



# GOVERNMENT CONTRACTING INSIGHTS

Forward Thinking Thought Leadership

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## Increased Department of Defense (DOD) Spending Drives Greater Need for Adequate Contractor Business Systems

### Background

Government contractors have expressed relief over the recent 2016 Armed Services Board of Contract Appeals (ASBCA) decision concerning certain subcontractor costs questioned by the Defense Contract Audit Agency (DCAA). To know how this decision impacts contractors, it is important to understand the DCAA approach to evaluation of these costs. In recent years, DCAA has questioned the entire claimed subcontract amounts in many audits for prime contractor incurred cost submissions. The main reason for this is the prime contractor not having evidence showing an adequate audit of the subcontractor costs.

In the subject ASBCA case, the court sided with the contractor, Lockheed Martin Integrated Systems (LMIS), indicating that the Government had overreached in its conclusions regarding the prime contractor's responsibilities in this area. This white paper will discuss the case as well as the relevant requirements prime contractors face and best practices for compliance.

### ASBCA CASE 59508 and 59509

The heart of the dispute was related to DCAA's position (as supported by the Contracting Officer) that LMIS was responsible, under Federal Acquisition Regulation (FAR) 42.202(e)(2), Assignment of Contract Administration, to perform the role that the Government would play if the contract was a prime contract. Given this, all of the audit oversight responsibilities that the Government performs on the LMIS prime contract would be the responsibility of LMIS with regard to its subcontractors. However, LMIS and the ASBCA found flaws with this position. Principally, the cited FAR clause is not in the LMIS contract nor is it incorporated by reference. Therefore, DCAA's assertion was fatally flawed because it relied on the presumption that LMIS was subject to this clause. As a result, the ASBCA sided with LMIS and dismissed the Government's claim.

### DOD Inspector General (DODIG) Report

On December 23, 2014, the DODIG issued a report titled "Hotline Complaint Regarding the Defense Contract Audit Agency Examination of a Contractor's Subcontract Costs." In that report, the DODIG found that DCAA had failed to comply with Generally Accepted Government Auditing Standards (GAGAS) due to its approach of questioning subcontract costs through the application of a 20% decrement factor. The factor was applied because the prime contractor did not perform or initiate an audit of subcontractor incurred costs. Under GAGAS, the application of an arbitrary "decrement factor" is not permissible. To express an opinion, as DCAA did in its incurred cost audit reports, DCAA must accurately quantify its exceptions to be compliant with GAGAS. However, the DODIG report did not address the other aspects of the DCAA audit report including statements in the report about the prime contractor's responsibilities under certain FAR clauses. So, while it is likely that DCAA will discontinue application of the "decrement factor", this does not mean that prime contractors do not have reason for concern.

### Prime Contractor Responsibilities To Subcontract An Audit

While helpful, the ASBCA decision and DODIG report do not fully address the actual requirements for subcontract audit responsibilities of prime contractors. There are indications that DCAA will continue its approach of questioning subcontract costs. However, it will cite different regulations to support its position.

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## Regulatory Requirements For Subcontract Oversight

While specific requirements depend upon the nature of the subcontracts, requirements relative to cost-type subcontracts are more stringent than other contract types:

- **Cost-type (Cost Plus Fixed Fee, Cost Plus Incentive Fee, etc.):** These subcontracts present the most risk to prime contractors due to the likelihood of DCAA questioning subcontract costs. This is primarily because indirect rates are subject to true up and final audit before a contract can be closed.
- **Time and Material and Labor Hour Contracts:** These contracts are less chancy in terms of compliance risk because indirect rates are fixed and do not require audit. However, there are requirements relative to oversight of materials and other direct costs.

The primary clause included in Government contracts necessitating prime contractor review of subcontractor costs incurred is FAR Clause 52.216-7(d)(5), Allowable Cost and Payment. The clause addresses both interim reimbursement of costs and determination of final indirect rates and billing rates.

- **Interim Reimbursement of Costs:** To comply with this aspect of the clause, the contractor should have strong controls in place to review direct costs billed on a monthly basis, as interim billings are received, to ensure compliance with contract terms and FAR allowability requirements.
- **Determination of Final Indirect Rates:** This clause stipulates that "The prime contractor is responsible for settling subcontractor amounts and rates included in the completion invoice or voucher and providing status of subcontractor audits to the contracting officer upon request." To comply with this aspect of the clause, the contractor should ensure that an audit of indirect rates is performed either by DCAA, by the prime contractor's audit function, or by a CPA firm capable of performing GAGAS compliant audits. The Government has begun requiring GAGAS-compliant subcontract audits and audits that are not GAGAS-compliant are subject to rejection by the Government. Many prime contractors find that DCAA is unwilling to perform the subcontract audit because it lacks the internal capability to perform a GAGAS-compliant audit. In these circumstances, the prime contractor should consider engaging a qualified CPA firm to conduct the indirect rate audits.

## How CohnReznick Can Help

CohnReznick is a leader in auditing incurred cost submissions in accordance with GAGAS standards. We perform these audits in an efficient and timely manner. We have performed these audits directly for Federal agencies and the reports have uniformly been accepted by the Government. The costs of the audit are generally an allowable cost billable to the Government through the Government prime cost-type contract.

CohnReznick also provides consulting services to establish controls relative to subcontractor invoice review, subcontract audit, and close-out of subcontracts in accordance with FAR and DFARS requirements. Our proven methodology addresses the unique situations faced by contractors in reporting and substantiating their compliance to Government auditors.

We can also provide staff resources to supplement yours in performing subcontract administration duties. We can provide assistance with:

- Evaluating current subcontract oversight and audit policies and procedures, if present, and identify potential deficiencies
- Developing policies and procedures that address regulatory subcontract oversight and audit requirements
- Providing subcontract oversight and audit training based on the compliant policies and procedures
- Addressing issues raised by the DCAA or other Federal auditors
- Establishing an internal audit function that is capable of performing or overseeing the performance of GAGAS-compliant subcontract audits

## Contact

- **Christine Williamson**, Partner  
703-847-4412 | [christine.williamson@cohnreznick.com](mailto:christine.williamson@cohnreznick.com)
- **Kristin Soles**, Partner, Government Contracting Industry Practice Leader  
703-847-4411 | [kristen.soles@cohnreznick.com](mailto:kristen.soles@cohnreznick.com)
- **Jeff Witt**, Senior Manager  
703-847-4435 | [jeffrey.witt@cohnreznick.com](mailto:jeffrey.witt@cohnreznick.com)

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