact associated with a significant accounting control weakness. As a result, we are suggesting that estimates be required only where they are reasonably quantifiable.

Please let us know if there are questions concerning our comments or if we can be of assistance in any way.

Sincerely,

Madison Pedigo

Madison Pedigo
Manager, Overhead Reporting and Analysis
Office of Government Liaison

MP/jb

(3)

PART 242 - CONTRACT ADMINISTRATION

COMMENTS ON PROPOSED RULE - TEXAS INSTRUMENTS INCORPORATED

(Additions are underlined, otherwise, existing language is unchanged.)

242.7403 PROCEDURES

(a) The Defense Contract Audit Agency (DCAA) will establish and manage programs for evaluating the adequacy of contractor internal accounting controls <u>in relation to the contractor's overall internal control system</u>. The auditor shall advise the Administrative Contracting Officer (ACO) of significant findings of the evaluation.

(b) <u>Significant accounting control deficiencies are present if accounting control weaknesses are so severe as to render the overall accounting system inadequate or ineffective for Government costing or payment purposes</u>. If significant accounting control deficiencies exist, the DCAA report to the ACO shall -

(1) Provide an estimate of the potential cost impact, <u>if it is reasonably quantifiable</u>; and

(2) Include findings on the acceptability of the contractor's corrective action plan.

(c) Upon receipt of a DCAA report identifying significant accounting control deficiencies, the ACO may suspend an appropriate percentage of progress payments or reimbursement costs proportionate to the estimated cost risk to the government, until the submission and acceptance of the contractor's corrective action plan. (See FAR 32.503-6(b).

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

91-004
#2

Audit Policy and Oversight

JUL 1 1991

MEMORANDUM FOR DIRECTOR, DEFENSE ACQUISITION REGULATIONS COUNCIL

SUBJECT: Defense Acquisition Regulation Case 91-004

We have reviewed the proposed changes to the Defense Federal Acquisition Regulation Supplement (DFARS) parts 209 and 242 relative to contractor internal controls. We have no comment on the changes to part 209 and support its adoption. We do offer the following comments relative to the changes to part 242.

The revision to part 242 adds subpart 242.74 on policies and procedures for contractor internal accounting controls. We strongly support the inclusion of this subpart in the DFARS as being necessary to ensure that contractors establish sufficient internal accounting controls and to clarify the Defense Contract Audit Agency (DCAA) and Administrative Contracting Officers (ACO) responsibilities to review them. To improve on the effectiveness of the subpart, we believe that the definition of Accounting Controls, contained in 242.7401, should be expanded to eliminate some of its subjectivity. We recommend that the following sentence be added to the proposed definition: At a minimum, internal accounting controls will ensure that a proper authorization of transactions and an appropriate segregation of duties exist, commensurate with the size and structure of the contractor's organization.

We also recommend that 242.7403, Procedures, be clarified as follows:

1. Subparagraphs (b) and (c) refer to contractor corrective action plans, however, the requirement to submit this plan is not specified in the proposed subpart. Although subparagraph (c) states that the ACO may withhold some payments until a plan is submitted and accepted, it should be expanded to specifically state the requirement to submit a plan and define what an acceptable plan includes, i.e., the specific corrective actions to be taken in response to the DCAA recommendations and the date the action will be implemented.

2. The proposed subparagraph (c) also states that the ACO "may" suspend an appropriate percentage of progress payments or reimbursable costs proportionate to the estimated cost risk to the government. This authority, relative to progress payments, is referenced to Federal Acquisition Regulation (FAR) 32.503-6(b) payments. We agree with the intent of this paragraph and the FAR reference. However, the FAR reference states that the ACO "shall" suspend either a portion or all progress payments until changes are made. Since the reason for adding this new subpart

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was to clarify the fact that internal controls are an integral part of an acceptable accounting system, we believe that the ACO should treat both aspects the same. Therefore, we recommend that "may" be changed to "shall" to be consistent with the FAR and to ensure that the full benefit of this new subpart is achieved.

We appreciate the opportunity to comment on this case. If there are any questions concerning our comments, please contact me or Mr. Robert A. Vignola at (703) 693-0010.

Michael R. Hill
Assistant Inspector General
for Audit Policy and Oversight

91-004

Allied-Signal Aerospace Company

2525 West 190th Street
Torrance, CA 90504-6099
(213) 323-9500 or 321-5000

Allied Signal

July 22, 1991

#3

Defense Acquisition Regulations Council
Attention: Barbara Young
Procurement Analyst
DAR Council, OUSD(A)DP(DARS) Rm. 3D139
The Pentagon
Washington, D.C. 20301-3000

Subject: DAR case 91-004

Ms. Young:

The proposed rule appears to be an overreaction to a specific incident. According to June 10, 1991 issue of the Federal Contracts Report, "the changes come in response to a DOD Inspector General's report regarding problems in the timekeeping and labor accounting systems of several shipbuilding contractors (#APO 90-006, 2/12/91), the official noted." We address in our conclusion the lack of need for this rule.

The rule could cause more problems than it solves because of phrases which are open to interpretation. Some examples include the following:

209.104-1 General Standards

(e)(S-70) "Have sufficient internal accounting controls to ensure the validity of all costs, both direct and indirect, charged to the government."

Remarks: the word "ensure" is defined by Webster's Dictionary as: "to make sure, certain, or safe; guarantee." This implies a 100% accuracy. In addition, the word "sufficient" is ambiguous, having no defined meaning from either an accounting or legal perspective. The phrase, both in this section and in section 242.7402, would be more appropriate if it read: Have internal accounting controls that provide reasonable assurance that all costs, both direct and indirect, charged to the government are valid.

209.106-2 Requests for preaward surveys

Factor E- Accounting System- "..... Normally an accounting system review will be requested when conditions such as progress payments or a cost or incentive type contract is contemplated or when accounting system or internal accounting control deficiencies are thought to exist."

Remarks: the concern is the words, "thought to exist". This is so subjective that it provides for auditing when no justifiable reason exists. Clearly, there should be reasonable indications that an audit is necessary. It is recommended that the phrase "thought to exist" be changed to "reasonably believed to exist".

The background section states that the proposed rule "will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act..." and "The proposed rule does not impose any reporting or recordkeeping requirements which require the approval of OMB...". We disagree with both statements . This proposed rule is one of many rules which are directly or indirectly causing the exodus of small businesses from Government contracts. The added requirement inevitably increase time expended by small businesses to comply with the regulations.

The recent CSIS report entitled "Integrating Commercial and Military Technologies for National Strength" identified four factors that drive a wedge between commercial and military businesses. The first is accounting and auditing requirements. This proposed rule is but another example of the abuse of regulatory authority causing this wedge to drive deeper.

The proposed rule is redundant. The Foreign Corrupt Practices Act of 1977 that prohibited U.S. companies from bribing foreign officials also included two accounting provisions that required all public companies to maintain:

1) "reasonably detailed records which accurately and fairly reflect company financial activities, and

2) devise and maintain a system of internal accounting controls sufficient, among other things, to provide reasonable assurance that transactions are properly authorized, recorded, and accounted for."

If the proposed rule will not enhance these objectives, it should not be implemented.

The proposed rule does not address the fact that a principle element of adequate internal accounting controls is an assessment of risk. This inherent concept is missing from the proposed rule. The term "risk" was not mentioned anywhere in the regulation. When costs of a system outweigh benefits, then minimizing risk is counterproductive. When using the same standards of risk on a small business or commercial company that is used on a major prime contractor, then minimizing risk is counterproductive. Clearly, the proposed rule has not made this distinction.

The proposed rule also appears to be in conflict with stated DOD objectives of disengagement. Programs such as IQUE and CRAG were designed as voluntary programs in the desire to achieve contractor self governance; itself an outgrowth of the Defense Industry Initiatives.

In summary, we believe that, if the rule was proposed because of perceived deficiencies in the shipbuilding industry, those deficiencies should be identified and corrective action taken as appropriate. The proposed rule is an overreaction that has as a solution the authorization of extensive reviews of contractors' internal controls. Any regulation that attempts "to ensure" inevitably will be too costly and even then cannot be achieved. There must be assessment of risk and the cost of minimizing that risk. A reasonable assurances standard adequately balances risk and cost, if a rule of any nature is justified. It is incumbent for the council first to justify this need, however.

Sincerely,

G.F. Germann
Assistant Controller
Allied-Signal Aerospace Company

FMC Corporation
2880 De La Cruz Boulevard Box 58123
Santa Clara California 95052
408 289-0111

FMC #4

July 25, 1991

Defense Acquisition Regulations Council
Attn: Ms. Barbara J. Young, Procurement Analyst
OUSD (A)DP(DARS), Room 3D139
The Pentagon
Washington, DC 20301

Reference: DAR Case 91-004

Dear Ms. Young:

FMC's Defense Group is pleased to provide comments on the proposed revision to the DFAR Supplement that adds a new subpart at 242.74 on policies and procedures for contractor internal accounting controls. Comments also address the related revisions to DFARS Part 209 that are included in DAR Case 91-004. The two revisions were described in the Federal Register as clarification to existing requirements applicable to contractor accounting systems.

We strongly believe that the proposed rule is more than a clarification, and establishes onerous new ambiguous requirements that will be costly, increase oversight, and restrict entry of new contractors into the government procurement process. More importantly, we believe existing regulations provide the Government with adequate mechanisms to assure the reliability of contractor accounting systems.

We are concerned that the proposed rules unnecessarily require the DCAA to "establish and manage programs for evaluating the adequacy of contractor internal accounting controls." DCAA currently conducts pre and post contract proposal reviews, detailed material and labor cost audits, contractor compensation analyses, and contractor overhead cost submissions. DCAA also examines regularly a contractor's compliance with the Government Cost Accounting Standards and exclusion of unallowable costs.

(1)

The proposed rules are excessive and are counter productive to contractor self-governance programs. These increasing audit requirements are contrary to stated DOD goals to relax adversarial tensions between the Government and contractors, to encourage contractor integrity and ethical conduct, and to coordinate audit plans --- all needed to streamline the procurement process. How then can these new requirements add value to the progress of the DOD stated goals?

In summary, the proposed rule should be withdrawn because of the adequacy of existing DCAA programs that evaluate contractor accounting systems.

Again, we appreciate the opportunity to provide our comments and ask that our concerns be thoroughly investigated before DOD issues a final rule.

Yours truly,

Hugh B. Sommer/lw

Hugh B. Sommer
Manager of Government
Affairs Compliance

dw

(11)

Delco Electronics
Subsidiary of
GM Hughes Electronics

#5

July 25, 1991

Defense Acquisition Regulations Council
Ms. Barbara J. Young, Procurement Analyst
OUSD(A)DP(DARS)
Room 3D139, The Pentagon
Washington DC 20310-3000

Subject: POSITION ON PROPOSED DFARS RULE
DAR CASE 91-004
CONTRACTOR ACCOUNTING CONTROLS

Dear Ms. Young,

We believe the proposed revisions to the DoD FAR Supplement part 209 and 242 are unnecessary and should not be adopted. The proposed language is ambiguous and likely to be the subject of recurring and significant disputes. Further, the intent of the revision is counter to the spirit of the Contractor Risk Assessment Guide (CRAG). Finally, the Governments acceptance of internal control systems may carry the appearance of liability to others for harm caused by reliance on an "approved" system. That liability, real or not, will likely prevent or delay DCAA acceptance of adequate internal control systems.

Reviews of internal control systems are addressed in several authoritative forums. The General Accounting Office in its 1988 revision to "Government Auditing Standards" (the "Yellow Book") addressed internal controls several times. The Yellow Book places responsibility for internal control systems with management. Reporting standards for financial audits also require comments on the reliance placed by the auditors on the system of internal controls.

The GAO guidance is clear; internal control systems should be reviewed to determine the scope of audit work required. However, the responsibility for the establishment and operation of the internal control system rests with the entity being reviewed.

The Defense Contract Audit Agency (DCAA) also recognizes the importance of evaluating contractor internal control systems. In its Contract Audit Manual (CAM), the DCAA requires internal control systems be reviewed in determining the scope of planned audits. In fact, the DCAA has developed a system

Delco Systems Operations
[illegible]7 Hollister Avenue
Goleta, California 93117
805 961-5011
Fax 805 961-6437

(12)

specifically to integrate an assessment of internal controls in audit planning. The system is the "Vulnerability Assessment Procedure or "VAP". VAP analysis summarizes the findings of internal control reviews performed concurrently with incurred cost, functional reviews and operations audits.

The emphasis DCAA places on reviews of internal control systems is evidenced by the dedication of a complete chapter to the subject. CAM chapter five, "Review of Policies, Procedures, and Internal Controls Relative to Accounting and Management Systems" specifically addresses contractor internal control systems as well as DCAA auditors responsibilities in reviewing those systems.

Finally, DCAA audit planning includes Mandatory Annual Audit Requirements (MAARS). The MAARS are described within the CAM as "core requirements" for incurred cost audit planning. The first MAAR is a requirement to update the internal control survey.

In addition to U.S. Government guidance, the American Institute of Certified Public Accountants (AICPA) has published guidance relating to internal control reviews. In it 1990 "Audits of Federal Government Contractors" the AICPA includes a section headed "Management Responsibility for the Internal Control Structure". Further, the AICPA has issued Statement on Auditing Standards (SAS) number 55 entitled "Consideration of Internal Control Structure in a Financial Statement Audit". The AICPA guidance requires auditors to review contractors systems of internal controls in determining the scope of field work required to meet audit requirements.

Clearly, all professional audit groups recognize the importance of reviewing internal controls. However, until this revision to the DoD FAR Supplement, those reviews were not audits in and of themselves. This change removes the review from its use as an audit planning tool. It will become the Governments responsibility to issue an opinion on the overall system of internal controls. No guidance is provided to determine what constitutes an acceptable system of internal controls.

The proposed revision contains numerous examples of terms or requirements which are ambiguous. For example, in the General Standards the term "validity" is used relating to costs. Validity is not defined, nor is it addressed in other

(13)

regulatory guidance. Allowability, Reasonableness, and Allocability are all used, and defined, in addressing costs. Validity should be defined within the context of the proposed rule, or an already defined and understood term should be substituted. The Definition includes the requirement that costs be "properly charged". The "proper" treatment of a particular cost is frequently the subject of disagreement. Those disagreements do not mean a system of internal controls is inadequate. In fact, the disagreements may be an indication that the internal control system is functioning normally. In the Policy section the requirement to ensure the "integrity of all costs" is identified. Integrity, like validity, is undefined in this context. If "integrity" should be read as "compliant with regulations and contract terms", then those words should be used. Further, the usage of previously undefined terms and additional system reviews are not in the spirit of the CRAG.

In the forward to the November 1988 Program Steering Group booklet, June Gibbs Brown, the Inspector General included "It [the CRAG] provides the framework for industry to demonstrate to the government that strong, effective internal controls are in place and functioning as intended. The government's commitment to the CRAG Program is to reduce oversight in those areas where internal control systems are documented and shown to be effective." Rather than reducing oversight as was intended, the proposed revision introduces a specific system review and increases oversight. In the May 14, 1990 edition of the "DEFENSE NEWS" Robert Liebermann, an assistant inspector general for analysis and follow-up in the DoD Inspector Generals office said "The slow pace at which this [CRAG] has gotten off the ground is a good indication of how poor the relationship has [become] between government and industry". The proposed DFARS revision reverses the recent movement toward contractor self-governance and a return to the type relationships Mr. Liebermann referred.

With the expansion of the DCAA role into formal evaluation of internal control systems comes attending liability. The procedure requires the DCAA evaluate contractors internal control systems. The DCAA is required to render its opinion that an internal control system will ensure the integrity and propriety of <u>all</u> costs charged to the government, or conversely, that it will not. Once the DCAA reviews the internal control system, it must advise the Administrative Contracting Officer (ACO) of significant findings. System approval will require both DCAA and the ACO's acceptance.

That acceptance, using language in the DFARS revision, will be for a system which will "ensure the integrity of all costs, both direct and indirect, charged to the government". The approved system will also "ensure the validity of all costs".

The Government is moving to a new standard with this position. Contractor management, as well as Boards of Directors and shareholders/owners will take comfort in knowing the U.S. Government has reviewed and approved a system which "ensures the integrity of all costs, both direct and indirect, charged to the government". This change also makes the DCAA responsible for determining the parameters for "integrity of all costs" as well as "sufficient internal accounting controls".

It will likely prove extremely difficult for any DCAA manager to sign an audit report which states a contractors system will ensure the integrity of all costs. Likewise it will be difficult, and costly, for contractors to implement systems to comply with the letter of the regulation. The revision, as written, adds little except the requirement for the Government to issue its position on contractors systems of internal controls. It does, however, allow the Government to withhold portions of payments to recognize an undefined "estimated" risk.

There are already enough vehicles for the Government to unilaterally withhold or suspend payments to contractors. Pre award audits can produce unsupported or questioned costs. MMAS reviews may produce questioned costs or cost avoidance recommendations. ADP reviews, Labor accounting reviews, Operational reviews, Post Award reviews, Disclosure Statement reviews, or any other audit the DCAA conducts, may generate adverse cost impacts. Additional opportunities for the government to reduce payments to contractors are counterproductive.

An assessment of internal control risk is appropriate, and required, for any audit. It should be performed during the planning phase of audits, as has clearly been intended from the authoritative guidance. Contractor internal control systems should not be systems which the Government approves, unless it is willing to share the cost and risk of consequences.

We believe the proposed revision is unnecessary. Its only

addition to already existing requirements is to issue formal recommendations. Positive recommendations will likely be difficult and expensive to obtain.

I believe in strong internal controls, and fully appreciate the need to review internal controls in determining audit scope. I do not believe the proposed DFARS wording will accomplish the intended objective.

Please call me at (805) 961-5383 or our Manager of Internal Controls, Gary Wibracht at (805) 961-5309 with questions or comments on this letter.

Sincerely,

Arthur R. Jackson
Comptroller

(16)

HUGHES

Subsidiary of GM Hughes Electronics

DONALD L. CASSIDY Vice President and Chief Contracts Officer

July 29, 1991

#16

Defense Acquisition Regulations Council
Attn: Ms. Barbara J. Young, Procurement Analyst
DAR Council
OUSD(A)DP(DARS), Room 3D139
The Pentagon, Washington, DC 20301-3000

Dear Ms. Young:

Hughes Aircraft Company appreciates the opportunity to submit comments on DAR Case 91-004 relative to Contractor Accounting Controls which would change the DFARS to add a new subpart at 242.74 and amend sections 209.104-1, 209.104-3, and 209.106-2.

The proposed revisions to the DFARS would establish policies and procedures for contractor internal accounting controls and add a general standard of responsibility for prospective contractors to have sufficient internal accounting controls to ensure the validity of all costs charged to the Government. The supplementary background information states that these revisions clarify existing requirements applicable to contractor accounting systems.

The proposed rule is no mere clarification. Rather, the proposed section 242.7403 is a broad mandate for the Defense Contract Audit Agency (DCAA) to dictate contractor internal accounting controls under the guise of reviewing those controls and expressing opinions on their adequacy. DCAA can effectively enforce its view of what constitutes <u>appropriate</u> accounting controls through the threat of reduced progress payments.

For contractors undergoing a DCAA audit, the threat of lost progress payments or cost reimbursement on public vouchers is real and cannot be lightly dismissed with the admonition that if the contractor disagrees, its remedy is under the Contract Disputes Act. Such an approach has the Alice in Wonderland effect of imposing sentence first with verdict to follow as contractors are penalized with lost progress payments or cost reimbursements <u>before</u> the adequacy of the contractor's internal accounting system is adjudicated by a neutral tribunal. Such a system simply smacks of a lack of fundamental due process.

(17)

In our opinion, such a mandate to DCAA is contrary to public policy considerations regarding the independent role of contractors in providing goods and services to the Federal Government. It represents a serious encroachment into the management of the business and financial affairs of companies who enter into contracts with the Federal Government. We believe existing regulations provide the Government adequate mechanisms to assure the reliability of contractor's accounting systems, without imposing a new policy requirement on contractors which is specified in the proposed section 242.7402, and new procedural requirements on DCAA which are specified in the proposed section 242.7403.

When the Federal Government contracts for goods and services, it procures a tangible product or a specified service, not the financial and accounting systems which are used to record the costs of producing such goods and services. While a contractor's internal accounting controls may indirectly affect the recording of costs, it is the actual costs ultimately charged to contracts that are relevant to the Government. To require, as a matter of policy, the maintenance of an accounting system "which contains sufficient internal accounting controls to ensure the integrity of all costs, both direct and indirect, charged to the government" is not practicable. It would be literally impossible to establish definitive criteria for defining "sufficient internal accounting controls" since such a determination is a matter of judgment in light of the individual circumstances.

Additionally, there is absolutely no way that contractors can ensure the integrity of all costs. The concept of "reasonable assurance" which underlies a contractor's internal control structure recognizes that the cost of an internal control structure should not exceed the benefits that are expected to be derived. The American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards 55 states: "Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship."

According to the Supplementary Information provided with the proposed DFARS amendment, the proposed changes purportedly have no impact on either the Regulatory Flexibility Act or the Paperwork Reduction Act. Notwithstanding these disclaimers, these two statutes are impacted. Small businesses will clearly be affected economically as the threshold for adequate internal controls is ratcheted up. As DCAA imposes additional checks on and more audits of internal

accounting controls in order to achieve conformity with DCAA's standard of what constitutes adequate controls, the costs for those controls will increase. The consequence of a uniform system of internal controls is not merely increased costs for all contractors, including small business contractors, it includes increased paperwork for everyone. The assertion that neither the Regulatory Flexibility Act nor the Paperwork Reduction Act is impacted is simply incorrect.

Even more, the addition of new policies and procedures in the DFARS appear to be contrary to the intent of the Defense Management Review which involves the Regulatory Relief Task Force attempting to eliminate duplicative and unnecessary DFARS provisions. The desire, in part, is to remove matters from the DFARS that ought rightly be in the FAR. The proposed DFARS change involves matters that are not uniquely applicable to Defense Department contracts. If any such change is necessary, the matter should be addressed to the entire DAR Council and Civilian Agency Acquisition Council membership.

The procedures under the proposed section 242.7403 provide that "The Defense Contract Audit Agency (DCAA) will establish and manage programs for evaluating the adequacy of contractor internal accounting controls." This places the DCAA in a position of making critical judgments regarding a contractor's decisions concerning its internal control structure policy and procedures. While an assessment of internal control risk may be appropriate, we do not believe it was ever intended by the promulgators of auditing standards that the kind and quality of internal accounting controls were necessarily susceptible to a quantitative determination of specific approval or disapproval. Generally accepted auditing standards approved and adopted by the AICPA require: "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed" (emphasis added). The proposed change appears to make an audit of a contractor's internal accounting controls an end in itself by requiring DCAA to evaluate "the adequacy of contractor internal accounting controls" and to "advise the Administrative Contracting Officer (ACO) of significant findings of the evaluation." We believe that giving DCAA the authority to "establish and manage programs for evaluating the adequacy of internal accounting controls" and perform such reviews is tantamount to granting DCAA a new and unfettered authorization to conduct operational audits of contractors, and the ability to withhold payments by authorizing the ACO to suspend progress payments or reimbursement of costs in an amount equal to the "estimate of the potential cost impact" resulting from any accounting control deficiencies it determines.

It should be noted that the traditional division of authority and responsibility in the Department of Defense has been for procurement policy decisions to be made by the Under Secretary of Defense (Acquisition) and for contract audit policy decisions to be under the purview of DCAA. We believe this separation of responsibility is important. Further, the role of DCAA historically has been, and should continue to be, advisory.

The proposed rule also provides that a contractor may not receive a cost or incentive type contract, or a contract providing for progress payments, unless the contractor's accounting system, including its accounting controls, is "adequate." In the absence of clear, unambiguous language in the proposed rule as to what constitutes "adequate" internal accounting controls, and the absence of any limits placed on DCAA's discretion to find a contractor's system "inadequate," the rule is unconscionable.

Moreover, the proposed revisions are, in our opinion, contrary to stated Department of Defense goals to relax adversarial tensions between the Government and contractors, encourage contractor integrity and ethical conduct, improve audit coordination, increase contractor self-initiated corrective action when necessary, streamline the procurement process, encourage greater commerciality in defense contracting, and reduce the burden of excessive oversight.

We are greatly concerned that the proposed rule runs counter to the intent of contractors' participation in the Defense Industry Initiatives and will damage or undo many of the positive accomplishments already achieved under existing contractor self-governance programs and the contractor risk assessment guide (CRAG) program. For example, even though it has been publicly stated that participation in the CRAG program is voluntary, DCAA auditors may attempt to use the current CRAG as a benchmark to determine whether or not a contractor's internal accounting controls are "adequate." Consequently, the CRAG program will become an essentially mandatory program for those contractors having or contemplating a cost or incentive type contract, or a contract providing for progress payments.

Finally, we believe that the proposed rule is an unnecessary additional burden on contractors since existing DCAA programs to evaluate contractor accounting systems and the authority already provided to the ACO to suspend progress payments when accounting deficiencies are identified, are currently adequate.

As an administrative note, the proposed addition to 209.106-2 which states: ". . . or when accounting system or internal accounting control deficiencies are thought to exist" requires clarification. It is unclear under what contractual situations an accounting system review would be required other than the stated conditions involving progress payments and the award of a cost or incentive type contract.

In summary, we recommend the proposed rule be withdrawn for the following reasons:

(i) It is contrary to public policy and represents an encroachment into the management of companies,

(ii) It runs counter to DoD initiatives and presents a strong disincentive for contractors to support and participate in voluntary programs currently being emphasized by the Defense Department.

(iii) It is an unnecessary additional burden on contractors,

(iv) It runs counter to the Regulatory Flexibility Act and the Paperwork Reduction Act, and

(v) It runs counter to the initiatives of the Defense Management Review.

If you have any questions, please contact me at (213) 568-7801 or Joyce Sakai of my staff at (213) 568-7181.

Sincerely,

Donald L. Cassidy

rec'd 8/5

#7

Aerospace Industries Association

LeRoy J. Haugh
Vice President
Procurement and Finance
371-8520

July 31, 1991
DAR Case 91-004

Ms. Barbara J. Young
Procurement Analyst
Defense Acquisition Regulatory Council
OUSD(A) DP(DARS)
The Pentagon
Room 3D139
Washington, D.C. 20301-3000

Dear Ms. Young:

The Aerospace Industries Association (AIA) is pleased to provide comments on the proposed DFARS rule which adds a new subpart at 242.74, and revises subpart 209.1 (DAR Case 91-004), as published in the Federal Register on June 10, 1991 (56 FR 26645).

The proposed revisions to the DFARS would establish policies and procedures to highlight contractors' responsibility to maintain adequate accounting systems and internal controls, and add a general standard of responsibility for prospective contractors to have sufficient internal controls to ensure the validity of all costs, both direct and indirect, charged to the Government. The supplementary background information in the proposed rule asserts that these revisions are merely to clarify existing requirements applicable to defense contractor accounting systems.

If the proposed rule indeed merely clarifies existing requirements, we believe the rule to be unnecessary and recommend that it not be finalized. It is clearly contrary to the simplification effort currently underway under the Defense Management Review. We are also concerned that DCAA auditors will view this rule as a license to impose controls they desire regardless of necessity, practicality or cost.

The proposed DFARS 209.104-1(e)(S-70) identifies the general standard that contractors "Have sufficient internal accounting to ensure the validity of all costs, both direct and indirect, charged to the government." There is, however, absolutely no way that contractors can ensure the "validity of all [emphasis added] costs ... charged to the Government." The concept of "reasonable assurance" which underlies a contractor's internal control structure recognizes that the cost of an internal control structure should not exceed the benefits that are expected to be derived. The American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards 55 states "Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship." Although we do not believe the proposed DFARS serves any useful purpose, any rule which discusses internal controls should incorporate the reasonable assurance standard.

We are also concerned that the proposed rule can be read in a way which establishes the auditor, rather than the contracting officer, as the individual who determines whether "significant accounting control deficiencies" exist. In fact, the only function the rule provides to the contracting officer is the decision to "suspend" payments. This type of coverage only serves to enhance the power of DCAA at the expense of the contracting officer. We believe that regulations should preserve and strengthen contracting officer discretion, and clearly state that DCAA serves only in an advisory capacity. If this rule is redrafted to provide that the contracting officer, rather than DCAA, determines whether significant deficiencies exist, we recommend that the rule clearly indicate that the contracting officer should solicit the contractor's views prior to making any deficiency determination.

Finally, we are concerned that the proposed payment suspension provision will lead to suspension of costs well above the true risk to the government. Suspension of financing payments is more and more used as a penalty or as a means to force contractor compliance with controls desired by the government. Consequently, if internal controls related to a particular cost element are questioned, the government often withholds all payments related to that cost element. Such general suspensions certainly reduce government risk but almost always result in significant under-financing to the contractor.

We recommend that any rules which call for suspension or withholding of payments indicate that withholds should be targeted at producing financing payments which are the most likely estimate of the "correct" amount rather than one which totally eliminates all costs in a cost element.

In summary, the proposed rule is an unnecessary additional burden on contractors and should be withdrawn. We believe that currently existing regulations provide the Government adequate mechanisms to assure the reliability of contractors' accounting systems, without imposing a new policy requirement on contractors as specified in the proposed DFARS 242.7402, and new procedural requirements on DCAA as specified in the proposed DFARS 242.7403. We are particularly surprised that this rule appears at a time when the government has encouraged the use of the Contractor Risk Assessment Guide (CRAG) which deals with internal controls. DCAA has stated that CRAG participation is voluntary -- yet, under the proposed rule, auditors can easily use the CRAG chapters as a benchmark to determine if internal accounting controls are "adequate." Thus, the proposed rule is not only unnecessary, but works against voluntary self-governance programs.

Again, AIA appreciates the opportunity to provide you with these comments. Further, AIA representatives would be pleased to discuss the proposed rule in more detail or answer any questions you may have regarding our comments. Paul J. Cienki, Director, Financial Administration, AIA is the point of contact for this issue. He can be reached at (202) 371-8526.

Sincerely,

LeRoy J. Haugh

(24)

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
National Headquarters

1025 Connecticut Avenue, N.W.
Suite 300
Washington, D.C. 20036
Telephone: (202) 775-1440
FAX: (202) 775-1309

JUL 31 1991

Defense Acquisition Regulations Council
Attention: Ms. Barbara J. Young
Procurement Analyst
DAR Council
OUSD(A)(DP(DARS)
Room 3D139
The Pentagon
Washington, DC 20301-3000

Subject: DAR Case 91-004

Dear Ms. Young:

The National Security Industrial Association (NSIA) has reviewed the draft rules and procedures for contractor internal accounting controls which are proposed for incorporation into the Defense FAR Supplement (June 10, 1991 Federal Register, DAR Case 91-004). NSIA is of the opinion that the proposed changes at 48 CFR Parts 209 and 242 are not only placing an additional and needless burden on contractors, but also by inclusion of an ambiguous term and establishment of inconsistencies from current Government/Industry initiatives will increase both the costs of doing business with the Government and the adversarial relationship between the Government and Industry while providing no tangible benefit to either party. NSIA believes that a careful review of existing rules and regulations which govern contractor's internal accounting controls, including those legislated by the Congress, those promulgated by the Agencies and those required by outside auditors adequately protect the interests of the Government. The following comments address NSIA's specific concerns with the proposed changes.

Counterproductive

If the objective is to upgrade the accounting systems of small contractors, the regulation increases administrative costs, decreases competitiveness and creates an additional barrier to entry into the government procurement arena. If the desire is to improve the systems of established contractors, the proposal adds another oversight activity to industry. This proposal is not a clarification of existing policy. Rather, if implemented, this proposal will create a new and duplicative layer of contract administration.

In addition, the DCAA broad review scope could result in the duplication of, or conflict with, the accounting provisions of Contractor Risk Assessment Guide (CRAG) and with the operation of the external audit process.

Use of Ambiguous Terms

The policy and procedures identify a requirement which can result in parties taking inflexible and extreme positions. Specifically, Part 209.104-1(e)(S-70) states that a contractor should:

> Have sufficient internal accounting controls to ensure the validity of all costs, both direct and indirect, charged to the government.

One interpretation of this paragraph could mandate the contractors' internal accounting control systems be 100% accurate. Anything less than perfect accuracy will expose a contractor to decrements in their progress payment rates. In most cases a regulation of this type would require a contractor "to ensure with reasonable accuracy the validity of all costs, both direct and indirect, charged to the government." We recommend this requirement be replaced with the following:

> Have internal accounting controls that provide reasonable assurance that all costs, both direct and indirect, charged to the government are valid.

Undermines Self-Governance Initiatives

Over the last several years both Government and Industry have attempted to improve their strained relationship. Both parties realized that an adversarial relationship worked to their detriment not their benefit. In recognition of this new environment, several programs promoting self-governance were established, e.g., Defense Industry Initiatives (DII) and CRAG. Direct DCAA intervention in the operation of contractor accounting systems undermines the aforementioned self-governance and mutual cooperation initiatives without providing any constructive benefit.

Due Process

Clarification of the steps in the Procedures at 242.7403 are required. Specifically, it should be made clear that when the DCAA cites alleged accounting control deficiencies to the Administrative Contracting Officer, (ACO), the ACO should then provide the contractor time to respond to the DCAA report. The ACO should issue a determination of adequacy only after both the DCAA findings and the contractor's response have been filed. To make a determination of inadequacy prior to allowing a contractor time to respond is inconsistent with the concept of due process.

Conclusion

NSIA is very much aware of the importance of maintaining adequate internal accounting controls and the need to protect the Government's interests. However, we suggest that the interests of the Government are best served by encouraging self-governance initiatives and efficiency, not by duplicating the efforts of internal auditors and independent accounting firms through the implementation of this proposed rule. Specific Government concerns should be identified and their remedy limited to those concerns. A wide and imprecise expansion of the DCAA charter is not the answer. Accordingly, it is requested that the proposed rule be rescinded.

We would be pleased to discuss this further with you. The NSIA point of contact is Colonel E.H. Schiff, US Army, Retired, Procurement Committee Executive, telephone (202) 775-1440.

Sincerely,

Wallace H. Robinson, Jr.
President

WHR/dlb

#9

COMMENT OF

THE AMERICAN CONSULTING ENGINEERS COUNCIL

FOR THE

DEFENSE ACQUISITION REGULATORY COUNCIL

AUGUST 1, 1991

The American Consulting Engineers Council (ACEC), a federation of 51 state and regional councils, is a national professional association representing over 5,000 private-practice consulting engineering firms employing 160,000 engineers, scientists, technicians and others, and annually designs over $100 billion in constructed public works and private industry facilities.

(78)

American Consulting Engineers Council
1015 Fifteenth Street, N.W., Washington, D.C. 20005
202-347-7474
FAX: 202-898-0068

August 1, 1991

Defense Acquisition Regulations Council
ATTN: Ms. Barbara J. Young
Procurement Analyst
DAR Council
OUSD(A)DP(DARS)
Room 3D139
The Pentagon
Washington, D.C. 20301-3000

Case 91-004

Dear Ms. Young:

The American Consulting Engineers Council (ACEC) is responding to the request for comments on the proposed rule entitled "Department of Defense Federal Acquisition Regulation Supplement; Contractor Accounting Controls."[1]

Introduction

ACEC has a great interest in the contractor qualifications and the contract administration policies of the Department of Defense (DOD). Over 40% of ACEC's member firms regularly contract with the federal government and in particular with the Army Corp of Engineers and the Navy Facilities Command within the Department of Defense.

We commend the Defense Acquisition Regulations (DAR) Council for their efforts in publishing this proposed rule and request for comments.[2] In particular, ACEC appreciates this opportunity to describe the experience of the architect-engineering services community with the DOD auditing and accounting system controls as established and as clarified in the proposed rule at issue.

1 56 Federal Register 26645 (June 10, 1991).

2 48 CFR Parts 209 and 242.

Background

The DOD has proposed clarifications under "Supplementary Information, A. Background", as follows:

> "Revisions to the Defense FAR Supplement are proposed to add a new subpart at 242.74 on policies and procedures for contractor internal accounting controls.[3] Revisions to 209.1 are also proposed to add a general standard of responsibility for prospective contractors to have sufficient internal accounting controls to ensure the validity of all costs

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3 Part 242 - Contract Administration
5. A new subpart 242.74 is added to read as follows:
Subpart 242.74 - Contractor Accounting Controls
242.7400 Scope of subpart
This subpart provides policies and procedures applicable to contractor internal accounting controls.
242.7401 Definition
Accounting controls means those internal control procedures established by contractor management to ensure costs are properly charged within the accounting system.
242.7402 Policy
All contractors shall maintain an accounting system throughout contract performance which contains sufficient internal accounting controls to ensure the integrity of all costs, both direct and indirect, charged to the government.
242.7403 Procedures
(a) The Defense Contract Audit Agency (DCAA) will establish and manage programs for evaluating the adequacy of contractor internal accounting controls. The auditor shall advise the Administrative Contracting Officer (ACO) of significant findings of the evaluation.
(b) If significant accounting control deficiencies exist, the DCAA report to the ACO shall-
(1) Provide an estimate of the potential cost impact; and
(2) Include findings on the acceptability of the contractor's corrective action plan.
(c) Upon receipt of a DCAA report identifying significant accounting control deficiencies, the ACO may suspend an appropriate percentage of progress payments or reimbursement costs proportionate to the estimated cost risk to the government, until the submission and acceptance of the contractor's corrective action plan. [See FAR 32.503-6(b)]

charged to the Government.[4] These revisions clarify existing requirements applicable to contractor accounting systems."

Hence, this proposed rule re-asserts DOD authority to determine contractor's accounting standards. The above proposed rule describes in general definition, policy and procedure terms the recognized perogatives of the Defense Contract Audit Agency (DCAA) and the Administrative Contracting Officer (ACO) to establish standards of acceptable accounting systems.

Discussion

Our comments focus on the general trend of increased accounting controls, oversight and use of the remedy of suspended progress payments or reimbursement costs on small businesses offering their services to the DOD.

First, recognize that such increased accounting requirements and broadened DCAA authority has produced in the professional design industry a measurable expense which is accrued to all involved, including ultimately the taxpayer. The comprehensive audits such as those proposed above have already resulted in

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4 Section 209.104-1 is revised to read as follows [with the following additions]:
209.104-1 General Standards
(e) (S-70) Have sufficient internal accounting controls to ensure the validity of all costs, both direct and indirect, charged to the government.....
209.104-3 Application of Standards
(b) The accounting system including its accounting controls must be adequate if the prospective contractor is to receive progress payments or a cost or incentive type contract is contemplated.....
209.106-2 Major Factors
Factor E Accounting System
242.7401 (Normally an accounting system review will be requested when conditions such as progress payments or a cost or incentive type contract is contemplated [Text repeated.]) or when accounting system or internal accounting control deficiencies are thought to exist.

extensive delays and greater costs.[5] Moreover, the results of these current audits are often ignored in favor of arbitrary caps and cost levels.

Secondly, the purposefully vague and overly-broad language used throughout the proposed rule raises concerns as to what limitations exist on the authority and oversight of the DCAA and the ACO. Further, it is unknown what avenues of inquiry and protest may be available for an individual contractor confronted with the subjective decisions of a particular ACO under these clarifications. What steps are being taken to provide a direction to measuring the adequacy of a given firm's accounting controls? Thirdly, we comment as a professional service association composed primarily of small businesses doing public sector work. Specifically, eighty percent of architectural/engineering firms include only twenty-five or fewer employees. These small businesses are at a disadvantage in their ability to accommodate multiple, customized accounting systems and to finance delayed progress payments or reimbursement costs. The public sector's repeated reliance on the remedy of suspended payments has led many qualified A/E firms to offer their services exclusively to the private sector. This ultimately reduces competition, innovation and diversity for public sector projects.

Conclusion

The professional design community believes that the factors discussed above should be considered in this and future decisions regarding DOD contractor accounting controls. Thank you for considering our perspective.

Sincerely,

Larry A. McKee

Larry A. McKee
Vice President

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5 1991 PSMJ Financial Statistics Survey, showing firms incur an average cost of .48% of revenues to comply with multiple financial rules in government contracting (Survey included 337 firms.)

Data from Florida Department Audit Group indicating audit cost was .4% of proposed A/E contract cost.

"Report on Oversight Review of the Time Lines of Price Proposal Audit Reports", issued by the Defense Contract Audit Agency, Office of Inspector General showing time for pre-award audit of A/E contracts averaged 80 days.

"Streamlining the Architect-Engineer Process", a 1990 U.S. Army Corps of Engineers study indicating the time for pre-award audits of A/E contracts ranged from 30 days on small (less than $100,000) to 320 days on large (over $1,000,000) projects.

AMERICAN BAR ASSOCIATION Section of Public Contract Law
Writer's Address and Telephone

360 N. Crescent Drive
Beverly Hills, CA 90210
(213) 859-5985
FAX (213) 859-5940
ABAnet Roberts.N

#10

August 1, 1991

Defense Acquisition Regulatory Council
Attn: Ms. Barbara J. Young
Procurement Analyst
DAR Council, OUSD(A)DP(DARS)
Room 3D139
The Pentagon
Washington, D.C. 20301-3000

Re: DAR Case 91-104 - Contractor Accounting Controls

Dear Ms. Young:

This letter is submitted on behalf of the Section of Public Contract Law of the American Bar Association pursuant to special authority extended by the Association's Board of Governors to the Section to comment on acquisition regulations. The views expressed are those of the Section of Public Contract law and have not been considered by the Association's Board of governors or its House of Delegates.

On June 10, 1991, the Department of Defense ("DOD") published proposed amendments to Parts 209 and 242 of the Department of Defense Federal Acquisition Regulation Supplement ("DFARS"). These amendments would add language concerning a contractor's internal accounting controls and would allow contracting officers to suspend progress payments or refuse to award a cost or incentive type contract to companies alleged to have inadequate accounting controls.

SUMMARY OF COMMENTS

The Section fully supports the government's interest in the reliability of internal accounting controls, but believes that such interests are adequately protected under presently existing regulations. Furthermore, the Section believes that the sanctions provided are serious, and the proposed rule provides few safeguards to protect contractors from what amounts to a unilateral decision of the contracting officer to effectively debar a company from receiving certain contracts.

BH912120.010

I. Existing Regulations are Adequate to Protect the Needs of the Government

Government contractors are presently subject to many legal and accounting-related contractual principles which regulate the costs that are charged under a government contract. These guidelines include the legally mandated FAR/DFARS Cost Principles, and the Cost Accounting Standards and their implementing contract clauses. Another set of guidelines is the AICPA (American Institute of Certified Public Accountants) Guide, *Audits of Federal Government Contractors* which contains specific language on required internal controls which references SAS No. 55, "Consideration of Internal Control Structure in a Financial Statement Audit." All of these rules and policies define requirements or guidelines to protect the government by insuring the integrity of a contractor's internal controls in charging costs to government contracts.

In addition, legal sanctions currently exist which specifically address the reliability of such accounting controls. For example, subparagraph (f), "Control of Costs and Property" of FAR 52.232-16, "Progress Payments" provides, in pertinent part, that "the contractor shall maintain an accounting system and controls adequate for the proper administration of this clause." As a penalty for having what is judged by the contracting officer to be inadequate accounting controls, FAR 52.232-16(c) provides that "the Contracting Officer may reduce or suspend progress payments ... after finding on substantial evidence any of the following conditions: 1) The Contractor failed to comply with any material requirement of this contract (which includes paragraphs (f) and (g) below)" (emphasis added). FAR 32.503-2, "Supervision of Progress Payments"; 32.503-3, "Initiation of Progress Payments and Review of Accounting Systems"; and 32.503-6 "Suspension or Reduction of Payments" also contain language prohibiting progress payments unless, inter alia, "the contractor's accounting system and controls are adequate for proper administration of progress payments."

The Section believes that these existing regulations and guidelines adequately protect the interests of the government in insuring the accuracy of costs charged to cost type and incentive contracts as well as for progress payments, rendering this Proposed Rule unnecessary and duplicative.

II. The Proposed Language Does Not Provide Sufficient Procedural Safeguards

The proposed language to be added to DFARS 209.104 goes far beyond an attempt to "clarify existing requirements applicable to defense contractor accounting systems" as stated in the Summary of the Federal Register notice of

proposed rulemaking for DAR Case 91-104. For example, proposed DFARS 209.104-3(b) would allow a mere Defense Contract Audit Agency ("DCAA") report to be a sufficient basis for the prohibition of receipt of "progress payments or a cost incentive type contract.." Thus, a contractor could be effectively debarred from receiving anything but firm fixed price contracts simply on the basis of an unchallenged statement in a DCAA audit. Additionally, on existing contracts, under proposed DFARS 242.7403(c) , progress payments may be suspended by "an appropriate percentage of progress payments or reimbursement costs proportionate to the estimated cost risk to the government...."

Internal "accounting controls" can by definition be a very subjective topic, for which there is not always clear guidance. The proposed language in DFARS 209.104-3(b) implies that the judgment of DCAA would automatically take precedence over the proper exercise of discretion by the Contracting Officer who should consider the unique facts and circumstances of each situation before electing to suspend progress payments on a particular contract. The Section believes that this proposed methodology for the suspension of progress payments fails to achieve even the minimum legal standards for due process and it is thereby seriously flawed for that reason alone should not be promulgated as a final rule.

III. Imprecise Definitions in the Proposed DFARS Would Lead to Uncertainty in Application

The Proposed Rule does not define the term "significant accounting control deficiencies" thus leaving substantial room for disagreements between contractors and the Government. SAS No. 60, "Communication of Internal Control Structure Related Matters Noted in an Audit" (1988) paragraphs 2 through 6 and 15 discusses the definitions of "reportable conditions," "significant deficiencies" and "material weaknesses."[1] In this regard, if the proposed rule is adopted, the Section believes that only "material weaknesses" should be considered as the standard by the ACO

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[1] SAS No. 60, ¶15. "A reportable condition may be of such magnitude as to be considered a material weakness. A material weakness in the internal control structure is a reportable condition in which the design or operation of the specific internal control structure elements do not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Although this Statement does not require that the auditor separately identify and communicate material weaknesses, the auditor may choose or the client may request the auditor to separately identify and communicate as material weaknesses those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses." *Id.*

in deciding whether to reduce or suspend progress payments.

The requirement for DCAA to "provide an estimate of the potential cost impact" is also troublesome. Unlike an accounting change, an internal control deficiency does not necessarily have or create a potential cost impact. Indeed, the cost impact concept, at least as it is understood in the context of a change in accounting practice, simply doesn't make sense with respect to internal controls. What does make sense, however, is the "cost-benefit relationship" discussed in paragraph 14 of SAS No. 55.[2] The disturbing lack of legal safeguards associated with these methods for the suspension of progress payments is a source of great concern.

IV. The Proposed Language Negates the Concepts of Corporate Self-Governance Espoused in Programs such as CRAG (Contractor Risk Assessment Guide)

We believe that the proposed language takes a step back from the concepts of teamwork and trust which both industry and government have been working to restore to the government procurement process. The CRAG program as proposed by the Government is a symbol of how trust and teamwork may be encouraged. Under programs such as CRAG, a contractor could voluntarily undertake the adoption of certain internal accounting controls. In return DCAA would focus its resources on other auditing areas. The language of the proposed DFARS, however, appears to direct DCAA not only to focus its attention on internal corporate matters, but to encourage DCAA to substitute its judgment for that of the contractor. This interference with corporate management discretion undercuts the very concept of mutual trust that programs such as CRAG are seeking to restore.

V. Conclusion

In summary, the Section suggests that the proposed language be deleted as unnecessary and inconsistent. Instead, we would recommend that the government confirm the adequacy of costs charged to a government contract by concentrating on the broad resources and remedies available under existing regulations.

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[2] SAS No. 55, ¶14. "The concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitiative estimates and judgments in evaluating the cost-benefit relationship." *Id.*

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely

Norman L. Roberts
Chair
Section of Public Contract Law
American Bar Association

cc: All Section Officers & Council Members
Marilyn M. Neforas

Shipbuilders Council of America
Suite 330
4301 N. Fairfax Drive
Arlington, Virginia 22203
Tel: 703-276-1700 Fax: 703-276-1707

August 1, 1991

Dear Ms. Young:

On behalf of the Shipbuilders Council of America, the national trade association representing American shipbuilders, ship repairers, and manufacturers of marine equipment, I wish to expand upon the comments that were submitted by the Council of Defense and Space Industry Associations concerning the proposed revisions to the Defense Federal Acquisition Regulation Supplement (DFARS), as they relate to contractor accounting controls and accounting systems (DAR Case 91-004).

First and foremost, the breadth of opposition throughout the Defense Industry to the proposed revisions should serve as a clarion that those revisions are fundamentally flawed. In addition to being flawed; being redundant to the existing FAR provisions; and being contrary to the mandate to streamline procurement regulations; they appear to be a veiled attempt to circumvent definitive rules that have been judicially clarified and embraced by the federal courts, including the Fourth Circuit Court of Appeals, which limited Defense Contract Audit Agency's (DCAA) access to a contractor's internal audits. Furthermore, a logical application of the proposed revisions are almost certain to have a "significant economic impact," thereby subjecting to question the certification as to compliance with the Regulatory Flexibility Act. Still further, the certification that suggests compliance with the Paperwork Reduction Act seems to be a perfunctory statement that does not comport with the reality of the substance of the proposed revisions. Accordingly, we believe that the proposed rule must be approved by "OMB under 44 U.S.C. 3501, et seq."

Our opposition to the proposed revisions is also based on our concern that they do not provide fundamental due process rights to the contractors. In this regard, DCAA would be vested with unfettered authority to make determinations that are subjective, arbitrary or punitive, and the contractor would have no regulatory right to refute the determinations made by DCAA. Such open ended authority will surely emasculate a contracting officer's (C.O.) authority to make independent determinations. After one or more private and excruciating experiences by a C.O., who has to explain why his or her unilateral determination was at odds with a DCAA determination, human nature will surely nurture a "go with the flow" mindset. In short, contracting by intimidation merely exacerbates the debilitating and counterproductive adversarial relationship between the Government and the Defense Industry.

Another concern of ours, which has been expressed by others, bears repeating. That is the lack of definition of the phase "risk to the government." Without a standard of definition for that phrase, DCAA will be free to develop creative interpretations and definitions that may attempt to quantify risk and base it upon an absolute standard of perfection. To do so would ensure significant underpayments or lack of timely payments to the contractors. Such inequitable consequences could be avoided if a "reasonable assurance" standard were adopted, which would ensure that progress payments could not be delayed or reduced as a result of random or inconsequential deviations that result in no additional costs to the Government. Without such clarity of definition of the phrase "risk to the government", and any other words and phrases that may be used in determining the meaning of "risk to the government," the litigiousness of Government contracting will unnecessarily increase. Such a potentially counterproductive waste of resources could be avoided if this were more properly treated as a FAR case so that any new procedures would be uniformly applied Government-wide rather than just being limited to the Defense Industry. To suggest that only the Defense Industry is in need of special accounting controls unfairly impugns the integrity of the Industry as a whole.

Please accept my comments in the constructive manner in which they are intended as we are joint partners in our national defense efforts, and it is in our mutual best interest for all parties to not only follow the strict letter of the law, but also to do what is fair and right.

Sincerely,

John J. Stocker
President

Defense Acquisition Regulations Council
ATTN: Ms. Barbara J. Young
Procurement Analyst, DAR Council
OUSD(A)DP(DARS), Room 3D139
The Pentagon
Washington, DC 20301-3000

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COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

1225 Eye Street, N.W., Suite 950
WASHINGTON, D.C. 20005

(202) 682-4435

#12

August 1, 1991
CODSIA Case 12-91

Defense Acquisition Regulations Council
ATTN: Ms. Barbara J. Young
Procurement Analyst, DAR Council
OUSD(A)DP(DARS), Room 3D139
The Pentagon
Washington, DC 20301-3000

Dear Ms. Young:

The undersigned members of the Council of Defense and Space Industry Associations (CODSIA) wish to submit for your favorable consideration the following comments concerning the proposed revisions to the Defense Federal Acquisition Regulation Supplement (DFARS), as they relate to contractor accounting controls and accounting systems (DAR Case 91-004).

CODSIA is opposed to the proposed revisions to the DFARS. The proposed revisions do not meet the standard for agency acquisition regulations under Section 1.302 of the Federal Acquisition Regulation (FAR). They are neither necessary to implement FAR policies and procedures nor necessary to satisfy the specific needs of the Department of Defense (DoD). The proposed DFARS 209.104-3 duplicates accounting control provisions already contained in FAR 16.301-3 for cost type contracts and FAR 32.503-3 for progress payments. Adequate protections are also included in FAR Sections 30 and 31. Furthermore, CODSIA believes that the proposed DFARS revisions are contrary to the initiatives, under the Defense Management Review (DMR) process, that were undertaken by the Secretary of Defense to streamline the procurement regulations.

Notwithstanding our opposition to the proposal, we find that the coverage is ill-conceived from a procurement policy standpoint. The proposed rule creates new standards for making a responsibility determination under DFARS Section 9 as a prerequisite to contract award. Yet, the penalties imposed in DFARS Section 42 are post-award actions. Presumably, a contract would not be awarded to a contractor who did not receive a favorable responsibility determination (i.e., had inadequate accounting controls). It seems that, instead, the proposed revisions should be tailored to modify FAR Sections 16 and 32.

CODSIA is deeply concerned with the proposed DFARS procedures for making determinations and withholding payment for lack of adequate accounting controls. As written, DFARS tends to cede to the Defense Contract Audit Agency authority that has almost uniformly

been vested in the Contracting Officer. The procedures do not (1) characterize the DCAA role as advisory, (2) call for a determination by the Contracting Officer, or (3) allow written rebuttal comments by the contractor. Instead, the procedures impose a payment withholding without any consideration to the due process procedures afforded the contractor in FAR 32.503-6. CODSIA further believes that the proposed process violates the traditional authority warranted to the Contracting Officer.

While we are encouraged by the recognition given in the proposed Section 242.7403 (c) for withholding only an "appropriate percentage," the criteria to be applied are not adequately defined. Industry has observed instances where "risk to the Government" has unfortunately resulted in withholdings of entire cost categories (e.g., material, labor). It should not be necessary, for example, to withhold payment on all material costs if a contractor's purchase orders were not prenumbered. CODSIA recommends that "risk to the Government" be clarified to mean the accounting control deficiency poses a significant chance that substantial overpayment will result. A "reasonable assurance" standard should be adopted. Accordingly, we recommend as an alternative to the language proposed in Section 209.104-1 (e) (S-70) the following language:

> "Have internal accounting controls that provide reasonable assurance that all costs, both direct and indirect, charged to the Government are valid."

Finally, we do not believe this proposal should be pursued as a change to the DFARS. Since the issue concerns the adequacy of a contractor's accounting controls, the proposal should be considered in a broader regulatory forum. If adopted, it will affect all Government contractors who have a combination of DoD and other contracts.

We thank you for affording us the opportunity to provide our comments, and trust that they will be constructively reviewed.

Sincerely,

John J. Stocker
President
Shipbuilders Council of America

Dan C. Heinemeier
Vice President
Electronic Industries Association

Wallace H. Robinson, Jr.
President
National Security Industrial Association

rec'd 8/5

#13

Rockwell International Corporation
2230 East Imperial Highway
El Segundo, California 90245

Rockwell International

August 1, 1991 In Reply Refer to: 91-CO-152

Defense Acquisition Regulations Council
Attn: Ms. Barbara J. Young, Procurement Analyst
OUSD(A)DP(DARS)
Room 3D139
The Pentagon, Washington, DC 20301-3000

Dear Ms. Young:

Rockwell International Corporation is pleased to provide comments on DAR Case 91-004 (56 FR 26645) which would add a new Defense FAR (DFAR) Supplement at subpart 242.74 and amend the DFAR Supplement at sections 209.104-1, 209.104-3, 209.106-2.

The proposed revisions to the DFAR Supplement would establish policies and procedures to highlight contractors' responsibility to maintain adequate accounting systems and internal controls, and add a general standard of responsibility for prospective contractors to "have sufficient internal controls to ensure the validity of all costs, both direct and indirect, charged to the Government." The supplementary background information asserts that these revisions are merely to clarify existing requirements applicable to defense contractor accounting systems.

Rockwell believes the proposed rule is much more than a clarification of existing requirements applicable to defense contractor accounting systems and, in fact, represents an onerous new requirement that is so lacking in definition it is likely to precipitate numerous applications which are unnecessary, costly for both DoD and its contractors, and administratively intrusive.

The proposed rule, besides the significant impact it portends for current and prospective DoD contractors (especially small businesses attempting to do business with the Department of Defense for the first time), is also contrary to stated DoD intentions to reduce adversarial tensions with its contractors; to encourage contractor self-governance; to improve audit coordination; to increase contractor self-initiated corrective action where necessary; to encourage greater commerciality in defense contracting; and to reduce the continuing major burden of excessive contractor oversight.

The proposed rule also duplicates, to some extent, the work of contractors' independent auditors who are guided by professional auditing standards and the Accounting Guide for Audits of Federal Government Contractors.

Additionally, there is no reasonable way that contractors can ensure the "validity of all costs...charged to the Government." The concept of "reasonable assurance" which underlies a contractor's internal control structure recognizes that the cost of an internal control structure should not exceed the benefits that are expected to be derived. The American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards 55 states: "Although the cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgements in evaluating the cost-benefit relationship."

Rockwell is also concerned that the proposed rule may unnecessarily and defectively grant the DCAA the right to "establish and manage programs for evaluating the adequacy of contractor internal accounting controls." The proposed rule also provides that a contractor may not receive a cost or incentive type contract, or a contract providing for progress payments, unless the contractor's accounting system, including its accounting controls, is "adequate."

In the absence of clear, unambiguous language in the proposed rule as to what constitutes "adequate" internal accounting controls, it would seem DCAA is to have virtually unlimited discretion to find a contractor's system "inadequate." Such unbounded authority is not only highly questionable, but can also be expected to damage or undo many of the positive accomplishments already achieved under contractor self-governance programs and the Contractor Risk Assessment Guide (CRAG) program.

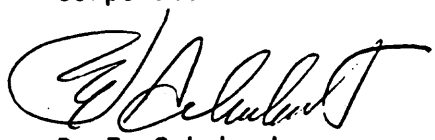
For example, the DCAA has stated publicly that participation in the CRAG program is voluntary -- yet, under the proposed rule, DCAA auditors may use the current CRAG program as a benchmark to determine if a contractor's internal accounting controls are "adequate." Consequently, the CRAG program may become essentially mandatory for those contractors having or contemplating a cost or incentive type contract, or a contract providing for progress payments, despite the fact these contractors have in good faith embraced CRAG in reliance upon DoD's assurances the program is in fact voluntary.

The proposed rule also appears to grant the DCAA limitless authority to conduct operational audits of contractors, and provides a new and unfettered authorization to withhold payments by authorizing the ACO to suspend progress payments or reimbursement of costs in an amount equal to the "estimate of the potential cost impact" resulting from any accounting control deficiencies as determined by DCAA. However, the proposed rule provides no due process mechanism for the contractor to request the cognizant ACO in writing to reconsider the suspension of progress payments or reimbursement of costs and to discuss the DCAA findings with the contractor.

In summary, the proposed rule is an unnecessary additional burden on contractors and should be withdrawn. We believe currently existing regulations provide the Government with adequate mechanisms to assure the reliability of contractor's accounting systems, without imposing a new policy requirement on contractors which are specified in the proposed section 242.7402, and new procedural requirements on DCAA which are specified in the proposed section 242.7403.

Rockwell International Corporation appreciates the opportunity to submit our comments.

ROCKWELL INTERNATIONAL CORPORATION
Corporate Offices



P. E. Schubert
Assistant Controller
Western Region

DEPARTMENT OF DEFENSE

48 CFR Parts 209 and 242

Department of Defense Federal Acquisition Regulation Supplement; Contractor Accounting Controls

AGENCY: Department of Defense (DOD).

ACTION: Proposed rule and request for comments.

SUMMARY: The Defense Acquisition Regulations (DAR) Council is proposing changes to the Defense FAR Supplement to add a new subpart at 242.74 on policies and procedures for contractor internal accounting controls. Also, changes to 209.1 are proposed to add a general standard of responsibility for prospective contractors to have sufficient internal accounting controls to ensure the validity of all costs charged to the Government. These revisions clarify existing requirements applicable to defense contractor accounting systems.

DATES: Comments on the proposed rule should be submitted in writing to the address shown below on or before July 10, 1991, to be considered in the formulation of the final rule. Please cite DAR Case 91-004 in all correspondence related to this issue.

ADDRESSES: Interested parties should submit written comments to: Defense Acquisition Regulations Council, ATTN: Ms. Barbara J. Young, Procurement Analyst, DAR Council, OUSD(A)DP(DARS), room 3D139, The Pentagon, Washington, DC 20301-3000.

FOR FURTHER INFORMATION CONTACT: Ms. Barbara J. Young, Procurement Analyst, DAR Council, (703) 697-7266, FAX No. (703) 697-9845.

SUPPLEMENTARY INFORMATION:

A. Background

Revisions to the Defense FAR Supplement are proposed to add a new subpart at 242.74 on policies and procedures for contractor internal accounting controls. Revisions to 209.1 are also proposed to add a general standard of responsibility for prospective contractors to have sufficient internal accounting controls to ensure the validity of all costs charged to the Government. These revisions clarify existing requirements applicable to contractor accounting systems.

B. Regulatory Flexibility Act

An initial Regulatory Flexibility Analysis has not been performed because the proposed rule will not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* because it basically defines and emphasizes the requirement for contractor internal accounting controls which are already required as part of an acceptable accounting system. However, comments from small businesses concerning the affected DFARS Subparts will also be considered in accordance with section 610 of the Act. Such comments must be submitted separately and cite DAR Case 91-610 in all correspondence.

C. Paperwork Reduction Act

The proposed rule does not impose any reporting or recordkeeping requirements which require the approval of OMB under 44 U.S.C. 3501, *et seq.*

List of Subjects in 48 CFR Parts 209 and 242

Government procurement.

Nancy L. Ladd,

Director, Defense Acquisition Regulations Council.

Therefore, it is proposed that 48 CFR parts 209 and 242 be amended as follows:

1. The authority citation for 48 CFR parts 209 and 242 continues to read as follows:

Authority: 5 U.S.C. 301, 10 U.S.C. 2202, DoD Directive 5000.35, DoD FAR Supplement 201.301.

PART 209—CONTRACTOR QUALIFICATIONS

2. Section 209.104-1 is revised to read as follows:

209.104-1 General Standards

(e) (S-70) Have sufficient internal accounting controls to ensure the validity of all costs, both direct and indirect, charged to the government.

(S-71) Have the necessary safety programs applicable to materials to be produced or services to be performed by the prospective contractor and subcontractors.

3. Section 209.104-3 is amended by adding a new paragraph (b) to read as follows:

209.104-3 Application of Standards

(b) The accounting system including its accounting controls must be adequate if the prospective contractor is to receive progress payments or a cost or incentive type contract is contemplated.

* * * * *

4. Section 209.106-2, is amended by revising factor E in paragraph (S-70)(5), section III, Block 19, Major Factors, to read as follows:

209.106-2 Requests for preaward surveys

Section III, Block 19, Major Factors

* * * * *

Factor E—Accounting System—An assessment by the Defense Contract Audit Agency (DCAA) of the adequacy of the prospective contractor's accounting system and related accounting controls as defined in § 242.7401. Normally, an accounting system review will be requested when conditions such as progress payments, or a cost or incentive type contract is contemplated or when accounting system or internal accounting control deficiencies are thought to exist.

* * * * *

PART 242—CONTRACT ADMINISTRATION

5. A new subpart 242.74 is added to read as follows:

Subpart 242.74—Contractor Accounting Controls

Sec.

242.7400 Scope of subpart.
242.7401 Definition.
242.7402 Policy.
242.7403 Procedures.

Subpart 242.74—Contractor Accounting Controls

242.7400 Scope of subpart

This subpart provides policies and procedures applicable to contractor internal accounting controls.

242.7401 Definition

Accounting controls means those internal control procedures established by contractor management to ensure costs are properly charged within the accounting system.

242.7402 Policy

All contractors shall maintain an accounting system throughout contract performance which contains sufficient internal accounting controls to ensure the integrity of all costs, both direct and indirect, charged to the government.

242.7403 Procedures

(a) The Defense Contract Audit Agency (DCAA) will establish and manage programs for evaluating the adequacy of contractor internal accounting controls. The auditor shall advise the Administrative Contracting Officer (ACO) of significant findings of the evaluation.

(b) If significant accounting control deficiencies exist, the DCAA report to the ACO shall—

(1) Provide an estimate of the potential cost impact; and

(2) Include findings on the acceptability of the contractor's corrective action plan.

(c) Upon receipt of a DCAA report identifying significant accounting control deficiencies, the ACO may suspend an appropriate percentage of progress payments or reimbursement costs proportionate to the estimated cost risk to the government, until the submission and acceptance of the contractor's corrective action plan. (See FAR 32.503-6(b)).

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