

SUBCONTRACT AUDIT COMPLIANCE: IS YOUR COMPANY PREPARED?

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Government contractors – do you understand the expectations of your government customers regarding subcontract audits?

There have been changes to how the government assigns responsibility for audits of flexibly priced subcontracts, including cost type, time and material (T&M), and labor hour (LH). The Defense Contract Management Agency (DCAA) has made its position clear on this issue with the following directive to its contracting officers:

The prime contractor is responsible for auditing subcontractors and generally closes subcontracts using procedures similar to the government. The functional specialist shall ensure that the prime has settled subcontractor costs before closing a contract/order. [The Defense Contract Audit Agency (DCAA)] may issue a qualified indirect cost audit report indicating that audit of certain subcontract costs has not been completed...¹

DCAA has followed through and is qualifying its audits of prime contractors whenever there are flexibly priced subcontract costs that have not been audited. While recent contract appeals² have touched on subcontract audits, and hampered DCAA's ability to question the subject contracts' costs, these cases did not change the government's position that subcontract audits are generally the responsibility of the prime contractor. Therefore, DCAA now qualifies the costs. This means the contract cannot be closed until audits of the subcontractors have been performed by those responsible.

¹Defense Contract Management Agency, DCMA-INST 135 (March 8, 2016): § 3.2.3.2 "Subcontract Costs," available at <https://www.dcma.mil/Portals/31/Documents/Policy/DCMA-INST-135.pdf>.

²I.e., Lockheed Martin Integrated Systems Inc.; ASBCA Nos. 59508, 59509 (December 20, 2016).

Other agencies have followed a similar approach to assigning responsibility to conduct (or cause to be conducted) audits of flexibly priced subcontracts before the prime contract can be closed out. The Department of Energy, for example, includes a clause in its contracts requiring that subcontract audits be performed.

Some contractors have argued that there is presently no requirement in their contracts to compel them to audit their subcontractors. While this is debatable, it is still the government's position that it is the prime contractor's responsibility because the prime has privity with the subcontractor. Noncompliance places companies at risk in several ways, including negative contractor ratings, inability to close out contracts, and potential harm to customer relationships.

What Are the First Steps Toward Compliance?

- Perform an inventory of flexibly priced subcontracts under flexibly priced prime contracts
- Talk with your government customers and understand their expectations for the performance of audits on flexibly priced subcontracts. Proactive communication will ensure the ability to closeout contracts is not impacted

Which Subcontracts Should be Audited?

For contractors with a high number of T&M and LH subcontracts, a risk-based approach can be developed and shared with the contracting officer who can indicate whether it is considered acceptable. CohnReznick has experience developing risk-based approaches to conducting audits and can assist your organization in preparing a submission to your contracting officer. In some cases, contracting officers are unwilling to commit to the acceptability of the risk-based approach. In other cases, this has been successful in reducing the amount of testing required.

What Does a Compliant Solution Look Like?

The following are some issues to consider when answering this question:

Which Types of Audits Will Be Considered “Acceptable” to Meet the Government’s Expectations?

Throughout the course of our work with prime contractors in this area, CohnReznick has participated in numerous conversations concerning the government’s expectations for the types of audits that will be considered acceptable. In our experience, government agencies most often expect that the prime contractor’s audits of its subcontractors will be performed as Generally Accepted Government Auditing Standards (GAGAS)–compliant audits. This is largely because DCAA—the largest agency providing government contract audits—performs these audits as GAGAS-compliant audits.

Who Should Perform the Audits?

The government has not explicitly stated whether the audits must be performed by an external audit firm (CPA firm) or if the audits can be performed by the internal audit function of the prime contractor. However, if the preference is expressed for GAGAS-compliant audits, the internal audit functions of many entities may not be equipped to meet the requirements to perform them.

The requirements for GAGAS-compliant audits include:

- Independence requirements
- Stringent professional competence requirements for all audit team members
- Completion of GAGAS-specific continuing professional education (CPE) credit accruing activities by all team members
- An acceptable audit quality control system
- External peer review
- Policies and safeguards related to custody and retention of audit documentation
- Specific work paper approaches and quality requirements

Simply put, many government contractors aren’t in the audit business. Such contractors often elect to outsource the audit of subcontracts to audit firms that meet GAGAS requirements. Getting help with compliance allows contractors to focus on what matters—critical goals that accelerate growth and improve operational focus.

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