



Limitations on Pass-Through Charges

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Two new clauses were added to the FAR effective January 2011 - FAR 52.215-22 Limitations on Pass-Through Charges-Identification of Subcontract Effort, and FAR 52.215-23 Limitations on Pass-Through Charges. We are now seeing these two clauses incorporated in Government solicitations and awards. These rules are creating serious concern in the government contracting community due to their “subjective” nature and the creation of new post-award audit rights regarding recovery of “excessive pass-through charges”.

Applicability

According to FAR 15.408(n)(1)/(2)(i), Limitations on Pass-Through Charges, these rules apply to:

- Civilian contracts/task orders/delivery orders that are cost-reimbursement type and in excess of the simplified acquisition threshold; or
- All types of DOD contracts/task orders/delivery orders in excess of the cost or pricing data threshold except for firm-fixed-price contracts awarded on the basis of adequate price competition or a firm-fixed-price contract for the acquisition of a commercial item.

Furthermore, FAR 15.408(n)(2)(ii) gives the CO discretion to include the clauses when the total estimated contract/order value is below the thresholds cited above.

Even though not specifically addressed in the FAR, T&M proposals should follow the applicability criteria as stated above. We expect T&M Commercial Item contracts would be exempt. We also expect that the “Time” portion of T&M Non-Commercial Item contracts with adequate price competition would be exempt. However, the clause does not provide guidance on applicability to portions of contracts or certain cost elements. Given the current contracting environment, we are concerned that this clause will be applied to entire T&M contracts and not just the “Materials” portion, especially for T&M non-commercial item contracts without adequate price competition.

FAR 52.215-22, Limitations on Pass-Through Charges-Identification of Subcontract Effort

This clause is included in solicitations, and requires that an offeror, in its proposal:

- Identify the total cost of the work to be performed by the prime contractor versus the total cost of the work to be performed by “subcontractors”; and

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- If the offeror intends to subcontract more than 70% of the total cost of the work, then the offeror must identify the amount of indirect costs and profit/fee applicable to the subcontracted work and provide a description of the added value provided by the offeror as it relates to the subcontracted effort.

Under this clause, a subcontract means “any contract, as defined in FAR 2.101, entered into by a subcontractor to furnish supplies or services for performance of the contract or subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders”. This clause also defines a subcontractor as “any supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime contractor or another subcontractor”, see FAR 52.213-23, (a), Definitions. As we see it, any goods or services purchased by the contractor in support of an awarded contract and/or subcontract would meet the subcontractor/subcontract definition and would need to be included in the 70% calculation.

The objective of this FAR requirement is for contractors to **substantiate the added value they provide on their subcontracted efforts**. Failure to demonstrate that value is added will subject the contractor to having the proposed indirect costs and profit applicable to subcontracted work deemed excessive and thus unallowable per FAR 52.215-23 (discussed next). Many contractors are reevaluating their “make or buy” decisions so that they do not trigger (or come near) this 70% requirement. We are not encouraged that such a conservative approach yields the best results for the Government but we see it happening more and more.

This clause has another key requirement worth mentioning, it is a **mandatory flow-down** to lower-tier subcontractors.

FAR 52.215-23, Limitations on Pass-Through Charges

This is the clause included in the contract that results from the FAR 52.215-22 solicitation clause. FAR 52.215-22 describes the identification and disclosure requirements for subcontracted efforts, while FAR 52.215-23 defines “added value” and the consequences of failing to demonstrate “added value” on the subcontracted work.

FAR 52.215-23, Limitations on Pass-Through Charges, essentially states that if an offeror adds “no or negligible value” to a subcontractor, then the indirect costs and profit/fee applied to the work performed by the subcontractor by the higher tier contractor is defined as an “excessive pass-through charge” and disallowed. Furthermore, FAR 52.213-23(b) states that the COs shall determine if excessive pass-through charges exist.

According to this FAR, “no or negligible value” is defined as a contractor or subcontractor who “cannot demonstrate to the CO that its **effort added value** to the contract or subcontract in accomplishing the work performed under the contract/order”. As you can see, this language is subjective and without any interpretation guidelines provided by the courts, COs will most likely construe this wording broadly and automatically disallow all contractor mark-ups (indirect costs and profit/fee) on subcontractor costs when the subcontracted value exceeds 70% and the contractor has not clearly demonstrated added value in the proposal or during contract performance.

Monitoring and Notification Requirements

FAR 52.215-23(c)(1) requires contractors to establish and maintain procedures for notifying the CO in writing:

- If the contractor/subcontractor changes the amount of subcontract/lower-tier subcontractor effort, after award, such that it exceeds 70% of the total cost of work to be performed under the contract or subcontract.
- The notification shall identify the revised cost of the subcontract effort and shall include verification that the contractor will provide added value.
- If a contractor cannot support "value-added services" for its subcontracted costs, then any indirect costs and profit associated with these costs are considered "excessive pass-through costs" and are deemed unallowable.

This monitoring and notification requirement was also included in the interim DFARs contractor business system clause, 252.244-7001, Contractor Purchasing System Administration. Contractors need to develop policies and procedures for monitoring and notifying the Government when subcontractors exceed the 70% threshold or face the risk of unallowable “excessive pass-through charges” or disapproval of their Purchasing Systems.

Contract Cost Principles Revision and Post-award Audit Rights

There are other, far-reaching ramifications to this new type of unallowable cost. CO’s may perform an evaluation of excessive pass-through charges at proposal submission, and reduce the proposed costs/prices accordingly. FAR 31.203, Indirect Costs, has been modified to state that “indirect costs that meet the definition of *excessive pass-through charges* in 52.215-23 are unallowable” FAR 31.203(i). Also, for DOD fixed-price contracts subject to this clause, the Government will be able to obtain a price reduction for the amount of excessive pass-through charges included in the contract price.

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By updating FAR Part 31, Contract Cost Principles and permitting an after-the-fact price reduction for “excessive pass-through charges”, it appears that the final decision regarding contractors’ “added value” may default to the government auditors. As previously discussed, the “adds value” determination is subjective in nature and we believe this clause creates another area of potential post-award financial risk. Contractors can mitigate this risk by:

- Obtaining an advance agreement that you, the offeror, “add value” as defined in FAR 52.215-23 and that your indirect costs and profit/fee applied to the subcontracted work are fair and reasonable.
- Modifying your Estimating System so the “Value Added” is expressly defined and explained in the cost/price narrative included in every proposal.
- Establishing a subcontract and material handling rate that encompasses the subcontract management functions/costs that benefit the Government, such as qualifying vendors, processing subcontract orders, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, and performing quality assurance functions, see FAR 52.215-23(a), Definitions, “Added value”.

The strategy that each firm adopts will depend on the circumstances and cost profile – how significant are subcontract costs? Are subcontract handling activities charged direct or indirect? What G&A base does the contractor use?

We hope this Government Contracts Update provides useful information on the FAR Limitations on Pass-Through Charges rules. Should you have questions or concerns, please contact Nadine A. Massih at 703.624.9553 or nmassih@costtrend.com.