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PSC STAFF

Stan Z. Soloway
President & CEO
soloway@pscouncil.org

Alan Chvotkin
Executive Vice President & Counsel
chvotkin@pscouncil.org

Bryan Bowman
Manager, Marketing
bowman@pscouncil.org

Matt Busby
Manager, Member Services
busby@pscouncil.org

Joe Carden
Vice President, Marketing
& Membership
carden@pscouncil.org

Elise Castelli
Manager, Media Relations
castelli@pscouncil.org

Bethany Egan
Administrator, Coalition of
International Development
Companies
egan@pscouncil.org

Larry Halloran
Director, PSC International
Development Initiative
halloran@pscouncil.org

Karen L. Holmes
Office Manager/Receptionist
holmes@pscouncil.org

Victoria Huet
Events Support Coordinator
huet@pscouncil.org

Roger Jordan
Vice President, Government
Relations
jordan@pscouncil.org

Jeremy W. Madson
Manager, Federal Affairs
madson@pscouncil.org

Kate Petersen
Manager, Legislative Affairs
petersen@pscouncil.org

Melissa R. Phillips
Director of Meetings & Events
phillips@pscouncil.org

Robert Piening
Director of Finance
piening@pscouncil.org

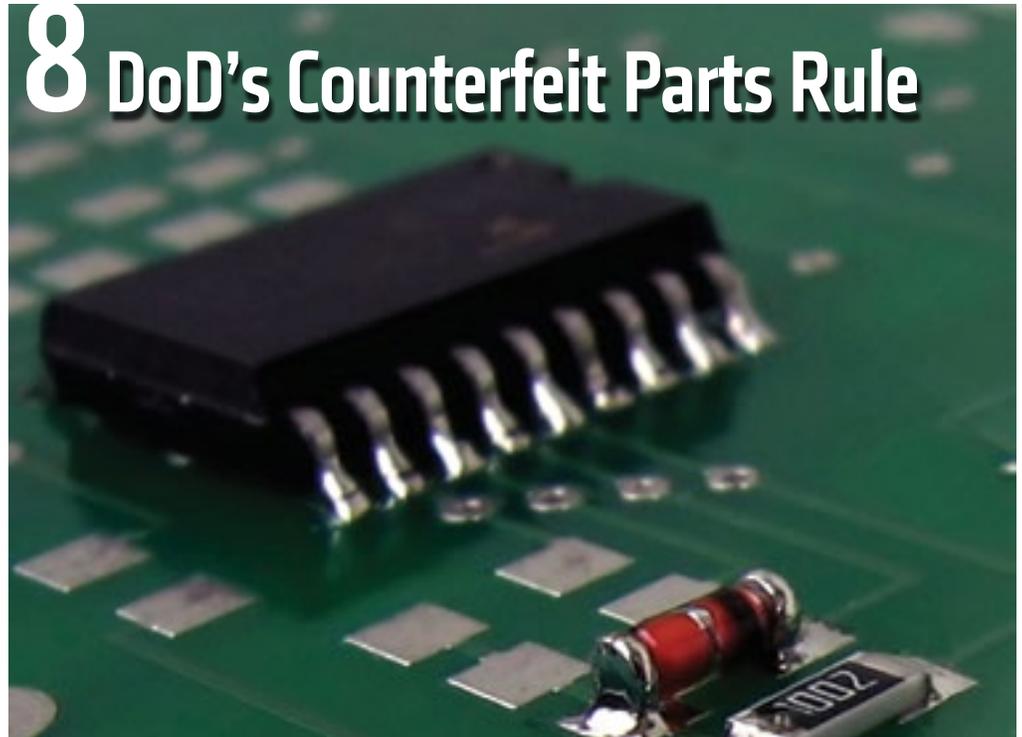
Jean Tarascio
Membership Associate
tarascio@pscouncil.org

Kristine Thomas
Executive Assistant
thomas@pscouncil.org

For advertising or to submit articles or items for the Member News section, contact: Bryan Bowman

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DoD's Counterfeit Parts Rule: *What Result When That Butterfly Beats Its Wings?*



by **Robert S. Metzger, Patricia A. Meagher and Jeffery M. Chiow**
Rogers Joseph O'Donnell

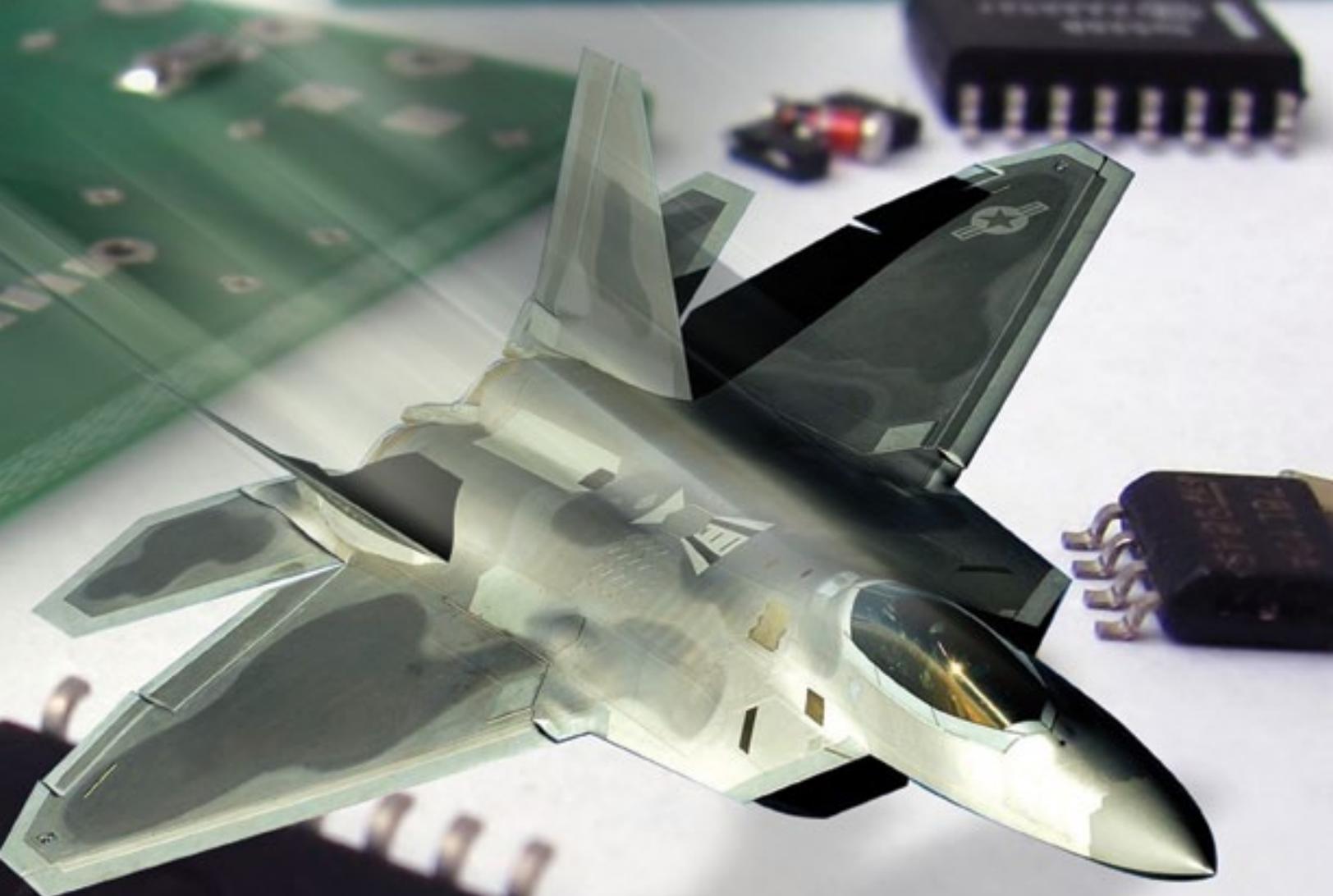
The rules concerning counterfeit electronic parts that the Department of Defense (DoD) was expected to publish on September 26, will, of course, impact contractors supplying electronic parts and systems to DoD. Perhaps less obvious are the reverberations that the new rules mandated by Section 818 of the 2012 National Defense Authorization Act (NDAA) will send throughout the defense supply chain and beyond, affecting

ostensibly commercial manufacturers and distributors as well as system integrators, logistics and supply chain support contractors, engineers, testing facilities, acquisition professionals, business consultants, accountants, lawyers, and many more service providers.

A Senate Armed Services Committee (SASC) hearing last November gave rise to the counterfeit parts legislation and the SASC's May 2012 investigative report provides substantial evidence that DoD's

systems and personnel are presently at risk because of counterfeit electronic parts. Recognizing that there is a problem, there are no easy answers.

More than 20 years ago the DoD began a steady and substantial shift away from purchasing military specific (MIL-SPEC) items in order to enjoy the benefits of the commercial market. The movement toward commercial technologies revolutionized federal acquisitions and the way we live. For all the criticism lobbed at DoD acquisitions, imagine how much each



MIL-SPEC GPS-enabled, 9.5" x 7.3", touch-sensitive, rugged, handheld data storage and computation device would cost—certainly much more than any of the ubiquitous tablet devices available with a government purchase card. At the same time, the existence of an active government market no doubt encouraged many technical innovations in the commercial sector. While both DoD and commercial companies

benefited from this symbiotic relationship, the failure to adequately consider military-specific needs, such as decades-long system lives versus the short production cycles for constantly evolving commercial products, created a chasm between DoD's needs and what the commercial market could readily supply.

The resulting obsolescence problem has created an urgent need for military-grade electronic parts to repair or replace aging DoD systems. At some point in the short lifecycle of commercial electronics, manufacturers stop producing one product so that they can begin making the successor product that is more capable and intended to meet evolving commercial

needs. From that point forward, there is a finite stock of genuine parts from which anyone with a need may draw. As the supply decreases, prices for older parts increases and eventually creates an incentive for unscrupulous actors to create counterfeit parts. In the city of Shenzhen, China, an entire counterfeit industry exists to provide bogus parts to meet the demand for hard-to-find parts.

Beginning in 2008, media reports first identified the counterfeit parts problem in DoD's supply chain suggesting that counterfeit parts had been included in fielded military aircraft and were degrading the reliability of U.S. weapons systems. In the succeeding years, investigations

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by the Department of Commerce's Bureau of Industry and Security, Government Accountability Office (GAO), SASC and DoD itself confirmed that DoD's supply chain was infected with counterfeit parts and that reforming DoD and contractor purchasing practices was a necessary step in dealing with counterfeit parts. Section 818 represents Congress's attempt to mandate that DoD and its contractors take the steps necessary to reduce the risk of counterfeit electronic parts. A full discussion of Section 818's requirements is beyond the scope of this article, so we will focus on the likely impact of key requirements on service contractors.

1. Costs of counterfeits and remediation. Section 818 makes contractors responsible for the costs of any counterfeit part delivered to DoD and any associated rework or corrective action. All such costs are unallowable. Even setting aside



the issue of the government's role in creating the counterfeit parts problem, implementing the rule in the real world exposes prime contractors to substantial and inevitable risk. The law requires contractors to, whenever possible, purchase electronic parts from Original Equipment Manufacturers (OEMs), their authorized distributors or "trusted suppliers." If a contractor follows that mandate and purchases from one of these three trustworthy sources or receives

a part as government-furnished equipment (GFE), the law still seeks to place 100 percent of the financial responsibility on the contractor. Prime contractors will understandably seek to shift risk to suppliers by requiring certifications and indemnification; and the counterfeit parts clause will be a mandatory flow down provision. Nonetheless, service professionals will need to create terms and conditions that account for this novelty and the inability, especially of lower-tier participants, to accept liability substantially beyond the contract value.

In most cases, contract liability as between the prime contractor and the government is a negotiated term, and the government self-insures. Where Section 818 is concerned, the law makes the prime contractor the insurer against counterfeit parts-related liability—potentially in excess of the contract value—which the contractor may have been forced to

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accept by the government's purchasing rules. Evaluating, managing, pricing and dealing with claims relating to that risk will require the skills of many service professionals.

2. Contractor systems to detect and avoid counterfeit parts. DoD's new regulations provide the framework for new contractor systems for the detection and avoidance of counterfeit electronic parts. Many elements of required contractor systems are spelled out in the law and supply chain scholars and standards organizations have developed guidance on mitigating the risk of counterfeit parts. Establishing, operating, auditing and certifying those contractor systems will also require the skills of many service professionals. Other service providers will perform, perhaps as a third party, testing and inspection services.

3. Managing obsolescence. Contractors that deliver new products to DoD, and those that

have contracts to perform operations and maintenance support, will need to account for and, where possible, avoid the business risk posed by Section 818. At all stages, from bidding through performance, contractors may involve engineers, risk analysts, quality professionals and other service professionals to mitigate the risk posed by obsolete parts. Similarly, for contracts already in place, if purchasing from reliable sources is not possible, contractors will need to consider or create alternatives through engineering, refurbishing or replicating parts of unknown authenticity. Contractors should notify DoD before trying to replicate parts because even if they are successful, they will have likely introduced a "counterfeit part" under DoD's current definition.

DoD's counterfeit parts regulation will likely be a precursor to requirements that will someday apply to all federal acquisitions. So

even companies that deal primarily with civilian agencies will want to stay apprised of DoD's implementation and industry's efforts to deal with the unique obligations imposed by Section 818. There will be many challenges in implementation, and over time contractors and the government will reorder their practices to satisfy the laudable goal of avoiding counterfeit parts in systems the government buys. Until that occurs, there will be no shortage of problems in need of service sector solutions.

Rogers Joseph O'Donnell, with offices in San Francisco and Washington, D.C., has a national reputation built on 30 plus years committed to public contracting matters. Robert S. Metzger is the partner in charge of Rogers Joseph O'Donnell's D.C. office; Patricia A. Meagher is a partner in Rogers Joseph O'Donnell's San Francisco office; and Jeffery M. Chiow is an associate in Rogers Joseph O'Donnell's D.C. Office.

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