Excessive Pass-Through Costs

Executive Summary

Due to a new FAR provision effective January, 2011, and new audit Guidance from DCAA, indirect costs and fee or profit associated with subcontracts may be unallowable when the total subcontracted content of a contract or individual delivery order exceeds seventy percent of the total cost.

The contracting officer may make a determination that pass-through costs are excessive and thus unallowable prior to award, but is not required to do so. DCAA will examine contracts containing the new implementing FAR clause during incurred cost submission audits and the review of final vouchers. This means that any DCAA opinion on allowability of indirect costs or fee/profit associated with subcontract costs may not be rendered until years after the costs are incurred.

DCAA audit guidance on the new provisions appears to reach far beyond the intent of the regulation and effectively puts the burden on the contractor to "demonstrate" the value added by the indirect costs. Absent such demonstration, auditors are required to question the allowability of both the indirect costs and any fee or profit associated with all subcontract costs on the covered contract or delivery order.

These new regulations and the implementing guidance could result in sweeping changes to large IDIQ, MAC and GWAC programs currently dependent on large prime/sub teams for delivery order performance.

Background

The concept of limiting the allowability of G&A and profit on subcontracts goes back to a failed House bill, the Clean Contracting Act of 2006. That bill, sponsored by Congressman Henry Waxman (D, CA) was partially a response to a public outcry over FEMA contracting in the aftermath of Hurricane Katrina.

The bill proposed to…

- ban "monopoly contracts" and most IDIQs
- reduce the use of cost-plus contracts
- prohibit "layer cake" deals that inflate costs through tiers of subcontractors
- limit noncompetitive contracts
- increase oversight, and effectively ban award fees
- deter corruption in contracting
- end sole source contracting with Alaska Native Corporations
- require Prime contractors to perform 65% of the work on ALL contracts

The bill failed, but a provision was successfully inserted in the National Defense Authorization Act (NDAA) for Fiscal Year 2007 to require DoD to "prescribe regulations to ensure that pass-through charges on contracts or subcontracts that are entered into for or on behalf of DoD are not excessive in relation to the cost of work performed by the relevant contractor or subcontractor." The language was somewhat vague and applied only to Defense contracts, but it did provide a starting point for the initiative.

In the mean time, a bill very similar to the Clean Contracting Act entitled the "Accountability in Government Contracting Act," was offered by Senator Susan Collins (R, ME) in 2007 including a provision which would have required tiering of subcontracts to be "minimized." The bill was flawed in a number of respects and was never reported out of committee.

The same year, Senator Byron Dorgan (D, ND) offered yet another version, the "Honest Leadership & Accountability in Contracting Act," but that bill also failed to survive committee consideration.

Congressman Henry Waxman (D, CA) then reintroduced a somewhat watered down version of his "Clean Contracting Act," in 2008, but once again, the bill seemed unlikely to pass.

Public Awareness of the Issue

There was little or no public awareness or interest in the issue, despite a DFARS rule that was effective 26 April, 2007 (implementing the requirement of the 2007 NDAA), until the 2008 Presidential campaigns. In a number of stump speeches, Senator John McCain began to publicize the issue, railing against what he termed "layer cake contracting." His speeches cited examples of costs that doubled or tripled as invoices passed through multiple layers of subcontract tiers. His unfortunate staffers were unable to find real examples of such invoices, but that didn't deter the bloggers or the media.

Actually, the public response was a resounding yawn, but the Congressional response was somewhat more alert.

The Enabling Legislation and Chronology of the Rule

Anticipating yet another failure of the Clean Contracting Act, Congressman Waxman inserted the entire 2008 version of the bill into the Duncan Hunter National Defense Authorization Act (NDAA) for Fiscal Year 2009 (H.R. 5658) as an amendment. The amendment contained a section entitled "Anti-Fraud Provisions," another entitled "Curbing Abuse-Prone Contracts," and, finally, a provision requiring that the FAR be modified within one year to insert a provision to "minimize the excessive use by contractors of subcontractors, or of tiers of subcontractors, that add no or negligible value, and to ensure that neither a contractor nor a subcontractor receives indirect costs or profit on work performed by a lower tier subcontractor to which the higher-tier contractor or subcontractor adds no, or negligible, value."

Passage of the 2009 NDAA kicked off the rule-making process on 14 October, 2008. Section 866 of the Act required an implementing FAR change within one year resulting in the following actions:

- 14 October, 2009 – Interim rule published for comment
- 14 December, 2009 – Comment period end
- 13 December, 2010 – Final rule published in the Federal Register
- 13 January 2011 – Final Rule became effective

While not actually part of the rule-making process, there was one more significant event on 18 February, 2011. DCAA issued guidance to auditors on excessive pass through costs via Audit Guidance Memo (AGM) 11-PSP-003

The FAR Changes to Implement the Rule

FAR was amended with changes to…

- Prohibit "excessive" pass-through charges on cost-reimbursement contracts with civilian agencies in excess of the simplified acquisition threshold
- Prohibit “excessive” pass-through charges on all types of contracts with DOD in excess of $650,0000 (except for fixed-price contracts awarded based on adequate price competition or for commercial items)
- Require that the provisions be flowed down to subcontractors
- Require that covered contractors and subcontractors report specific information about pass-through charges (indirect costs and profit) either…
  - In their proposals when they intend to subcontract more than 70 percent of the contract or subcontract effort, or
  - After award when they actually subcontract more than 70 percent of the effort

The FAR Mechanisms

New Instructions to Contracting Officers

A new FAR provision was added to Part 15 to control use of the new FAR Solicitation provision and contract clause(s).

15.408 (n), Limitations on Pass-Through Charges.

> (1) The contracting officer shall insert the provision at 52.215-22, Limitations on Pass-Through Charges—Identification of Subcontract Effort, in solicitations containing the clause at 52.215-23.

The contract clause at 52.215-23 is required…

- For civilian agencies, in all cost-reimbursement contracts over the simplified acquisition threshold ($100k)
- For DOD, in all contracts except…
  - A firm-fixed-price contract awarded on the basis of adequate price competition;
  - A fixed-price contract with economic price adjustment awarded on the basis of adequate price competition;
  - A firm-fixed-price contract for the acquisition of a commercial item; or
  - A fixed-price contract with economic price adjustment, for the acquisition of a commercial item.

The difference in the treatment of DoD and Civilian Agency contract arises out of the differing provisions of the 2007 and 2009 National Defense Authorization Acts. The 2007 provision applies to all contracts except certain types of fixed price arrangements. The 2009 provision extends coverage to the contracts with Civilian agencies, but only for cost-reimbursable contracts.

A New Cost Principle

The FAR cost principles were modified to insert a new category of unallowable costs in Part 31, Section 203.

31.203 (i) - Indirect costs that meet the definition of "excessive pass-through charge" in 52.215-23, are unallowable.

A New Solicitation Provision

A new FAR Solicitation Provision was added:

52.215-22 Limitations on Pass-Through Charges—Identification of Subcontract Effort.

- Requires that excessive [pass-through charges be excluded from the proposal
- Requires that the proposal identify the ($) amount of work to be performed by subcontractors
- If the amount to be subcontracted exceeds 70%...
    - Requires the Prime to describe (and substantiate) the value added to be performed with respect to the subs efforts (indirect, not direct)
    - Requires the Prime to identify the amount of all indirect cost and profit applicable to (each) sub's work
- Requires a flow down to subs for proposal purposes

A New Contract Clause

A new contract clause, "Limitations on Pass-Through Charges," was added at FAR 52.215-23.

As prescribed in 15.408(n)(2), use the following clause:
LIMITATIONS ON PASS-THROUGH CHARGES (OCT 2009)

Here are the highlights of the clause…

- 52.215-23(b) - The Government will not pay excessive pass-through charges. The Contracting Officer shall determine if excessive pass-through charges exist.
- 52.215-23(c)(1) - The Contractor shall notify the Contracting Officer in writing if—
    - The Contractor changes the amount of subcontract effort after award such that it exceeds 70 percent of the total cost of work to be performed
    - Any subcontractor changes the amount of lower-tier subcontractor effort after award such that it exceeds 70 percent of the total cost of the work to be performed under its subcontract
- 52.215-23(d)(1) - If the Contracting Officer determines that excessive pass-through charges exist
    - For other than fixed-price contracts, the excessive pass-through charges are unallowable
    - For applicable DoD fixed-price contracts, as identified in 15.408(n)(2)(i)(B), the Government shall be entitled to a price reduction for the amount of excessive pass-through charges
- Flowdown to subs is required. (Note that the reporting responsibility is on the Prime, NOT the sub)
- Subs must report to the Prime (who is then required to report to the Gov't)

The DCAA Audit Guidance

DCAA guidance to auditors on excessive pass through costs was issued in the form of Audit Guidance Memo (AGM) 11-PSP-003(R) on 18 February, 2011.

The memo provides direction as follows: "as part of a forward proposal pricing audit, auditors should perform procedures to evaluate a contractor's proposed support to demonstrate its added value when the proposed subcontracts are expected to exceed 70 percent of the total costs of the work performed"

It also directs that during "incurred cost audits and evaluations of final vouchers, auditors should also perform procedures to test compliance with the subject FAR provisions"

DCAA's (Mis)Interpretation of the FAR Rule

The new FAR provisions require the Prime to "provide a description of the added value it will provide" and gives examples such as processing orders, maintaining inventory, reducing delivery lead times, managing multiple sources, coordinating deliveries, and performing quality assurance.

The new DCAA Audit Guidance requires auditors to "evaluate the reasonableness of the contractor's description and supporting documentation of the added value"

Neither "reasonableness of the description" nor "supporting documentation for the added value" are required by the FAR provisions.

With respect to audits of final vouchers, DCAA again oversteps the regulation by requiring the auditors to "provide a description *and a demonstration* of the added value by the contractor" DCAA further directs auditors to question costs and profits as excessive if "the contractor cannot demonstrate its added value efforts." Finally, DCAA reminds auditors that "functions/costs not determined excessive under FAR 31.203(i) are still subject to the general (FAR 31.2) allowability, allocability, and reasonableness criteria"

In other words, if you can't question the costs under the new excessive pass-through clause, question them as not allocable or not reasonable.

The Effect of the Audit Guidance

Given the new audit guidance on this issue and the outstanding audit guidance on Government officials who ignore DCAA recommendations, the following expectations seem reasonable:

- G&A and profit on any proposal, contract or delivery order with more than 70% subcontracting are likely to be questioned
- Most contracting officers will be likely to pursue those recommendations – perhaps post-award in many cases.
- The solicitation provision and contract clause(s) will almost certainly be misused.

Agencies are already including the provision in commercial item acquisitions despite the fact that they are exempted from the requirement and FAR Part 12 bars "the tailoring of solicitations for commercial items in a manner inconsistent with customary commercial practice."

One such solicitation out of DLA has already been the subject of a protest

The agency defended the use of the provisions saying that it “wanted to avoid excessive pass through charges from multiple sources along the supply chain.”

GAO denied the protest

Contractor Exposure

The intent of the new FAR solicitation provisions and clauses is for the contracting officer to be aware of the subcontract content and to afford the Government the opportunity to make a pre-determination that pass-through charges are “excessive” and thus unallowable. There is, however, no *requirement* for such a determination and consequently the lack of such determination is no protection against a future disallowance. Likewise, there is no provision for a pre-determination that such charges will be allowable. By making no determination at or prior to award, the Government can give itself as many bites at this particular apple as it would like.

Failure to report if a contract’s subcontract content has “grown” post award to exceed 70% is a contractual non-compliance and could result in a finding of a significant system deficiency. DCAA’s Audit Guidance Memo (AGM) 11-PSP-003 states “If the auditor finds through the procedures below that the contractor failed to comply with the requirements of FAR 52.215-23(c) this should be considered an accounting and/or purchasing system deficiency.”

In ALL contracts where subcontract costs exceed 70% of the total, the auditors are directed “If the contractor cannot demonstrate its “added value” efforts, then the indirect costs (and profit) added by the contractor to the subcontracted work should be questioned.”

Unfortunately, AGM 11-PSP-003 directs these reviews in proposals, the incurred cost submissions and final vouchers, but no other time. While other examinations could certainly occur, it would be unlikely given DCAA’s current backlog of other work. As a result, any opinion by DCAA as to the allowability of indirect costs and profit applied to subcontract costs may not surface until years after the costs were incurred. In some cases, it could be many years afterward.

The FAR language treats each delivery order separately. Most other examination of subcontracting efforts on IDIQ contracts (such as Small Business Subcontracting Plan Compliance) is conducted on the total contract (or even on an Enterprise basis), not delivery order by delivery order. This could effectively ban G&A and profit on “pass-through” prime/sub IDIQ arrangements – like many orders placed under the Alliant, Encore, SEWP, Eagle, Seaport-e, and dozens of other programs.

Mitigation of the Exposure

Contractors should consider a value added G&A base if large teams or high subcontract content are part of the business model or strategy. The new FAR clause 52.215-23 contains a specific exception for “subcontract management costs” stating that costs to be disallowed are “*other than* charges for the costs of managing subcontracts and any applicable indirect costs and associated profit/fee based on such costs”. This would seem to specifically exempt the traditional “Material Handling” rate from disallowance under the new clause(s), but the very exclusion of subcontracts from a “Value Added” G&A base could also result in a near-automatic position by DCAA that there should also be no profit allowed.

Contractors should document very carefully the functions performed with respect to subcontract management and administration and the costs included in *any* indirect rate applied to subcontracts. They should also should develop standardized descriptions of the “value added” efforts performed and ensure they are in every proposal – not just the ones with high subcontract content.

Contractors should examine teaming and competitive strategies very carefully. The large team/order pass-through strategy that has been so successful on large competitive IDIQ programs may be considerably less attractive for future proposals unless…

- Orders are to be fixed price and competed, or
- The Prime will retain and perform more than 30% of every order

Contractors should monitor subcontract costs in both proposals and actual costs and make reporting both standard and routine.

Finally, they should ensure that every contract brief contains a statement concerning the value of services performed with respect to subcontracts.

Looking Forward

These new FAR provisions and DCAA’s audit guidance could have far-reaching implications for IDIQ programs designed to encourage teaming and pass-through arrangements.

- Seaport-e orders are heavily cost-type and often 99% subcontracted. G&A and profit may not be unallowable on such orders.
- Many other IDIQ programs’ contracts are held by a prime who passes work through to a subcontract team member. Those may also be affected.

In addition, the impact on “unpopulated joint ventures” where virtually all of the work is subcontracted to the venture companies is uncertain.

Since much of DCAA’s emphasis is on examination of subcontract costs through the incurred cost submission or final vouchers (possibly years after performance), it will almost certainly result in new documentation and record-keeping requirements.

Given the difficulty of making such subjective judgments on the effectiveness of efforts performed years before (such as subcontract administration or management), will DCAA could began reviewing subcontract content on interim vouchers, giving the Government still more bites at the apple?