

Recommendation 73: Revise the definition of business system deficiencies to more closely align with generally accepted auditing standards.

Problem

The definition of the term significant deficiency for contractor business systems in Section 893 of the FY 2011 NDAA and the DFARS does not align with generally accepted auditing standards for evaluating and reporting on internal control deficiencies. This lack of consistency creates confusion regarding the identification, severity, meaning, and resolution of deficiencies.

Background

The FY 2011 NDAA and DFARS definition for *significant deficiency* describes it as materially affecting DoD officials' and contractor's ability to rely on information produced by the business system that is needed for management purposes. The term in generally accepted auditing standards for a deficiency of this severity, that is, a deficiency that is material, is *material weakness*. Generally accepted auditing standards also use the term *significant deficiency*, but to describe a deficiency that is less severe than a *material weakness*. The use of the same term to mean different levels of severity of a deficiency creates confusion about the meaning of significant deficiency among contractors, independent public accountants performing SOX 404(b) audits, government auditors, and the acquisition community.

The FY 2011 NDAA and the DFARS regulations provide for only a significant deficiency, but in reality, the contractor business system could have a number of deficiencies that range from trivial to severe. Reporting deficiencies by different levels of severity, and in a manner that aligns with established auditing standards, will allow contracting officers to make informed decisions on the acceptability of the business system

Discussion

The FY 2011 NDAA, Section 893, and DFARS 252.242-7005, Contractor Business Systems, define *significant deficiency* as "a shortcoming in the system that materially affects the ability of officials of the Department of Defense and the contractor to rely on information produced by the system that is needed for management purposes." The term and its definition are mismatched relative to generally accepted auditing standards, which have a two-tiered approach to evaluating and reporting business system deficiencies. As shown here, the statutory and regulatory definition above better aligns with the private-sector, Public Company Accounting Oversight Board, *GAO Yellow Book*, and Securities and Exchange Commission definitions of material weakness:

Material weakness. A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.

Significant deficiency. A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those

charged with governance. (AICPA, Professional Standards, AU-C section 265, Communicating Internal Control Related Matters Identified in an Audit)

Financial statement audits and examination engagements conducted in accordance with GAO, Government Auditing Standards 2018 Revision, (paragraphs 6.29 and 7.42), refers to use of the terms material weakness reporting on internal control deficiencies. The paragraph also references the AICPA, Professional Standards, AU-C section 265, for consistent use of the terminology.

Conclusions

The definition for system deficiencies in the FY 2011 NDAA, Section 893, and DFARS regulation require revision to be more consistent with the definitions in generally accepted auditing standards that apply to different types of engagements (e.g., inspection, attestation, and performance).

Statutory Revision

In the FY 2011 NDAA, Section 893, the term *significant deficiency* and its definition need to be stricken and replaced with the term *material weakness* and its definition as follows:

- *Material Weakness*: A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.

DFARS Revision

In the DFARS regulations (e.g., Accounting System Administration 252.242-7006, Contractor Business Systems 252.242-7005), the term *significant deficiency* and its definition should be stricken and replaced with the term *material weakness* and its definition. Additionally, the regulations should include new terms and their respective definitions for *significant deficiency* and *other deficiency*.

The definition of material weakness, significant deficiency, and other deficiency is applicable to any type of engagement (e.g., attestation, inspection) that is designed to test internal controls or compliance with a specific criterion. For an audit or inspection designed to test compliance with specific criteria, a deficiency can occur due to either internal control defect or a system shortcoming. A shortcoming in this regard would occur if a business system lacks a capability or element of functionality required by the system criteria. The revised DFARS language for business system deficiencies is as follows:

- *Material Weakness*: A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.

- *Significant Deficiency*: A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliance or other shortcomings in the system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.
- *Other Deficiency*: A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the system that have a clearly trivial, or inconsequential, effect on the ability of the business system to prevent or detect and correct, material noncompliances on a timely basis.

The *other deficiency* definition acknowledges the possibility that a business system deficiency, or combination of systems deficiencies, may have a clearly trivial effect on the quality of information produced by the contractor's business systems. Clearly trivial represents the inverse of *material* whether judged by any criteria of size, nature, or circumstances. Other deficiencies will not impact the audit opinion or conclusions and will not be included in the audit report. These deficiencies may be communicated to the contracting officer using email or other method of communication.

The revisions introduce new terms, such as material noncompliance and misstatement and a new definitions for acceptable contractor business system that are not currently in the DFARS but are important to understanding the revised business system deficiency definitions. As a result, and in conjunction with the revised DFARS deficiency definitions, the following definitions should be added to the DFARS to enhance understanding and provide clarity to stakeholders:

- **Material Noncompliance**: A misstatement in the information provided to the Government (e.g., billings, incurred cost submissions, pricing proposals, etc.) that will materially influence, and may adversely impact the economic or management decisions of the users of the information.
- **Misstatement**: Information provided to the Government does not comply with contract terms and applicable federal regulations such as the Federal Acquisition Regulations (FAR) and Cost Accounting Standards (CAS).
- **Acceptable Contractor Business System**: Contractor business systems that comply with the criteria of applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely on information produced by the business system that is needed for management purposes.

Implementation

Legislative Branch

- Revise and replace the definition for *significant deficiency* in Section 893 of the FY 2011 NDAA, Section 893, with the new definitions of *material weakness*.
- Define *material weakness* as a deficiency, or combination of deficiencies, in internal control over risks related to government contract compliances or other shortcomings in the business system, such that there is a reasonable possibility that a material noncompliance will not be prevented,

or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.

Executive Branch

- Revise the Business System DFARS sections (for all systems with the significant deficiency defined) to replace the term *significant deficiency* with the new definitions of material weakness, significant deficiency, and other deficiency as follows:
 - Significant Deficiency: A deficiency, or combination of deficiencies, in internal control over risk related to Government contract compliance or other shortcomings in the business system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.
 - Other Deficiency: A deficiency, or combination of deficiencies, in internal control over Government contract compliance or other shortcomings in the business system that have a clearly trivial, or inconsequential, effect on the ability of the business system to prevent or detect and correct, material noncompliances on a timely basis.
- Define *material weakness* as a deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances or other shortcomings in the business system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.
- Revise the Business System DFARS sections (for all systems) to include the definitions:
 - Material Noncompliance: A misstatement in the information provided to the Government (e.g. billings, incurred cost submissions, pricing proposals, etc.) that will materially influence, and may adversely impact the economic or management decisions of the users of the information.
 - Misstatement: Information provided to the Government does not comply with contract terms and applicable federal regulations such as the Federal Acquisition Regulations (FAR) and Cost Accounting Standards (CAS).
 - Acceptable Contractor Business System (DFARS Revision): Means contractor business systems that complies with the criteria of applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely on information produced by the system that is needed for management purposes.

Implications for Other Agencies

- There are no cross-agency implications for this recommendation.

RECOMMENDED REGULATORY REVISIONS

252.242-7005 Contractor Business Systems.

As prescribed in 242.7001, use the following clause:

CONTRACTOR BUSINESS SYSTEMS (FEB 2012)

(a) This clause only applies to covered contracts that are subject to the Cost Accounting Standards under 41 U.S.C. chapter 15, as implemented in regulations found at 48 CFR 9903.201-1 (see the FAR Appendix).

(b) *Definitions.* As used in this clause deficiencies may be either of the following—

Material Weakness: A deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable

Significant Deficiency: A deficiency, or combination of deficiencies, in internal control over Government contract risks or other shortcomings in the system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.

Other Deficiency: A deficiency, or combination of deficiencies, in internal control over Government contract risks or other shortcomings in the system that have a clearly trivial, or inconsequential, effect on the ability of the business system to detect and correct errors on a timely basis.

Acceptable contractor business system: means contractor business systems that comply with the criteria of the applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.

“Contractor business systems” means—

Accounting system, if this contract includes the clause at 252.242-7006, Accounting System Administration;

Earned value management system, if this contract includes the clause at 252.234-7002, Earned Value Management System;

Estimating system, if this contract includes the clause at 252.215-7002, Cost Estimating System Requirements;

Material management and accounting system, if this contract includes the clause at 252.242-7004, Material Management and Accounting System;

Property management system, if this contract includes the clause at 252.245-7003, Contractor Property Management System Administration; and

Purchasing system, if this contract includes the clause at 252.244-7001, Contractor Purchasing System Administration.

~~“Significant deficiency,” in the case of a contractor business system, means a shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.~~

(c) *General*. The Contractor shall establish and maintain acceptable business systems in accordance with the terms and conditions of this contract.

(d) ~~Significant deficiencies~~ *Deficiencies*. (1) The Contractor shall respond, in writing, within 30 days to an initial determination that there are one or more deficiencies in one or more of the Contractor’s business systems.

(2) The Contracting Officer will evaluate the Contractor's response and notify the Contractor, in writing, of the final determination as to whether the Contractor’s business system contains ~~significant deficiencies~~ material weaknesses. If the Contracting Officer determines that the Contractor’s business system contains ~~significant deficiencies~~ material weaknesses such that the system would be disapproved, the final determination will include a notice to withhold payments.

(e) *Withholding payments*. (1) If the Contracting Officer issues the final determination with a notice to withhold payments for ~~significant deficiencies~~ material weaknesses in a contractor business system required under this contract, the Contracting Officer will withhold five percent of amounts due from progress payments and performance-based payments, and direct the Contractor, in writing, to withhold five percent from its billings on interim cost vouchers on cost-reimbursement, labor-hour, and time-and-materials contracts until the Contracting Officer has determined that the Contractor has corrected all significant deficiencies as directed by the Contracting Officer’s final determination. The Contractor shall, within 45 days of receipt of the notice, either correct the deficiencies or submit an acceptable corrective action plan showing milestones and actions to eliminate the deficiencies.

(2) If the Contractor submits an acceptable corrective action plan within 45 days of receipt of a notice of the Contracting Officer’s intent to withhold payments, and the Contracting Officer, in

consultation with the auditor or functional specialist, determines that the Contractor is effectively implementing such plan, the Contracting Officer will reduce withholding directly related to the ~~significant deficiencies~~ material weaknesses covered under the corrective action plan, to two percent from progress payments and performance-based payments, and direct the Contractor, in writing, to reduce the percentage withheld on interim cost vouchers to two percent until the Contracting Officer determines the Contractor has corrected all ~~significant deficiencies~~ material weaknesses as directed by the Contracting Officer's final determination. However, if at any time, the Contracting Officer determines that the Contractor has failed to follow the accepted corrective action plan, the Contracting Officer will increase withholding from progress payments and performance-based payments, and direct the Contractor, in writing, to increase the percentage withheld on interim cost vouchers to the percentage initially withheld, until the Contracting Officer determines that the Contractor has corrected all ~~significant deficiencies~~ material weaknesses as directed by the Contracting Officer's final determination.

(3) Payment withhold percentage limits.

The total percentage of payments withheld on amounts due under each progress payment, performance-based payment, or interim cost voucher, on this contract shall not exceed--

Five percent for one or more ~~significant deficiencies~~ material weaknesses in any single contractor business system; and

Ten percent for ~~significant deficiencies~~ material weaknesses in multiple contractor business systems.

If this contract contains pre-existing withholds, and the application of any subsequent payment withholds will cause withholding under this clause to exceed the payment withhold percentage limits in paragraph (e)(3)(i) of this clause, the Contracting Officer will reduce the payment withhold percentage in the final determination to an amount that will not exceed the payment withhold percentage limits.

(4) For the purpose of this clause, payment means any of the following payments authorized under this contract:

Interim payments under—

Cost-reimbursement contracts;

Incentive type contracts;

Time-and-materials contracts;

Labor-hour contracts.

Progress payments.

Performance-based payments.

(5) Payment withholding shall not apply to payments on fixed-price line items where performance is complete and the items were accepted by the Government.

The withholding of any amount or subsequent payment to the Contractor shall not be construed as a waiver of any rights or remedies the Government has under this contract.

Notwithstanding the provisions of any clause in this contract providing for interim, partial, or other payment withholding on any basis, the Contracting Officer may withhold payment in accordance with the provisions of this clause.

The payment withholding authorized in this clause is not subject to the interest-penalty provisions of the Prompt Payment Act.

(f) *Correction of deficiencies.* (1) The Contractor shall notify the Contracting Officer, in writing, when the Contractor has corrected the business system's deficiencies.

(2) Once the Contractor has notified the Contracting Officer that all deficiencies have been corrected, the Contracting Officer will take one of the following actions:

If the Contracting Officer determines that the Contractor has corrected all ~~significant deficiencies~~ material weaknesses as directed by the Contracting Officer's final determination, the Contracting Officer will, as appropriate, discontinue the withholding of progress payments and performance-based payments, and direct the Contractor, in writing, to discontinue the payment withholding from billings on interim cost vouchers under this contract associated with the Contracting Officer's final determination, and authorize the Contractor to bill for any monies previously withheld that are not also being withheld due to other significant deficiencies. Any payment withholding under this contract due to other ~~significant deficiencies~~ material weaknesses, will remain in effect until the Contracting Officer determines that those significant deficiencies are corrected.

If the Contracting Officer determines that the Contractor still has ~~significant deficiencies~~ material weaknesses the Contracting Officer will continue the withholding of progress payments and performance-based payments, and the Contractor shall continue withholding amounts from its billings on interim cost vouchers in accordance with paragraph (e) of this clause, and not bill for any monies previously withheld.

If the Contracting Officer determines, based on the evidence submitted by the Contractor, that there is a reasonable expectation that the corrective actions have been implemented and are expected to correct the ~~significant deficiencies~~ material weaknesses, the Contracting Officer will discontinue withholding payments, and release any payments previously withheld directly related to the ~~significant deficiencies~~ material weaknesses identified in the Contractor notification, and direct the Contractor, in writing, to discontinue the payment withholding from billings on interim cost vouchers associated with the Contracting Officer's final determination, and authorize the Contractor to bill for any monies previously withheld.

If, within 90 days of receipt of the Contractor notification that the Contractor has corrected the ~~significant deficiencies~~ material weaknesses, the Contracting Officer has not made a determination in accordance with paragraphs (f)(2)(i), (ii), or (iii) of this clause, the Contracting Officer will reduce withholding directly related to the ~~significant deficiencies~~ material weaknesses identified in the Contractor notification by at least 50 percent of the amount being withheld from progress payments and performance-based payments, and direct the Contractor, in writing, to reduce the payment withholding from billings on interim cost vouchers directly related to the ~~significant deficiencies~~ material weaknesses identified in the Contractor notification by a specified percentage that is at least 50 percent, but not authorize the Contractor to bill for any monies previously withheld until the Contracting Officer makes a determination in accordance with paragraphs (f)(2)(i), (ii), or (iii) of this clause.

At any time after the Contracting Officer reduces or discontinues the

withholding of progress payments and performance-based payments, or directs the

Contractor to reduce or discontinue the payment withholding from billings on interim cost vouchers under this contract, if the Contracting Officer determines that the Contractor has failed to correct the ~~significant deficiencies~~ material weaknesses identified in the Contractor's notification, the Contracting Officer will reinstate or increase withholding from progress payments and performance-based payments, and direct the Contractor, in writing, to reinstate or increase the percentage withheld on interim cost vouchers to the percentage initially withheld, until the Contracting Officer determines that the Contractor has corrected all ~~significant deficiencies~~ material weaknesses as directed by the Contracting Officer's final determination.

252.242-7006 Accounting System Administration.

As prescribed in 242.7503, use the following clause:

ACCOUNTING SYSTEM ADMINISTRATION (FEB 2012)

a) *Definitions.* As used in this clause—

(1) ~~“Acceptable accounting system” means a system that complies with the system has an effective internal control structure complies with the system criteria in paragraph (c) of this clause to provide reasonable assurance that—~~ (i) ~~Applicable laws and regulations are complied with;~~

~~(ii) The accounting system and cost data are reliable;~~

~~(iii) Risk of misallocations and mischarges are minimized; and~~

~~(iv) Contract allocations and charges are consistent with billing procedures.~~

criteria of the applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.

(2) “Accounting system” means the Contractor’s system or systems for accounting methods, procedures, and controls established to gather, record, classify, analyze, summarize, interpret, and present accurate and timely financial data for reporting in compliance with applicable laws, regulations, and management decisions, and may include subsystems for specific areas such as indirect and other direct costs, compensation, billing, labor, and general information technology.

(3) “Material Weakness” means a deficiency, or combination of deficiencies, in internal control over risks related to Government contract compliances or other shortcomings in the system, such that there is a reasonable possibility that a material noncompliance will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible, meaning the chance of the future event occurring is more than remote but less than likely, or is probable.

(4) “Significant Deficiency” ~~means a material weakness, or a combination of material weaknesses, in internal control over government reporting objectives, such that there is a reasonable possibility that a material mischarge will not be prevented or detected on a timely basis. A shortcoming in the system that materially affects the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes~~ a deficiency, or combination of deficiencies, in internal control over Government contract risks or other

shortcomings in the system that is less severe than a material weakness yet important enough to merit the attention of those charged with governance.

(5) “Other Deficiency” means a deficiency, or combination of deficiencies, in internal control over Government contract risks or other shortcomings in the system that have a clearly trivial, or inconsequential, effect on the ability of the business system to detect and correct errors on a timely basis.

(6) “Material Noncompliance” means a misstatement in the information provided to the Government (e.g. billings, incurred cost submissions, pricing proposals, etc.) that will materially influence, and may adversely impact the economic or management decisions of the users of the information.

(7) “Misstatement” means that contract costs that are billed, proposed, or reported, to the United States Government do not comply with contract terms and federal regulations such as contract terms, Federal Acquisition Regulations (FAR) and Cost Accounting Standards (CAS).

(8) Acceptable contractor business system means contractor business systems that comply with the criteria of the applicable business system clauses and does not contain a material weakness that would affect the ability of officials of the Department of Defense to rely upon information produced by the system that is needed for management purposes.

(b) *General.* The Contractor shall establish and maintain an acceptable accounting system. Failure to maintain an acceptable accounting system, as defined in this clause, shall result in the withholding of payments if the contract includes the clause at 252.242-7005, Contractor Business Systems, and also may result in disapproval of the system.

(c) *System criteria.* The Contractor’s accounting system shall be evaluated by an internal control audit that provides reasonable assurance that government reporting objectives are met. The auditor will evaluate whether key internal controls are in place and operating in order to ~~provide for~~ provide reasonable assurance that:

- Direct costs and indirect costs are classified in accordance with contract terms, FAR, CAS and other regulations, as applicable.
- Direct costs are identified and accumulated by contract in accordance with contract terms, FAR, CAS and other regulations, as applicable.
- Methods are established to accumulate and allocate indirect costs to contracts in accordance with contract terms, FAR, CAS and other regulations, as applicable.
- General ledger control accounts accurately reflect all transactions recorded in subsidiary ledgers and/or other information systems that either integrate or interface with the general

ledger including, but not limited to, timekeeping, labor cost distribution, fixed assets, accounts payable, project costs, and inventory.

- Adjustments to the general ledger, subsidiary ledgers, or other information systems bearing upon the determination of contract costs (e.g. adjusting journal entries, reclassification journal entries, cost transfers, etc.) are done for reasons that do not violate contract terms, FAR, CAS, and other regulations, as applicable.
- Identification and treatment of unallowable costs are accomplished in accordance with contract terms, FAR, CAS and other regulations, as applicable.
- Billings are prepared in accordance with contract terms, FAR, CAS and other regulations, as applicable.

(d) *Significant Deficiencies Material Weaknesses*. (1) The Contracting Officer will provide an initial determination to the Contractor, in writing, of any ~~significant deficiencies~~ material weaknesses. The initial determination will describe the ~~deficiency~~ weakness in sufficient detail to allow the Contractor to understand the deficiency.

(2) The Contractor shall respond within 30 days to a written initial determination from the Contracting Officer that identifies ~~significant deficiencies~~ material weaknesses in the Contractor's accounting system. If the Contractor disagrees with the initial determination, the Contractor shall state, in writing, its rationale for disagreeing.

(3) The Contracting Officer will evaluate the Contractor's response and notify the Contractor, in writing, of the Contracting Officer's final determination concerning—

(i) Remaining ~~significant deficiencies~~ material weaknesses;

(ii) The adequacy of any proposed or completed corrective action; and

(iii) System disapproval, if the Contracting Officer determines that one or more ~~significant deficiencies~~ material weaknesses remain.

(e) If the Contractor receives the Contracting Officer's final determination of ~~significant deficiencies~~ material weaknesses that may result in a system disapproval, the Contractor shall, within 45 days of receipt of the final determination, either correct the ~~significant deficiencies~~ material weaknesses or submit an acceptable corrective action plan showing milestones and actions to eliminate the ~~significant deficiencies~~ material weaknesses.

(f) *Withholding payments*. If the Contracting Officer makes a final determination to disapprove the Contractor's accounting system, and the contract includes the clause at 252.242-7005, Contractor Business Systems, the Contracting Officer will withhold payments in accordance with that clause.
(End of clause)

SUBPART 242.70-- CONTRACTOR BUSINESS SYSTEMS

(Revised February 24, 2012)

242.7000 Contractor business system deficiencies.

(a) *Definitions.* As used in this subpart—

“Acceptable contractor business systems” and “contractor business systems” are defined in the clause at 252.242-7005, Contractor Business Systems.

“Covered contract” means a contract that is subject to the Cost Accounting Standards under 41 U.S.C. chapter 15, as implemented in regulations found at 48 CFR 9903.201-1

(see the FAR Appendix) (10 U.S.C. 2302 note, as amended by section 816 of Public Law 112-81).

Significant deficiency is “Deficiencies” are defined in the clause at 252.242-7005, Contractor Business Systems.

(b) *Determination to withhold payments.* If the contracting officer makes a final determination to disapprove a contractor’s business system in accordance with the clause at 252.242-7005, Contractor Business Systems, the contracting officer shall—

(1) In accordance with agency procedures, identify one or more covered contracts containing the clause at 252.242-7005, Contractor Business Systems, from which payments will be withheld. When identifying the covered contracts from which to withhold payments, the contracting officer shall ensure that the total amount of payment withholding under 252.242-7005 does not exceed 10 percent of progress payments, performance-based payments, and interim payments under cost-reimbursement, labor-hour, and time-and-materials contracts billed under each of the identified covered contracts. Similarly, the contracting officer shall ensure that the total amount of payment withholding under the clause at 252.242-7005, Contractor Business Systems, for each business system does not exceed five percent of progress payments, performance-based payments, and interim payments under cost-reimbursement, labor-hour, and time-and-materials contracts billed under each of the identified covered contracts. The contracting officer has the sole discretion to identify the covered contracts from which to withhold payments.

(2) Promptly notify the contractor, in writing, of the contracting officer’s determination to implement payment withholding in accordance with the clause at 252.242-7005, Contractor Business Systems. The notice of payment withholding shall be included in the contracting officer’s written final determination for the contractor business system and shall inform the contractor that—

(i) Payments shall be withheld from the contract or contracts identified in the written determination in accordance with the clause at 252.242-7005, Contractor Business Systems, until

the contracting officer determines that there are no remaining ~~significant deficiencies~~ **material weaknesses**; and

(ii) The contracting officer reserves the right to take other actions within the terms and conditions of the contract.

(3) Provide all contracting officers administering the selected contracts from which payments will be withheld, a copy of the determination. The contracting officer shall also provide a copy of the determination to the auditor; payment office; affected contracting officers at the buying activities; and cognizant contracting officers in contract administration activities.

(c) *Monitoring contractor's corrective action.* The contracting officer, in consultation with the auditor or functional specialist, shall monitor the contractor's progress in correcting the deficiencies. The contracting officer shall notify the contractor of any decision to decrease or increase the amount of payment withholding in accordance with the clause at 252.242-7005, Contractor Business Systems.

(d) *Correction of ~~significant deficiencies~~ **material weaknesses**.* (1) If the contractor notifies the contracting officer that the contractor has corrected the ~~significant deficiencies~~ **material weaknesses**, the contracting officer shall request the auditor or functional specialist to review the correction to verify that the deficiencies have been corrected. If, after receipt of verification, the contracting officer determines that the contractor has corrected all ~~significant deficiencies~~ **material weaknesses** as directed by the contracting officer's final determination, the contracting officer shall discontinue the withholding of payments, release any payments previously withheld, and approve the system, unless other ~~significant deficiencies~~ **material weaknesses** remain.

(2) Prior to the receipt of verification, the contracting officer may discontinue withholding payments pending receipt of verification, and release any payments previously withheld, if the contractor submits evidence that the significant deficiencies have been corrected, and the contracting officer, in consultation with the auditor or functional specialist, determines that there is a reasonable expectation that the

corrective actions have been implemented and are expected to correct the ~~significant deficiencies~~ **material weaknesses**.

(3) Within 90 days of receipt of the contractor notification that the contractor has corrected the ~~significant deficiencies~~ **material weaknesses**, the contracting officer shall--

(i) Make a determination that—

(A) The contractor has corrected all ~~significant deficiencies~~ **material weaknesses** as directed by the contracting officer's final determination in accordance with paragraph (d)(1) of this section;

(B) There is a reasonable expectation that the corrective actions have been implemented in accordance with paragraph (d)(2) of this section; or

(C) The contractor has not corrected all ~~significant deficiencies~~ material weaknesses as directed by the contracting officer's final determination in accordance with paragraph (d)(1) of this section, or there is not a reasonable expectation that the corrective actions have been implemented in accordance with paragraph (d)(2) of this section; or

(ii) Reduce withholding directly related to the significant deficiencies covered under the corrective action plan by at least 50 percent of the amount being withheld from progress payments and performance-based payments, and direct the contractor, in writing, to reduce the percentage withheld on interim cost vouchers by at least 50 percent, until the contracting officer makes a determination in accordance with paragraph (d)(3)(i) of this section.

(4) If, at any time, the contracting officer determines that the contractor has failed to correct the ~~significant deficiencies~~ material weaknesses identified in the contractor's notification, the contracting officer will continue, reinstate, or increase withholding from progress payments and performance-based payments, and direct the contractor, in writing, to continue, reinstate, or increase the percentage withheld on interim cost vouchers to the percentage initially withheld, until the contracting officer determines that the contractor has corrected all ~~significant deficiencies~~ material weaknesses as directed by the contracting officer's final determination.

(e) For sample formats for written notifications of contracting officer determinations to initiate payment withholding, reduce payment withholding, and discontinue payment withholding in accordance with the clause at DFARS 252.242-7005, Contractor Business Systems, see PGI 242.7000.

242.7001 Contract clause.

Use the clause at 252.242-7005, Contractor Business Systems, in solicitations and contracts (other than in contracts with educational institutions, Federally Funded Research and Development Centers (FFRDCs), or University Associated Research Centers (UARCs) operated by educational institutions) when—

(a) The resulting contract will be a covered contract as defined in 242.7000(a); and

(b) The solicitation or contract includes any of the following clauses:

(1) 252.215-7002, Cost Estimating System Requirements.

(2) 252.234-7002, Earned Value Management System.

(3) 252.242-7004, Material Management and Accounting System.

(4) 252.242-7006, Accounting System Administration.

(5) 252.244-7001, Contractor Purchasing System Administration.

(6) 252.245-7003, Contractor Property Management System Administration.