

DCAA Update and Limitation on Subcontracting

**Bristol Bay Native Corporation
2016 Annual Compliance Conference
Stephen D. Knight
Smith Pachter McWhorter PLC**

Scope of Government Audit Rights

- FAR 52.215-2, “Audit and Records – Negotiation”
 - Cost, incentive, T&M, LH, price redeterminable contract – contractor shall maintain . . . all records and other evidence sufficient to reflect properly all costs claimed to have been incurred or anticipated to be incurred directly or indirectly in performance of this contract
 - Certified COPD pricing actions – CO, in order to evaluate the accuracy, completeness, and currency of the certified COPD shall have the right to examine and audit all of the contractor’s records, including computations and projections related to – the proposal; the discussions conducted on the proposal (negotiations); pricing; performance
 - 3 years after final payment or FAR 4.7

Scope of Government Audit Rights

- *US v. Newport News Shipbuilding & Dry Dock Co.*, 837 F. 2d 162 (4th Cir. 1988) (internal audit reports not within DCAA subpoena scope)
 - Compare *United States v. ISS Marine Servs., Inc.*, 905 F. Supp. 2d 121 (D.D.C. 2012) (court enforces DOD Inspector General administrative subpoena for internal audit report)
- Pub. L. No. 112-239, FY 2013 NDAA
 - § 832, “DOD Access to, Use of, and Safeguards and Protections for Contractor Internal Audit Reports” requires DCAA revised guidance:
 - Written determination that access necessary to evaluate business systems
 - Ensure DCAA use limited to evaluate internal controls and reliability of associated business systems

Scope of Government Audit Rights

- DCAA MRD 12-PPS-019(R), “Audit Guidance on Access to Contractor Internal Audit Reports” (Aug. 14, 2012)
 - Response to GAO-12-88
 - FAO process to monitor DCAA access/use of internal audit reports; ref DCAM 4-202.1h
 - If access denied, DCAA Instruction 7640.17 (Dec. 19, 2008)
 - Regional Director determine whether to subpoena; ref DCAA Regulations 5500.5 (Oct. 10, 2006)
- DCAA Audit Guidance, “Updated Audit Guidance on Access to Contractor Internal Audit Reports” (Apr. 23, 2013)
- Does scope of audit access increase with new clauses (*e.g.*, FAR 52.203-13, DFARS Subpart 242.70)?

Scope of Government Audit Rights

- Contractor attorney-client privileged documents
 - DCAA MRD 12-PPS-018(R), “Audit Guidance – Denial of Access to Records Due to Contractor Assertion of Attorney-Work Product Doctrine or Attorney-Client Privilege” (July 25, 2012)
 - DCAM 1-504.4g
 - Written basis of assertion, reason other documents cannot be provided to meet auditor’s needs; pursue until “high level executive” asserts privilege
 - Regional Director contact “top level management”: contractor required to support how it complies with contractual requirements using non-privileged data
 - Disclosure to DCAA = waiver of privilege
 - Disallowance if “inadequate support”?

What Is “Adequate Documentation?”

- When are data “adequate”? How much is enough?
- Are inadequately supported costs expressly unallowable?
- FAR 31.201-2(d)
 - Contractor is responsible “for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles . . . The [CO] may disallow all or part of a claimed cost that is inadequately supported”

What Is “Adequate Documentation?”

- *Bearingpoint, Inc.*, ASBCA No. 55354, 09-2 B.C.A. ¶ 34289
 - USAID determined contractor security costs in Iraq not allocable due to lack of contemporaneous documentation
 - “We reject AID’s central argument that the disputed labor charges are unallocable for insufficient documentation. The contract clauses do not impose the stringent requirements of either ‘nice neat little files’ that [the CO] sought or the contemporaneous records for which AID appears to be arguing . . . [FAR 52.215-2(b)] prescribes no form that the ‘records’ or the ‘other evidence’ must take, and in fact we have read the clause more liberally than AID’s position suggests”

Contract-Required Audit Procedure

- FAR 52.216-7, “Allowable Cost and Payment”
 - (d) final indirect cost rates and bases established under FAR 42.7:
 - Contractor submits indirect cost rate proposal
 - “Upon receipt of the proposal,” audit begins.
 - Government negotiating team; negotiation position; conduct negotiations
 - Government and contractor “shall establish the final indirect cost rates *as promptly as practical after receipt of the Contractor’s proposal.*”
FAR 52.216-7(d)(2)(ii).

DCAA Audit Procedure

- DCAA late on indirect rate audits
 - Breach of contract – FAR 52.216-7
 - “First Breach” doctrine
 - Statute of Limitations – 6 years
- DCAA disallows direct costs
 - SOL may run from invoice submission
 - Check supporting documents submitted w/invoice
 - Does ACO have authority to disallow, demand repayment?
 - Government burden of proof if demand repayment

DCAA Audit Issues

- Costs that attract DCAA's attention:
 - Travel costs: contractor, subcontractor, consultant; lowest available airfare documentation
 - Organization costs: “directly associated” legal costs, annual GAAP goodwill valuations
 - Compensation measurement and reasonableness: executive and employee – salary, bonus, fringe benefits, retirement – use of surveys
 - Consultant costs: documentation, retainer letter, invoices, work product

DCAA Audit Issues

- Costs that attract DCAA's attention:
 - Subcontract Costs – Documentation
 - “Action did not occur if not documented”
 - Commercial item determinations
 - Cost/Price analyses, reasonableness
 - Sole source determinations
 - Personnel qualifications
 - Original timecards
 - Travel, ODCs

Limitations on Subcontracting

- FAR 52.219-14, Limitations on Subcontracting
- SBA regulations: 13 CFR § 125.6, “What are the prime contractor’s limitations on subcontracting?”
 - Revised 81 Fed. Reg. 34243 (May 31, 2016), effective June 30, 2016
- FY 2013 National Defense Authorization Act, §1651, *codified in 15 USC §657s*

Limitations on Subcontracting

- FAR 52.219-14 not yet changed to match revised SBA regulations
 - Services (not construction): 50% of cost of contract performance incurred for personnel shall be expended for employees of the concern
 - Supplies: the concern shall perform work for at least 50% of cost of manufacturing, excluding materials cost
 - Construction: the concern will perform at least 15% (general)/25% (special trade) of cost of contract, excluding materials cost, with its own employees

Limitations on Subcontracting

- *Excel Manufacturing, Ltd. v. US*, 111 Fed. Cl. 800 (COFC 2013), interpreting FAR 52.219-14(c)
 - “total contract cost (including profit) less materials and subcontracting costs is to be compared with all subcontracting costs less the subcontractor’s materials costs”
 - “the contractor’s total costs figure should include overhead costs, general and administrative (G&A) costs and profit”
 - Not “a simple comparison” of prime contractor labor costs and subcontractors’ labor costs

Limitations on Subcontracting

- Revised rule
 - “Section 1651 of the NDAA creates a shift from the concept of a required percentage of work to be performed by a prime contractor to the concept of limiting a percentage of the award amount to be spent on subcontractors.” 81 Fed. Reg. at 34244.
 - NDAA excludes from calculation percentage of award amount that prime contractor spends on “similarly situated” entity subcontractors.
 - Any work that a similarly situated subcontractor further subcontracts will count towards the percentage amount that cannot be exceeded.

Limitations on Subcontracting

- Revised § 125.6
 - Services (except Construction): small business “will not pay more than 50% of the amount paid by the government to it to firms that are not similarly situated.”
 - Supplies/products: small business “will not pay more than 50% of the amount paid by the government to it to firms that are not similarly situated . . . Cost of materials are excluded and not considered to be subcontracted.”

Limitations on Subcontracting

- Revised § 125.6
 - General Construction: small business “will not pay more than 85% of the amount paid by the government to it to firms that are not similarly situated. . . Cost of materials are excluded and not considered to be subcontracted.”
 - Special Trade Contractors: “no more than 75% of the amount paid by the government to the prime may be paid to firms that are not similarly situated. . . Cost of materials are excluded and not considered to be subcontracted.”

Limitations on Subcontracting

- Revised § 125.6
 - Mixed Contracts: CO shall select appropriate NAICS code. The relevant limitation shall apply only to that portion of the contract award amount.
 - Period of time used to determine compliance “will be the base term and then each subsequent option period.” For orders, “agency will use the period of performance for each order”

Limitations on Subcontracting

- Revised § 125.6
 - Penalties
 - Greater of \$500,000 or dollar amount spent, in excess of permitted levels, by the entity on subcontractors
 - “A party’s failure to comply with the spirit and intent of a subcontract with a similarly situated entity may be considered a basis for debarment . . . “
 - Other criminal, civil, *e.g.*, FSA, FCA

Limitations on Subcontracting

- Recommendations
 - Establish single approach and follow consistently
 - Document company approach
 - Until FAR is revised, disclose to procuring agency company's procedure for complying with § 125.6
 - For new procurements, request procuring agency to confirm § 125.6 applicability
 - For pre-existing contracts, discuss applicability with CO

Questions?

Stephen D. Knight

Smith Pachter McWhorter PLC

8000 Towers Crescent Drive, Suite 900

Tysons Corner, VA 22182

USA

1.703.847.6284

sknight@smithpachter.com