

**STATEMENT BY**

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**BEFORE THE**

**COMMISSION ON WARTIME CONTRACTING  
FOR IRAQ AND AFGHANISTAN**

**ON**

**CONTRACTOR BUSINESS SYSTEMS**

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COMMISSION ON WARTIME CONTRACTING**

Good morning Chairman Thibault, Chairman Shays, and Commissioners. On behalf of the Defense Contract Management Agency (DCMA) team, thank you for the opportunity to come before you to speak on contractor business systems.

DCMA is an agency of the Department of Defense reporting to the Under Secretary of Defense (Acquisition, Technology and Logistics). The DCMA mission is to provide Contract Administration Services to the Department of Defense Acquisition Enterprise and its partners to ensure delivery of quality products and services to the warfighter; on time and on cost. The DCMA team consists of approximately 10,300 professional civilians and military located at over 900 locations around the world. DCMA is responsible for the administration of about 325,000 contracts with unliquidated obligations of over \$220 billion awarded to over 19,000 contractors. DCMA accepts approximately 750,000 shipments of supplies and some 1,150 aircraft each year. We also manage over \$136 billion of government property and administer about \$36 billion of contract financing payments each year. As the Executive Director for Contracts at DCMA, I serve as the principal advisor to the Director, DCMA in the development and deployment of Agency policy and processes for contract administration services.

The DCMA mission support numbers above provide context to the tremendous increase in defense contracting dollars and contracting actions over the past decade. That, coupled with a significant reduction in personnel, has posed a significant challenge to the defense contracting community. Contractor maintenance of reliable business systems is one tool that will help address this challenge. Simply put, robust planning and control systems increase the likelihood that conforming supplies and services are delivered on-time and at a fair price. They also reduce

the Government's cost of processing individual transactions. Unfortunately, contractor business systems are not maintained at the reliability-level we would expect. This is a direct consequence of the tension between focusing on that which is urgent, the individual transactions, and that which is important, the systems that support the individual transactions. Today, on behalf of DCMA, I look forward to giving you insight into our assessment of contractor business systems and, more importantly, our efforts to resolve deficiencies in those systems. Additionally, I will provide suggestions for regulatory change that will facilitate our efforts to correct identified deficiencies. Three main points will be addressed today: (1) Authority and responsibility for determining systems status; (2) Importance of formal system ratings versus identification of the specific deficiencies; and (3) Available remedies for inadequate systems.

The Federal Acquisition Regulation (FAR) and related regulations give our Administrative Contracting Officers (ACOs) wide latitude to exercise business judgment when determining the application of rules, regulations, and policies to ensure contractors receive impartial, fair and equitable treatment. That said, while the authority and responsibility for determining system status clearly rests with the ACOs, they must consider the input provided by functional specialists as part of their decision-making process. The Defense Contract Audit Agency (DCAA) is integral to that process as the Department's expert with respect to contract auditing. In order to ensure DCAA recommendations are appropriately considered, we mandate in our internal policies that any determination inconsistent with DCAA recommendations is subject to higher level review that may include review by the DCMA "Head of Contracting Activity," a Senior Executive Service position within DCMA.

There are seven major contractor business systems prescribed by regulation. These systems are: Accounting, Estimating, Purchasing, Material Management and Accounting, Property Management, Earned Value Management, and Cost Accounting Standards Disclosure Statements. There are also “technical systems” related to Quality Assurance and Systems Engineering; but, my focus today is on the systems commonly termed “business systems.” There is no consolidated list of these systems in the FAR and Defense FAR Supplement (DFARS). Rather, the requirements are identified through a comprehensive reading of the acquisition regulations. There are different thresholds for application, depth of regulatory coverage and guidance, and suggested remedies for each. A brief summary of the system requirements and thresholds for application are provided:

**Accounting System (DFARS 242.75).** Contractors receiving cost-reimbursement or incentive type contracts, or contracts which provide for progress payments based on costs or on a percentage or stage of completion, are required to maintain an accounting system and related internal controls throughout contract performance which provide reasonable assurance that applicable laws and regulations are complied with; the accounting system and cost data are reliable; risk of misallocations and mischarges are minimized; and contract allocations and charges are consistent with invoice procedures.

**Estimating System (DFARS 215.407-5-70).** A large business contractor is subject to estimating system disclosure, maintenance, and review requirements, if in its preceding fiscal year, the contractor received DoD prime contracts or subcontracts totaling \$50 million or more for which cost or pricing data were required; or in its preceding fiscal year, the contractor

received DoD prime contracts or subcontracts totaling \$10 million or more (but less than \$50 million) for which cost or pricing data were required and the contracting officer, with concurrence or at the request of the ACO, determines it to be in the best interest of the Government (e.g., significant estimating problems are believed to exist or the contractor's sales are predominantly Government). The system is considered acceptable if the system is established, maintained, reliable, and consistently applied; produces verifiable, supportable, and documented cost estimates that are an acceptable basis for negotiation of fair and reasonable prices; is consistent with and integrated with the contractor's related management systems; and is subject to applicable financial control systems.

**Purchasing System (FAR 44.302).** A contractor is subject to a Contractor Purchasing System Review (CPSR) of the contractor's sales to the Government (excluding competitively awarded firm-fixed-price and competitively awarded fixed-price with economic price adjustment contracts and sales of commercial items pursuant to Part 12) if they are expected to exceed \$25 million during the next 12 months. As part of the review, the Government assesses the efficiency and effectiveness of the contractor's purchasing of material and services, subcontracting, and subcontract management from development of the requirement through completion of subcontract performance.

**Material Management and Accounting System (DFARS 242.72).** A contractor is subject to a review of its Material Management and Accounting System (MMAS) if it has \$40 million of qualifying sales to the Government during the contractor's preceding fiscal year; and the ACO, with advice from the auditor, determines an MMAS review is needed based on a risk

assessment of the contractor's past experience and current vulnerability. For the system to be compliant, the contractor must maintain an MMAS that reasonably forecasts material requirements; ensures that costs of purchased and fabricated material charged or allocated to a contract are based on valid time-phased requirements; and maintains a consistent, equitable, and unbiased logic for costing of material transactions.

**Property Management System (FAR 45.105).** The Contractor is required to manage (control, use, preserve, protect, repair and maintain) Government property in its possession. To be compliant, the system must satisfy the ten outcomes specified in the clause at FAR 52.245-1 including record-keeping and reporting responsibilities, subcontractor control, inventory performance and disclosure, and maintenance and repair of the property.

**Earned Value Management System (DFARS 234.2).** For cost or incentive contracts and subcontracts valued at \$20 million or more, the contractor's earned value management system must comply with the guidelines in the American National Standards Institute/Electronic Industries Alliance Standard 748, Earned Value Management Systems (ANSI/EIA-748). For cost or incentive contracts and subcontracts valued at \$50 million or more, the contractor must have an earned value management system that has been determined by the cognizant Federal agency to be in compliance with the guidelines in ANSI/EIA-748.

**Cost Accounting Standards (CAS) Disclosure Statement (48 CFR 9903).** Full and modified CAS covered contractors must maintain a CAS Disclosure Statement that adequately describes the contractor's cost accounting practices.

Now I would like to provide you with information on the overall status of contractor business systems and a comparison with those of the Logistics Civil Augmentation Program (LOGCAP) contractors. Most contractors doing business with the government have in place and maintain adequate, acceptable, and compliant systems; but, as stated earlier, there is room for improvement. Even our major defense contractors, with years of experience in government contracting and dealing with acquisition regulations, possess significant deficiencies in their systems. Only two of the ten largest segments/business units have adequate systems across the board. Assessing the seven systems required by regulation, four of the ten segments were considered "inadequate" in three or more of the systems evaluated. By comparison, the LOGCAP contractors each have only one "inadequate" system. Taking a broader view, of the 435 contractor purchasing systems that have been reviewed, 19 of them have had their approvals withheld. Of the 2,479 contractor property systems that have been reviewed, 80 have been found inadequate. Of the 66 Earned Value Management compliance reviews conducted since April 2006, only four suppliers have been found fully compliant with the guidelines. That said, it is difficult to gauge the severity and impact of the deficiencies found across various contractor systems.

More importantly, focusing on whether a system is rated compliant doesn't paint the whole picture. This is because an acceptable system may contain some deficiencies. Long-

standing practice and regulatory guidance allow contractors, in many cases, to avoid having systems disapproved if they submit adequate corrective action plans and make progress against the plans. The ACOs must consider the number, severity or materiality, and breadth of the deficiencies. The system rating is important – it may result in specific consequences (for example, a disapproved Purchasing System automatically leads to an increased subcontract consent requirement. But knowledge of the individual deficiencies is no less important. I say that because the negative impact of a deficiency on the instant contracting action or transaction can often be mitigated through Government action albeit typically through the expenditure of additional Government resources. To illustrate this point, consider that the regulatory guidance for Contractor Cost Estimating System deficiencies lists a number of potential risk mitigation strategies. These include use of a different contract type, performing additional cost analyses, or inclusion of a contract reopener clause that provides for adjustment of the contract amount after award. While a disapproved Purchasing System automatically leads to more subcontracts requiring ACO approval prior to award, a contracting officer may require consent regardless of the official system status if he/she is aware of deficiencies in subcontract competition or pricing. For that reason, we are working to improve the quality of our communications with contracting officers relative to system deficiencies. Our recent realignment of contracting personnel into a competency-based structure promotes greater sharing of information and improved communication among contracting personnel across the agency. To the extent we provide better, more specific information regarding contractor performance, our customers will be better equipped to select the best suppliers after considering all factors.



Responsible ACOs must act upon reports communicating deficiencies in contractor business systems. Our method for tracking resolution and disposition of reportable contractor business system audits is referred to as Contract Audit Follow-Up (CAFU). Policy related to CAFU is contained in DoD Instruction 7640.02. DCMA recently identified CAFU as a material weakness in our internal management control plan. As such, we are implementing policy that will require quality assurance plans and internal reviews of CAFU actions from the headquarters down through our divisions and contract management offices. In addition, the divisions will be required to report the results of those reviews on an annual basis and, if significant problems persist, we will implement higher level and/or more frequent reviews. Our primary focus will be on the appropriateness of the resolution and disposition of CAFU, but we will also evaluate the timeliness of our contracting officers' decisions.

Systems, like the regulations requiring them, differ. The consequences of failing to maintain acceptable systems vary. I have mentioned the additional consent requirements necessary for disapproved purchasing systems. An inadequate Accounting System may preclude the award of cost-type contracts, limit financing options, and preclude direct billing. An unacceptable Estimating System may result in increased post award reviews for defective pricing. An inadequate Property System may lead the Government to revoke its "assumption of risk" and hold contractors liable for Loss, Damage, Destruction, or Theft of Government property. With the exception of MMAS, none of these consequences expressly and contractually include reductions in contract price, payments, or financing. This is important and I mention it since it is my understanding that prior testimony to this Commission touched on the issue of "withholding" monies for unacceptable systems.

Certain clauses allow the Government to impact cash flow when contractors fail to maintain acceptable systems or correct deficiencies in a timely manner. Both the Progress Payments and Performance-Based Payments Clauses allow for reduction or suspension of those financing payments for any material noncompliance with contract terms. The Incentive Fee and Fixed Fee clauses allow the Contracting Officer to withhold payment of fee after 85% has been paid up to a total of \$100,000. (Note that this has generally been done to ensure submission of final rate proposals and final vouchers not to encourage improvements in business systems.) Additionally, while not a contractual remedy, in the event of deficiencies in accounting and related internal controls, DCAA may not approve a company for direct billing. These actions, while of some degree of significance, do not represent the hammer some folks seem to believe the Government possesses. Finally, the Allowable Cost and Payment Clause gives the contracting officer the authority to suspend or disallow reimbursement of costs found to be unallowable. However, unless a system deficiency can be found to directly impact a specific cost's allowability, this clause rarely provides the leverage needed to effect the correction of business system deficiencies.

Earned Value Management Systems (EVMS) are a good example. Since EVMS is primarily required on cost-type contracts, the remedies of the financing clauses are not available. Earned Value Systems are the recipients of accounting information, not the source of billing generation. So, it would not be common for the allowability of costs to be called into question by virtue of deficiencies in that system. Therefore, the only remaining monetary remedy would be withholds under the Fixed Fee and Incentive Fee clauses. Both clauses only provide the

contracting officer authority to withhold payment of fee up to \$100,000 for each impacted contract and only after payment of 85% of the fee. We recently offered some ideas to the Director, Defense Procurement and Acquisition Policy on additional “incentives” to obtain greater compliance with regulatory business system requirements such as suspension of up to 10% of costs for chronic system deficiencies (modification to FAR 52.216-7, Allowable Cost and Payment). We are also considering submitting a specific regulatory change to address withholds for EVMS deficiencies.

I would like to discuss one final complexity our contracting officers face when making system determinations. As previously stated, the seven major contractor **business systems** prescribed by the acquisition regulation are:

- Accounting System
- Estimating System
- Purchasing System
- Material Management and Accounting System
- Property Management System
- Earned Value Management System
- Cost Accounting Standards Disclosure Statements

In contrast, DCAA currently conducts and reports on the following 10 contractor **internal control systems** for large contractors:

- Control Environment and Overall Accounting System
- General Information Technology (IT) System
- Budget and Planning System
- Compensation System
- Labor System

- Indirect and Other Direct Cost (ODC) System
- Billing System
- Purchasing System
- Material System
- Estimating

The relationship of the business systems required by the FAR and DFARS to DCAA's internal control systems is not readily apparent and has led to a degree of confusion. The fact that some of the supporting internal control systems reviewed by DCAA (General IT System, Budget and Planning System, Labor System, and the Indirect and ODC System controls) are not even addressed in the acquisition regulations is a definite contributing factor. And while the billing and compensation systems are specifically mentioned in the acquisition regulations there is no specific requirement for contractors to maintain adequate billing or compensation systems. We are developing new policy to clarify this subject for the ACOs but it would be beneficial if the acquisition regulations recognized the internal control systems as required business systems and addressed the specific authority of the ACOs for determining system status.

In closing, we share the concerns you have with regard to the adequacy of contractor business systems and appreciate Congressional support of our efforts as the Department's primary contract management agency. DCMA strives every day to provide our nation's warfighters with quality products and services, on-time, and at fair prices. Again, thank you for the opportunity to appear before the Commission. This concludes my statement. I would be pleased to answer your questions.