It's a notable day when DCAA publishes a new MRD (Memorandum for Regional Directors). It's not like that happens very often anymore.

In February, DCAA published a new MRD (**19-PIC-001**) entitled "Audit Guidance on Revised Policies and Procedures for Auditing Incurred Subcontract and Inter-Organizational Transfer Costs."

Readers of this blog know that we have, in the past, taken issue with DCAA's approach to auditing subcontractor costs. DCAA is in a tough spot. They don't have privity of contract with the subcontractor, so they have to work through the prime contractor's costs. That means that if they question subcontractor costs during the audit of the subcontractor, and they believe the subcontractor's invoices to the prime were inflated by those questioned costs, then the method for recovering the inflated costs is to then question the prime contractor's claimed subcontractor costs. Which then puts the onus on the prime (not the government) to have the subcontractor make it whole by paying it (and not the government) the questioned costs.

That approach has a number of problems, not the least of which is the timing of the whole thing. Too often, when DCAA is reviewing the prime contractor's claimed costs the audit team reviewing the subcontractor's claimed costs isn't anywhere near to issuing its report. The timing situation leads to qualification of audit opinion, which doesn't help the contracting officers in the slightest.

Moreover, the entire Schedule J of the standard proposal to establish final billing rates is fundamentally flawed in concept and execution. According to the Allowable Cost and Payment clause (52.216-7, Aug. 2018), Schedule J is required to list "subcontracts awarded to companies for which the contractor is the prime or upper-tier contractor (include prime and subcontract numbers; subcontract value and award type; amount claimed during the fiscal year; and the subcontractor name, address, and point of contact information)."

Seems simple enough, right?

Let's start with: *what is a subcontract*? You want me to list it; so tell me what it is. Since the clause is prescribed by FAR Part 16, you would think that the definition would be found in that Part. *Nope.* No such luck. What about FAR Part 42? Since indirect rates are covered by 42.7, maybe the definition of subcontract can be found there? *Oops!*

Not there either. Okay. Maybe the definition can be found at FAR 2.101 (Definitions). Nope. Not there either. So what's a poor contractor, seeking to comply with the requirements of 52.216-7(d)(2)(iii)(J), to do?

At that point, the increasingly desperate contractor will probably beeline over to the DCAA website and download the "Checklist for Determining Adequacy of Contractor Incurred Cost Proposal." Looking that that document, the contractor may learn that Schedule J must include "all types of subcontracts (e.g., cost-type, T&M/LH, IDIQ with a variable element, and FFP) and inter-company costs claimed by the contractor on flexibly priced prime contracts and/or upper-tier subcontracts."

But wait a second. How did we get from listing subcontracts (whatever they are) to listing subcontracts *plus* inter-company costs? When did that get added to the required list? (We note for the record that various pieces of DCAA information for contractors are schizophrenic on this point: some guidance says inter-company costs should be included and other guidance doesn't. Further, if one looks at the example Schedule Js provided as an aide to contractors, none of those examples ever shows inter-company work.)

To sum this digression up, contractors are being asked to comply with the requirements of 52.216-7 by listing something that's never been defined and that may (or may not) include inter-organizational transfers. Objectively, compliance is not possible. But don't worry, because DCAA no longer audits three-quarters of the final billing rate proposals it receives. As a contractor, you only have a one-out-of-four chance of having an auditor dig into your Schedule J.

At this point, we're moving on.

Of course, the problem is bigger than Schedule J. The problem is that DCAA (and others) have been telling its auditors that prime contractors have responsibilities not found anywhere in regulations. Again, this assertion will not be news to readers of this blog.

See, for example, **this article** we wrote in 2016, taking issue with DCAA direction to auditors and contractors that, somehow, prime contractors were responsible "
to obtain an adequate incurred cost submission from subcontractor.

” Yeah, that was made-up bovine fertilizer, as we told our readers at the time.

And then, about six months later, we **wrote** about the ASBCA decision in the matter of Lockheed Martin Integrated Systems (LMIS), in which the Board sustained LMIS’s appeal of a COFD demanding some $117 million because the government’s case was predicated on a “plainly invalid legal theory” that was “originated by a [DCAA] auditor.” That LMIS case is important and, if you haven’t read it, you really should. Part of the recital of facts included some bits about how DCAA questioned $13.9 million of LMIS subcontractor costs (based on assist audit reports) but provided no details. Some amount of questioned (prime contractor) costs was based on differences between amounts claimed by LMIS in its annual proposal and amounts claimed by the subcontractors in their individual final billing rate proposals. All those issues were dismissed by the Board in its decision because the government’s case “provided no allegations of fact.” The decision stated—

Our pleading standard requires factual assertions beyond bare conclusory assertions to entitlement. The audit report, which was incorporated into the complaint, states that some assist audits questioned costs but does not explain on what grounds. It also states there were differences between amounts in LMIS's proposal and costs under subcontracts but provides no facts regarding these differences. More importantly, the COFD does not cite a single actual fact, only the audit report's unsupported conclusions.

Why didn’t DCAA (and the contracting officer) have more facts to offer in support of their claim against LMIS?

One theory is that the government ran out of time. The COFD was issued just one day before LMIS might plausibly argue that it was time-barred by the Contract Disputes Act’s Statute of Limitations. Another theory is that the subcontractor refused to allow DCAA to release its audit findings to the prime contractor. Chapter 10 of the Contract Audit Manual (CAM) briefly discusses this situation. The situation is also discussed in CAM Chapter 6 (Incurred Costs Audit Procedures) at 6-802.6. The CAM states—

When a DCAA subcontract assist audit is contemplated, the higher-tier contractor normally will have made satisfactory arrangements for its unrestricted access to the subcontract audit results so that it will be able to fulfill its responsibilities for settling any audit exceptions. In rare cases, this may be impracticable. … Before beginning a subcontract audit, determine whether the subcontractor will have any restrictions or reservations on release of the resulting audit report(s)

to the higher-tier contractor. A significant reservation exists if the subcontractor desires to withhold its decision on release of an audit report pending review of the audit results or report contents. If the subcontractor does not assure unrestricted report release at the outset, refer the matter to the requesting higher-tier contract auditor.

Readers, we have been doing this for 35 years now. And we have got to tell you, in all those years we have never, *ever*, seen a DCAA auditor refer a subcontractor denial of release to a higher-tier contract auditor, to the cognizant contracting officer, or to the prime contractor for resolution. But that's what the guidance says is supposed to happen.

In essence, the entire framework of DCAA's audit of subcontractor costs is predicated upon the subcontractor granting release of audit findings to the prime contractor. In our experience, that happens only very rarely. Thus, if the subcontractor objects to release of the audit findings to the prime (as is the norm), then what is DCAA to do? Nothing. All the auditor can do is simply provide the amount of questioned costs without detail.

And we've seen how the ASBCA felt about that.

Now, having taken way too long to set the stage, we can take a look at the latest piece of DCAA audit guidance. (Hey, remember how we started this article? It *does* seem like a long time ago!)

The new audit guidance states—

Subcontract assist audits will no longer be requested for the life of the subcontract; instead, auditors will evaluate risk every year and request subcontract assist audits as needed. … The prime auditor will no longer request assist audits for the life of the subcontract based on the total expected subcontract value at the time of award. Rather, the prime auditor, in coordination with the subcontractor auditor, will assess the risk and need for assist audit effort based on subcontract costs included in the prime contractor's annual incurred cost proposal.

Further (and in reference to the LMIS discussion, above), the new audit guidance states "… auditors should not question subcontract costs based solely on deficiencies in the prime

contractor's subcontract management process." It seems DCAA got the message. *Finally.*

In addition to the above, the MRD announced revisions to the 10100 Incurred Cost Audit Program (Post Year-end Audit) that "incorporate suggestions from the field and stress the importance of clear communication between prime and subcontract auditors."

The revised audit program now includes the following steps:

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Where the contractor is performing subcontract or inter-organizational effort (as a lower-tier contractor, coordinate with the prime DCAA office(s) on whether an audit of the subcontractor or inter-organizational transfer cost is needed and if so, coordinate the timing of the audit and expected completion date. If the prime DCAA office does not require an audit, exclude the subcontract / inter-organizational costs from audit and adjust audit scope and auditable dollars (ADV) accordingly.

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Adjust government participation for risk assessment purposes taking into consideration contracts already closed, non-DoD contracts and subcontracts for which the civilian agency (reimbursable customer) does not participate in our audit, *subcontract cost where the prime / upper-tier auditor does not require an assist audit* , T&M contracts, settled cost reimbursable terminations, and contracts subject to the class deviation pilot for innovative technology projects. (Emphasis added.)

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Calculate the materiality of direct costs for contracts subject to audit. Remove dollars associated with contracts that are closed, non-DoD contracts/subcontracts where agency is not participating, *dollars associated with subcontracts / IOTs that prime / upper-tier auditor does not require an audit* , and contracts subject to the class deviation pilot for innovative technology projects. (Emphasis added.)

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Assess the need for an assist audit on significant lower-tier subcontract and inter-organizational transfer (IOT) costs included in the prime/higher tier contractor's

(contractor under audit) ICP based on documented risk. This assessment should include coordination with the auditors cognizant of the lower-tier contractor / performing segment and should take place prior to sending a request for assist audit.

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Due care should be taken to ensure both the prime / upper-tier and lower tier subcontract audits are completed within the required timeframe (i.e. one year) for any adequate submission received December 12, 2017 or later.

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The prime / upper-tier and lower tier auditors should communicate known risks from their perspective early to design the nature, extent, and timing of appropriate audit procedures.

There may be other relevant audit steps, but those were the ones we saw.

Let’s wrap this up. Recognizing the difficulties in which it placed its auditors with respect to audits of subcontractor claimed costs, Fort Belvoir has made changes to its audit program. Those changes should go a long way toward addressing the difficulties. However, had the auditors been following CAM direction, the additional audit guidance may not have been necessary.