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Excessive Pass-Through Charges: Brass Tacks And Booby Traps

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On May 13, the Department of Defense published its revised Defense Federal Acquisition Regulation Supplement interim rule (and related promulgation comments) addressing "excessive pass-through charges," as prescribed by § 852 of the fiscal year 2007 National Defense Authorization Act. This rule seeks to encourage prime contractors and subcontractors to "add value" in connection with subcontracted work.

Industry comments on the initial interim rule focused on "excessive pass-through charges," defined as indirect costs and profit applicable to subcontract costs for which the higher-tier contractor adds no or negligible value. In response to industry comments, DOD reemphasized that its hands are tied by the statute's plain language and stressed the rule's primary point: DOD will not pay indirect costs and profit applicable to subcontract costs unless the contractors seeking payment can establish added value.

Although the revised interim rule applies only to DOD contracts awarded on or after its effective date, the rule likely will be incorporated into the FAR and apply to civilian contracts as well. Additionally, Government audit and oversight agencies likely will allocate considerable effort to assessing compliance with the rule.

Mitigating the financial pitfalls introduced by this interim rule turns on four key areas:

- understanding, demonstrating and documenting added value;
- insisting that contracting officers insert Alternate I of DFARS Clause 252.215-7004 into all contract awards not otherwise exempt from the revised interim rule if added value can be demonstrated;
- diligently monitoring compliance with the postaward 70-percent subcontract cost reporting threshold; and
- documenting and properly accounting for excessive pass-through charges if "no or negligible" value is added.

Understand, Demonstrate and Document Added Value

The most obvious and easiest way to comply with the revised interim rule is to demonstrate added value for all subcontracted efforts during contract performance—regardless of the proportion of work scope subcontracted. "Added value," as newly defined by DOD, means

> the contractor performs *subcontract management* functions that the Contracting Officer determines are a benefit to the Government (e.g., processing orders of parts of services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, performing quality assurance functions).

DFARS 252.215-7004(a). (Emphasis added.)

Presumably, DOD chose the term "subcontract management" to distinguish value-added activities from basic subcontract administration activities,

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such as soliciting, awarding and administering subcontracts. The definition's parenthetical clarification seems to align subcontract management with a contractor's program and operations management. Such efforts often include cost, schedule, quality and technical aspects of contract performance, such as defining of requirements or deliverables and managing the integration of product and service components into broader contract execution or delivery objectives. Because subcontract management is not precisely defined, contractors should avail themselves of interpretational latitude when demonstrating added value. Added value must be demonstrated in connection with subcontracted products and services. General added value in terms of overall contract performance does not satisfy this requirement.

An industry best practice arising from this interim rule could be to identify and clearly articulate added value in all proposals if any subcontractors are expected to contribute meaningfully to overall contract performance. This practice will provide critical documentation in establishing a contractor's intent to add value to subcontracted elements of work. Because a contractor could add value for some subcontracts but not others, it will also be essential to articulate added value in sufficient detail in anticipation of audit scrutiny.

Insist on Alternate I of DFARS Clause 252.215-7004 in All Contract Awards

In solicitations, DFARS Clause 252.215-7003 requires an offeror to identify in its proposal the total cost of work it intends to perform, as well as the total cost of work to be subcontracted. If an offeror intends to subcontract work worth more than 70 percent of the total contract cost, the offeror is required to

- disclose the amount of its indirect costs and profit applicable to the subcontract costs, and
- describe how it adds value to the subcontracted work.

If a CO determines that the offeror will add value, Alternate I of DFARS Clause 252.215-7004 will be used in the awarded contract to affirm no excessive pass-through charges exist—largely mitigating any future risk on this issue.

There is a subtle catch if an offeror does not intend to subcontract more than 70 percent of the total contract cost. The arbitrary 70-percent reporting threshold in Clause 252.215-7003 has no bearing on the determination of pass-through charge allowability; rather, this threshold is merely a point at which offerors must affirmatively address added value. No language in the statute, the interim rule or the promulgation comments prevents or discourages postaward audit assessments of added value on contracts or subcontracts that remain below the 70-percent reporting threshold of Clauses 252.215-7003 and -7004. The following DOD comment illuminates the risk:

> The 70 percent reporting threshold is meant to capture those contracting situations where there is a higher risk that substantially all of the effort could be subcontracted without providing the required subcontract management or other value-added functions. Excessive pass-through charges are unallowable on *any subcontracting effort* when the contractor or subcontractor does not provide subcontract management consistent with its policies and procedures or does not otherwise provide value to the contract or subcontract.

(Emphasis added.)

DOD underscores this point by stating "the statutory provisions prohibit excessive pass-through charges when a contractor or subcontractor is providing no or negligible value." In sum, excessive pass-through charges are unallowable under any circumstance—the determination of which turns on demonstrating added value, not the 70-percent reporting threshold.

Concerning this risk, contractors should proactively seek pre-award CO determinations of added value and inclusion of Alternate I of DFARS Clause 252.215-7004 upon contract award. This affirmative pre-award added value determination is advised for *all* contracts under which *any* work scope element either will or could be subcontracted—not just when the 70-percent reporting requirements of DFARS Clause 252-215-7003 compel description of added value.

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For example, suppose an offeror proposes using subcontractors that will incur 50 percent of the total proposed contract cost. This offeror is not required to describe its added value pursuant to Clause 252.215-7003, and the CO is not required to make a determination as to the existence of excessive pass-through charges. If this offeror does not specifically request Alternate I (regardless of the 70-percent reporting rule), then Government auditors will have the opportunity to second-guess added value with the full benefit of hindsight. Furthermore, if the offeror receives the contract but cannot persuade its CO to make an affirmative added value determination and use Alternate I, then the prime contractor should diligently ensure its project files and business records contain documented evidence of added value for its subcontracted efforts. This documentation will be critical if auditors arrive (perhaps years later) for a postaward subcontract management assessment. Examples of such contemporaneous documentation evidencing added value may include:

- subcontract management policies, including process descriptions, tools, forms, etc.;
- subcontractor performance assessments;
- coordination of subcontractor production and delivery relative to inventory maintenance, contract production/delivery schedules, and project schedules indicating the coordination and integration of subcontracted efforts into the overall contract effort;
- subcontractor participation in periodic program status reviews;
- meeting minutes that document interactions between a contractor and its subcontractors;
- technical correspondence regarding design, development, and execution of quality improvement/assurance activities; and
- integrated project team interim status reports and work products.

The list could go on, but the point is the same: if the contractor can document an active subcontractor relationship from proposal, through project execution and contract completion, the Government likely will be satisfied with added value. The documentation will assure COs that they are not paying excessive pass-through charges and will greatly reduce audit risk.

Monitor Compliance with the 70-Percent Reporting Threshold

Unless subcontracts are exempt from the revised interim rule, DFARS 252.215-7003 and -7004 must be flowed down and added value must be demonstrated to the higher-tier contractor if the 70-percent reporting threshold is met. Moreover, if a contract or subcontract award was originally below the 70-percent threshold, but ultimately exceeds that threshold during contract/subcontract performance, DFARS 252.215-7004(c) requires contractors and subcontractors to verify added value. Even if a contract is initially below the 70-percent threshold and includes Alternate I of DFARS Clause 252.215-7004 (as recommended herein), a contractor must still comply with the clause's reporting requirements if total subcontracted effort grows beyond the 70-percent threshold during contract performance (essentially, a re-opener clause allowing the CO to reassess and confirm added value).

In most circumstances, the 70-percent threshold raises at least two compliance challenges. First, contractors must monitor the 70-percent threshold by designing and implementing new project cost accounting controls. Contractors can enhance their project cost management procedures by routinely reporting

- the ratio of fully burdened direct subcontract costs to total cost incurred, and
- calculating this ratio by using current estimates of costs to be incurred at contract completion.

Tracking these two metrics will provide management with continual visibility regarding the current

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and expected status of the 70-percent disclosure threshold.

Second, contractors must develop controls to monitor their subcontractors' compliance with the 70-percent threshold (if the revised interim rule must be flowed down). This mechanism will necessitate integrating new subcontract data reporting requirements with a contractor's subcontract oversight program. We suggest that contractors impose the above metrics on their subcontractors by means of a new contractual data reporting requirement, which will ensure the data is timely tracked and delivered to appropriate parties. This subcontractor data should be compiled and reported within the contractor's project cost reports so that self- and subcontractor- monitoring of the 70-percent reporting threshold can be performed efficiently and regularly.

Accounting for and Documenting Excessive Pass-Through Charges

Given the subjective nature of added value, it is encouraging that DOD has established an all-or-nothing approach to allowability: any amount of added value that is more than a negligible amount renders all pass-through charges allowable. Unfortunately, if history is a guide, some Defense Contract Audit Agency auditors and COs may attempt to disallow proportional pass-through charges based on degrees of added value.

In its promulgation comments, DOD definitively stated that excessive pass-through charges are *not* expressly unallowable costs, thus removing the specter of penalties from the compliance equation. This is likely because excessive pass-through charges, i.e., indirect costs and profit applicable to subcontract costs, are unique from an unallowable cost accounting perspective. First, in this context, only indirect costs can be unallowable because profit is not an element of contract cost. Second, unallowable indirect costs (as an element of excessive pass-through charges) can only be identified *after* they have been allocated to a particular subcontract for which a contractor adds no or negligible value. This particular aspect of allowability runs contrary to accounting theory, which requires cost allowability to be determined (or determinable) before cost incurrence. In this case, though, the elements of indirect cost allocable to subcontract costs are all presumably allowable. Only after allocation do excessive pass-through charges become "unallowable." Of course, this after-the-fact determination precludes identification and segregation of these costs within costs pools before allocation (as is the traditional practice of accounting for unallowable costs). Said another way, otherwise allowable indirect costs become excessive pass-through charges as a consequence of their allocation, not the specific identification of an underlying unallowable activity giving rise to the cost being allocated.

The accounting aspects discussed above are important because they determine how a contractor must account for excessive pass-through charges. Because this new flavor of "unallowable" indirect cost cannot be specifically identified and segregated when incurred (i.e., before allocation), they instead need to be accounted for after allocation (at final cost objectives) by identifying them relative to subcontract costs to which they are allocable. Once identified, excessive pass-through costs must be written off (i.e., not billed to the Government).

Alternatively, for contractors for which negligible added value is a common feature of either their contract structure, business model or particular industry, it is advisable to evaluate and perhaps adopt cost accounting practices based on value added allocation methods. This accounting practice will limit excessive pass-through charges to profit applicable to subject subcontracts because subcontract costs are not an element of most value-added allocation bases.

Summary

For reasons discussed above, contractors will find that the easiest and least risky approach to complying with the DFARS interim rule regarding excessive pass-through charges will be to—

- add value through effective subcontract and project management practices;

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- document that value in proposals and business records; and
- insist on the Alternate I clause in all contract awards if subcontracted effort will be meaningful but less than 70 percent.

Even flawless execution of these key points will not eliminate the 70-percent threshold requirement during contract performance. Sound internal accounting, subcontract administration and project controls must be developed and executed to ensure internal and subcontractor compliance. Regardless of the added value profile, contractors should implement and execute accounting procedures designed to identify, segregate and avoid billing excessive pass-through charges.

❖ Endnotes

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