GOVERNMENT CONTRACT
COSTS, PRICING & ACCOUNTING REPORT®

JANUARY 2016 | VOLUME 11 | ISSUE 1

¶ 1 DCAA Auditors Foraging Into The Qualifications Of Contractor Employees Whose Services Have Been Invoiced

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When tasked to establish indirect cost rates, Defense Contract Audit Agency auditors have become increasingly active in challenging employee qualifications to perform service contracts.[2] However, there are three reasons why this new trend in foraging by DCAA auditors is inappropriate. First, there is no contractual basis for DCAA auditors, when tasked to establish indirect rates, to burden contractors to provide documents concerning whether employees who performed services had the requisite contractual qualifications. Second, often the rule of finality of acceptance precludes challenges to employee qualifications if the challenge is made years after invoices have been paid. Finally, the method used by the Government in challenging the employee's qualifications wrongfully places the burden of proof on the contractor. For these reasons, contractors should consider resisting forays into direct expenses when DCAA has been tasked by contracting officers to finalize indirect cost rates for a specific fiscal year.

Chronology of DCAA Audit Policies Applicable to T&M Contracts

Below is a brief chronology of DCAA policies with respect to service contracts which typically are time-and-materials (T&M) contracts as well as labor-hour (LH) contracts described in Federal Acquisition Regulation ("FAR") Part 16.6.[3]

1. **July 31, 2007**. As described in DCAA Memorandum for Regional Directors (MRD) 07-PPD-023(R), the FAR and Defense FAR Supplement were "clarified" on Feb. 12, 2007 to ensure that subcontract and intercompany labor effort would be based on the subcontractor's own rates, and not on the rates of the prime contractor. Before and after this FAR change, DCAA maintained that subcontractor employees could be billed using a prime contractor labor category ("T" component of a T&M contract) only if explicitly stated in the prime contract; otherwise subcontract costs were billable at cost (under the "M" component). At the heart of this issue were so-called windfall profits, in some cases achieved by prime contractors' billing subcontractor labor hours at prime contractor "T" rates. The windfall consisted of the aggregate amounts paid to the prime contractor, which were significantly more than the subcontract costs.

2. **Nov. 26, 2007**. DCAA MRD 07-PPD-038(R), Reporting Questioned Costs on Time-and-Material (T&M)/Labor-Hour (LH) Contracts, focused on the expectation that auditors ensure that claimed or billed direct labor effort meets

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the labor category qualifications specified in the contract. In particular, FAR § 52.232-7(a)(3), effective Feb. 12, 2007, states,

> Labor hours incurred to perform tasks for which labor qualifications were specified in the contract will not be paid to the extent the work performed by employees do not meet the qualifications specified in the contract, unless specifically authorized by the Contracting Officer.

The MRD provided an example of a junior engineer billed at a senior engineer "T" rate, in which case the auditor is to identify the entire amount billed as unallowable. Notably, DCAA's policy stated that this same guidance should be applied to contracts negotiated before Feb. 12, 2007; hence, equally applied to any audit (current invoices or historical incurred costs regardless of the years involved).

3. **November 2010**. DCAA Master Document—Audit Program, Incurred Cost—Major Post Year-End Audit, Version 8.10, dated November 2010, includes a step (F-1 Direct and Indirect Labor, step 4) to determine whether the claimed T&M labor hours, rates, and employee qualifications comply with the contract provisions. Later, in October 2011, this audit program and this particular step were expanded to include a profit-margin test on T&M/LH contracts, comparing total contract billed amounts to total actual contract costs reported (i.e., comparing invoiced amounts on Schedule K to actual costs on Schedule H). The objective of the October 2011 expanded step was to focus additional testing in cases in which profits appeared excessive and could indicate that unqualified employees or subcontractor employees were invoiced at prime contractor "T" rates. As noted by a DCAA inquiry during an incurred cost audit, "We noted T&M projects with significant profits (28.3% to 39.7%), please explain" (the atypically high profit margins based upon a comparison of billed amounts to the recorded costs).

4. **May 22, 2014**. MRD 14-PPD-008(R), Labor Qualifications for Time-and-Material (T&M) Contracts, in essence restated the audit guidance from number 2 above. The memo emphasized that labor hours (that did not meet the contractual qualifications) could be billable if specifically authorized by the CO; hence, DCAA auditors were directed to coordinate with the CO prior to questioning (unqualified) labor hours. If specific authorization had not been given, but was being contemplated, auditors were to provide the CO with information such as the actual cost of the labor delivered that did not meet the contract qualifications. Although unstated, the purpose of this "information" was to dissuade the CO from authorizing labor hours that (in the eyes of the DCAA auditor) did not meet the contract qualifications for a specific labor category.

Because of these practices, DCAA's audit policies and audit programs relative to T&M contracts are resulting in Government claims being asserted against contractors. Here are two examples:

- $3.9 million of noncompliant T&M labor costs for employees not meeting contractually required education experience or years of relevant experience.[4]

- $13.9 settlement for overbilling for work performed by DRS personnel who lacked the job qualifications required by contract.[5]

These examples are but the tip of the iceberg in terms of the dollars at issue based upon untimely DCAA audits mixed with DCAA auditors' unrealistic expectations for documentation supporting T&M contractual requirements (qualifications) such as "25 years of relevant experience." These all-too-common DCAA audit issues raise the question of auditor competency to evaluate T&M contract qualifications (which require other than accounting expertise).

Moreover, in its zeal to expose overcharging for labor on service contracts, DCAA has ignored contractual and regulatory limitations on its forays. Four of these limitations are discussed below.

1. When Tasked by a CO to Establish Indirect Cost Rates, a DCAA Auditor Has No Contractual Basis to Ascertain whether Contractor Employees Who Have Provided Services on Specific Contracts Meet the Requisite Qualifications

The contractual authority for DCAA to perform incurred costs audits to finalize indirect rates is predicated on FAR § 52.216-7(d), Final Indirect Cost Rates. That provision states:

> Final annual indirect cost rates and the appropriate bases shall be established in accordance with *Subpart 42.7* of the Federal Acquisition Regulation (FAR) in effect for the period covered by the indirect cost rate proposal.[6]

FAR Subpart 42.7, Indirect Cost Rates, explains that under "the Allowable Cost and Payment clause at 52.216-7 the contractor is required to submit an adequate final indirect cost rate proposal to the contracting officer (or cognizant Federal agency official) and to the cognizant auditor."[7]

In short, when requested to establish final indirect cost rates pursuant to FAR Subpart 42.7, there is no relevant reason for DCAA auditors to be foraying into the allowability of direct costs to individual contracts. Not surprisingly, labor categories for work performed under service contracts are *not* designated as information that contractors are expected to provide when submitting final indirect cost rate proposals.[8]

Often, when DCAA auditors seek to challenge the qualifications of employees performing services, the underlying contracts are not cost-reimbursement contracts, but T&M or LH contracts.[9] Where the services have been performed under T&M or LH contracts, it is even more egregious for a DCAA auditor to stray from the task under FAR § 52.216-7(d) and FAR Subpart 4.7 to "establish final indirect rates." Succinctly put, FAR § 52.216-7 does not apply to T&M contracts or the labor portion of LH contracts. Specifically, FAR § 16.307(a)(1) provides the following guidance as the correct use of the FAR § 52.216-7 clause:

> The contracting officer shall insert the clause at 52.216-7, Allowable Cost and Payment, in solicitations and contracts when a cost-reimbursement contract or a time-and-materials contract (other than a contract for a commercial item) is contemplated. If the contract is a time-and-materials contract, the clause at 52.216-7 applies in conjunction with the clause at 52.232-7, but only to the portion of the contract that provides for reimbursement of materials (as defined in the clause at 52.232-7) at actual cost. Further, the clause at 52.216-7 does not apply to labor-hour contracts.

FAR § 16.307(a)(1). To repeat, FAR § 52.216-7 applies only to the material portion of T&M contracts, and "does not apply to labor-hour contracts."[10]

To conclude, when tasked to "establish final indirect rates," DCAA auditors should not exceed their tasking by burdening contractors with irrelevant document requests. It is especially improper for DCAA to probe into LH contracts and T&M contracts because FAR § 52.216-7 does not apply to LH contracts (or the labor portion of T&M contracts).[11]

2. Often the Rule of Finality of Acceptance Precludes Challenges to the Qualifications of Contractor Employees if the Challenge Is Made Years after the Government Paid the Invoices

A good place to begin is with the legal concept of acceptance. As explained in FAR § 46.501:

> Acceptance constitutes acknowledgment that the supplies or services conform with applicable contract quality and quantity requirements, except as provided in this subpart and subject to other terms and conditions of the contract.

Typically, acceptance is defined in the contract.[12]

Put in proper perspective, what is really happening has little to do with the DCAA auditor seeking to disallow a cost. Instead, the DCAA auditor is second-guessing the implicit decision of the agency that accepted and paid for the services. Stated in correct contractual parlance, the DCAA auditor is recommending to the CO that the Government revoke its acceptance of the services.

Since acceptance is typically defined in the contract, attention should be paid to FAR § 52.246-6, Inspection—Time-and-Material and Labor-Hour. Below are two noteworthy extracts from that clause:

> (e) Unless otherwise specified in the contract, the Government shall accept or reject services and materials at the place of delivery as promptly as practicable after delivery, and they shall be presumed accepted 60 days after the date of delivery, unless accepted earlier.
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> * * *
>
> (j) The Contractor has no obligation or liability under this contract to correct or replace materials and services that at time of delivery do not meet contract requirements, except as provided in this clause or as may be otherwise specified in the contract.

Hence, under FAR § 52.246-6(e), acceptance of services is supposed to be resolved within 60 days. The purpose of the 60-day limit is to resolve acceptance-related issues while the facts are still fresh in the parties' recollection. Allowing DCAA auditors to second-guess acceptance of services years after the services were performed is contrary to the purpose of FAR § 52.246-6(e). Also, under FAR § 52.246-6(j), the contractor "has no obligation or liability" for performing the work with unqualified employees, "except as provided in this clause or as may be specified in the contract."[13] Thus, after acceptance, the Government has relinquished its right to question whether the services were performed by unqualified personnel unless otherwise "specified in the contract."[14]

If the Government has not relinquished all post-acceptance rights, the reservation of such rights would be in a warranty of services clause. The FAR contains a Warranty of Services clause at § 52.246-20. Before examining the substance of that clause, two points are noteworthy. First, the clause is not mandatory.[15] Hence, unless the clause (or specifically drafted clause) is expressly in the contract, there is no exception to the acceptance being conclusive without any right of the Government to challenge the qualifications of the employee performing the work. Second, the Warranty of Services clause is designated only for "when a fixed-price contract for services is contemplated."[16]

Turning to the substance of the FAR § 52.246-20 clause, it does provide a remedy for the Government if the services were provided by an unqualified contractor employee:

> Notwithstanding inspection and acceptance by the Government . . . the Contractor warrants that all services performed under this contract will, at the time of acceptance . . . conform to the requirements of this contract.[17]

Another key concept of the FAR § 52.246-20 clause is the remedy that "[i]f the Government does not require correction or reperformance, the Contracting Officer shall make an equitable adjustment in the contract price."[18] Hence, rather than disallow the entire cost incurred by the Government for the services performed by the unqualified employee, the Government arguably is entitled only to the difference between the labor category charged and the correct labor classification of the employee who actually performed the work.

An important aspect of the FAR § 52.246-20, Warranty of Services, clause is that it is intended to extend the right to revoke acceptance only for a limited amount of time, such as 30 days after acceptance. Specifically the clause states,

> The Contracting Officer shall give written notice of any defect or nonconformance to the Contractor _____ *[Contracting Officer shall insert the specific period of time in which notice shall be given to the Contractor; e.g., "within 30 days from the date of acceptance by the Government,"; within 1000 hours of use by the Government;" or other specified event whose occurrence will terminate the period of notice, or combination of any applicable events or period of time]*.

FAR § 52.246-20(b) (italics in original). Clearly, it was the intent of the FAR Councils that the window of time for the Government to revoke acceptance was, at most, to be a few months—not years.

In summary, the rule of finality of acceptance often precludes a challenge to the qualifications of contractor employees if the challenge is made years after the Government has paid the invoice.[19]

3. DCAA Is Not the Cognizant Contracting Audit Agency for Services Acquired from GSA Schedule Contracts

From time to time, when requested to provide indirect rates, DCAA auditors foray into questioning employee qualifications for services ordered under GSA Schedule contracts. FAR § 42.705-2(a) states

"[t]he cognizant Government auditor shall establish final indirect cost rates for business units." The General Services Administration FAR Supplement makes clear that it is the GSA Inspector General—not DCAA—who is the cognizant audit agency for contracts awarded by GSA: "The contracting officer shall request all audit services through the Assistant Inspector General for Auditing or the Regional Inspector General for Auditing, as appropriate." GSAR § 542-102(a). Simply put, DCAA has no authority to question employee qualifications where a DoD entity acquires services through a GSA contract.

Moreover, DCAA forays into direct costs under GSA contracts are contrary to the Single Audit Act of 1984. In explaining the Single Audit Act, the Office of Management and Budget stated, "A single audit is intended to provide a cost-effective audit for non-Federal entities in that one audit is conducted in lieu of multiple audits of individual programs."[20]

4. Debunking the Burden of Proof

When questioning whether an employee is qualified to perform services, the DCAA auditor's preferred method of issuing a challenge is to use a DCAA Form 1, Notice of Contract Costs Suspended and/or Disapproved. However, unless the contract contains the FAR § 52.242-1, Notice of Intent to Disallow Costs, clause, there is no authority to disallow a cost. The FAR § 52.242-1 clause is designated for only the following contract types: cost-reimbursement, fixed-price incentive, and price redetermination. See FAR § 42.802. Hence, if a DCAA auditor seeks to challenge the qualifications of the employees performing services under LH or T&M contracts, the Government has no authority to disallow a cost.

It should not go unnoticed that by using a DCAA Form 1 to recommend disallowing costs attributable to labor performed by an unqualified employee, the Government gains a significant tactical advantage. Typically, whether an employee meets either the academic criteria or work experience set forth in the contract is subject to more than one reasonable interpretation. By disallowing the cost, the Government's interpretation is likely to prevail because "the burden of proof shall be upon the contractor to establish that such cost is reasonable."[21]

As previously mentioned, the legally correct perspective of a DCAA auditor challenging the qualifications of employees performing services is that the auditor is recommending a revocation of acceptance. Once viewed from this perspective, the contractor greatly benefits because no longer can the Government proceed under the flawed notion of "the burden of proof shall be upon the contractor to establish that such cost is reasonable."[22] Since the subject matter of the dispute is revocation of acceptance (rather than cost reasonableness), the burden of proof is on the Government if the Government is claiming it is entitled to an equitable adjustment from the contractor.[23] Where there is uncertainty if an individual meets the experience or education requirement, the party with the burden of proof is at a significant disadvantage if the matter is to be resolved through litigation.

Concluding Comments

When tasked to establish indirect cost rates, DCAA auditors have become increasingly active in challenging employee qualifications for service contacts. However, as shown by the analysis above, the Government typically has no contractual right to pursue such an audit. Moreover, the rule of finality of acceptance often precludes challenges to the qualifications of contractor employees if the challenges are made years after the invoices have been paid. Unwarranted recoveries by the Government based on such DCAA forays are often the result of contractors being lured into believing that they face a difficult burden of proof that their employees met the contractual qualifications. Unfortunately, many unsavvy contractors fail to realize that it is the Government that has the burden of proof.

Aggravating this misuse of DCAA resources is the fact that DCAA had a backlog of 18,185 incurred cost submissions awaiting audit at the end of fiscal year 2014.[24] It is troubling that DCAA is delinquent in performing its core responsibility of establishing indirect cost rates, but DCAA auditors are free to waste inordinate amounts of time second-guessing agency decisions to accept services.

In conclusion, contractors should consider more vigorously resisting DCAA auditors questioning the qualifications of contractor employees performing services. This recommendation is especially appropriate when the second-guessing occurs years after the services were accepted by the Government customer.

ENDNOTES:

[2]This trend has been encouraged by the DOD Inspector General. See http://www.dodig.mil/resources/fraud/pdfs/LaborMischarging.pdf.

[3]DCAA is greatly involved in administration of these contracts through the following clauses: (1) FAR § 52.232-7, Payments under Time-and-Materials and Labor-Hour Contracts, and (2) FAR § 52.216-7, Allowable Cost and Payment.

[4]DOD Inspector General Semi-Annual Report To Congress, Oct 1, 2014 to March 31, 2015 at 118.

[5]Department of Justice Press Release, October 7, 2014, available at http://www.justice.gov/opa/pr/defense-contractor-agrees-pay-137-million-settle-allegations-overbilling.

[6]Id (emphasis added).

[7]FAR § 42.705-1(b).

[8]See FAR § 52.216-7(d)(2)(iii).

[9]Returning to the basics, FAR Part 16, Types of Contracts, delineates the following categories of contracts: FAR Subpart 16.2, Fixed-Price Contracts; FAR Subpart 16.3, Cost-Reimbursement Contracts; FAR Subpart 16.6, Time-and-Materials, Labor- Hour and Letter Contracts.

[10]FAR § 16.307(a)(1).

[11]It is true that the FAR § 52.215-2 Audit and Records—Negotiation clause applies to cost-reimbursement, incentive, time-and-material, and labor-hour contracts. According to that clause, "the Contracting Officer, or an authorized representative of the Contracting Officer, shall have the right to examine and audit 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." Id. at (b). Hence, DCAA's authority to obtain access to a contractor's records is derived from the DCAA being the "authorized representative of the Contracting Officer." When tasking DCAA to "establish final indirect cost rates" under FAR § 42.705-2(a), the CO ostensibly has not authorized auditors to burden contractors to provide access to the contractor's records pertaining to an employee's qualifications to perform service contracts.

[12]The FAR defines acceptance as "the act of an authorized representative of the Government by which the Government, for itself or as agent of another, assumes ownership of existing identified supplies tendered or approves specific services rendered as partial or complete performance of the contract." FAR § 46.101. See also FAR § 52.246-20(a).

[13]Id.

[14]Id.

[15]See FAR § 46.710(d).

[16]Id.

[17]FAR § 52.246-20(b).

[18]FAR § 52.246-20(d).

[19]Fraud might be another possible way for the Government to recover money paid for services performed by unqualified contractor personnel. As previously mentioned, most DCAA challenges involve differing interpretations of the contractual education or experience requirements. If there is credible ambiguity, an allegation of fraud is unwarranted. See generally *U.S. v. Hanger One, Inc.*, 406 F.Supp. 60 (N.D. Ala. 1975) ("facts necessary for fraudulent violation of contract must be fuller and more profound if contractual provisions are equivocal or open to conflicting interpretation"). See also *Ulysses, Inc. v. U.S.*, 110 Fed. Cl. 618 (2013) ("where a claimant's obligations are not clear and the claimant candidly apprises the Government of its interpretations of its claim, it is inappropriate to find that the claimant acted with reckless disregard for the truth or falsity of such claim").

[20]See https://www.whitehouse.gov/omb/financial_fin_single_audit.

[21]FAR § 31.201-3.

[22]Id.

[23]See generally *Celesco Industries*, ASBCA 22251, 79-1 BCA ¶ 13604 ("We agree with the appellant that the Government has the burden of proof as to both the extent to which the contract requirements were reduced and the saving resulting therefrom.").

[24]This backlog has existed for years because DCAA failed to properly prioritize resources. As explained in DCAA's Report to Congress for FY 2014:

> At the end of FY 2014, DCAA had 11,324 adequate annual contractor incurred cost submissions on hand valued at roughly $419 billion. Additionally, DCAA was either awaiting receipt of, or had not made an adequacy determination for 6,861 incurred cost submissions valued at roughly $403 billion. This total year-end balance of 18,185 submissions was 4,924 less than the prior year-end balance of 23,109, or a reduction of 21 percent for the year.

Available at http://www.dcaa.mil/DCAA_FY

2014__Report__to__Congress.pdf.

