



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PSP 730.8.B.1/2010-003

February 18, 2011
11-PSP-003(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA
HEADS OF PRINCIPAL STAFF ELEMENTS, HQ, DCAA

SUBJECT: Audit Guidance on Limitations on Pass-Through Charges –
FAR 52.215-22, 52.215-23, 31.203(i)

SUMMARY

In accordance with Federal Acquisition Regulations (FAR) 52.215-23, any indirect costs and associated profit applicable to subcontract costs where the contractor does not provide “added value” (e.g., subcontract management functions) are considered excessive pass-through costs which are unallowable. As part of a forward pricing proposal audit, auditors should perform procedures to evaluate a contractor's proposed support to demonstrate its added value when the proposed subcontracts are expected to exceed 70 percent of the total costs of work to be performed. During incurred cost audits and evaluations of final vouchers, auditors should also perform procedures to test compliance with the subject FAR provisions.

The FAR provision, applicable to DoD and civilian agencies, was effective October 14, 2009. Prior to that date, Defense Federal Acquisition Regulation Supplement (DFARS), applicable only to DoD, contained similar provisions that became effective April 26, 2007.

BACKGROUND

Section 866 Duncan Hunter National Defense Authorization Act for Fiscal Year 2009 required that the FAR be amended to minimize excessive pass-through charges by contractors (or lower-tier subcontractors) that add no or negligible value to the subcontracted work. This resulted in an interim rule, effective October 14, 2009, that amended FAR 15.408(n) and created FAR 52.215-22 and 52.215-23 clauses. The final rule was effective January 12, 2011, which added fixed-price incentive contract types to the list of excepted contracts.

FAR 15.408(n) (Enclosure 1), as amended, requires the Contracting Officer to include FAR 52.215-22 Limitation on Pass-Through Charges—Identification of Subcontract Effort, (Enclosure 2) and FAR 52.215-23 Limitations on Pass-Through Charges (Enclosure 3) in solicitations and contracts as follows:

- *For Civilian agencies* when the estimated contract value or order value exceeds the simplified acquisition threshold and the contemplated contract type is expected to be a cost-reimbursement type.

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- *For DoD* when the total estimated contract or order value exceeds the threshold for obtaining certified cost or pricing data and the expected contract type is any contract type except—
 - Fixed-price with economic price adjustment, Firm-fixed-price or fixed-price incentive contract awarded on the basis of adequate price competition; or
 - Fixed-price with economic price adjustment, Firm-fixed price or fixed-price incentive contract for the acquisition of a commercial item.

Additionally, FAR 31.203 Indirect Costs was amended to include the provision “Indirect costs that meet the definition of ‘excessive pass-through charge’ in 52.215-23, are unallowable” (Enclosure 4).

With the revision to FAR 15.408(n) and the issuance of FAR 52.215-22 and 23, Defense Federal Acquisition Regulation Supplement (DFARS) 252.215-7003 and 252.215-7004, Excessive Pass-Through Charges have been eliminated. The issuance of FAR 31.203(i) eliminated the DFARS 231.203(d) language relating to excessive pass through charges. The DFARS interim rules have been in effect since April 26, 2007 and were nearly identical to the new FAR provisions. In FY 2009, Section 866 expanded the requirement to all agencies, resulting in the FAR change.

These requirements flow down to all levels of subcontracts.

GUIDANCE

FAR 52.215-22 requires the contractor to identify in its proposal the total cost of work to be performed by the offeror, and by each subcontractor. When more than 70 percent of the total cost of work to be performed is subcontracted, this clause also requires the contractor to (1) identify its indirect costs and profit applicable to the work to be performed by the subcontractor, and (2) provide a description of the “added value” it will provide related to the work performed by the subcontractor(s).

FAR 52.215-23 defines “added value” to be subcontract management functions (either direct or indirect) that are a benefit to the Government (e.g., processing orders of part or services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, performing quality assurance functions). Further, the clause provides that the Government will not pay indirect costs or profit/fee (i.e., pass-through charges) on work performed by a lower tier subcontractor to which the higher tier contractor cannot provide sufficient evidence that it provides “added value.”

Generally, the determination as to whether the contractor’s functions provide “added value” to the contracting effort and that there are no excessive pass-through charges is made at the time of contract award. Contract clause 52.215-23 Alternate I is then incorporated into the contract. Alternate I of this clause states the contracting officer HAS determined there will be no excessive pass-through charges.

For those instances where the contractor changes the amount of subcontract effort or the subcontractor changes the amount of lower-tier subcontractor effort (AFTER) contract award such

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that it exceeds 70 percent of the total cost of work under a covered contract or subcontract, a reporting requirement is imposed by FAR 52.215-23(c). The contractor must notify the contracting officer in writing of the revised cost of the subcontract effort and include verification that the contractor will provide “added value.” If the auditor finds through the procedures below that the contractor failed to comply with the requirements of FAR 52.215-23(c) this should be considered an accounting and/or purchasing system deficiency.

Forward Pricing – When proposed subcontract costs exceed 70 percent of the total cost of work to be performed, auditors should ensure the proposal includes a description of the contractor’s “added value” as required by FAR 52.215-22. The auditor should request the contractor specifically address “added value” during the proposal walk through. The auditor should evaluate the reasonableness of the contractor’s description and supporting documentation of the “added value” to assess whether the contractor is in compliance with the requirements set forth in FAR 52.215-23. If the “added value” description is not included, this should be considered a proposal inadequacy that should be discussed immediately with both, the contractor and contracting officer. Further, due to this proposal inadequacy, the auditor should consider issuing an estimating system flash report.

Incurred Cost – Auditors should use Schedule H (Schedule of Direct Costs by Contract/Subcontract and Indirect Expense Applied at Claimed Rates) of the contractor’s incurred cost submission to identify indicators of contracts with potential excessive pass-through charges (i.e., those with subcontract costs exceeding 70 % costs of work performed). Based on these indicators, auditors should perform procedures to test compliance with the subject FAR provisions. For example, for contracts identified where subcontract costs represent over 70 percent of the costs of work performed, the auditor should review contract briefings to identify contracts containing FAR 52.215-23, Alternate I. For those contracts containing Alternate I, auditors should perform procedures to determine if the contractor is performing its “added value” functions as asserted during the initial proposal evaluation. For all other contracts, auditors should obtain information from the contractor to ascertain if the subcontract costs are expected to exceed 70 percent of the total costs of work performed. If so, the auditor should notify the contracting officer and request the contractor to provide a description and demonstration of the “added value” by the contractor related to the subcontracted work. The auditor should evaluate the functions to determine if the “added value” functions are consistent with the definition in the contract clause and perform testing to determine if the contractor is performing the “added value” functions and ascertain if the costs are reasonable. If not, the pass through charges applicable to the subcontracted effort should be questioned based on FAR 31.203(i).

Evaluations of Final Vouchers – During an evaluation of the final voucher, auditors should calculate the percentage of subcontract costs to the total costs of work performed. If the percentage exceeds 70 percent; brief the contract for FAR 52.215-23 Alternate I and determine if testing has been completed (during incurred cost audits) to determine the contractor performed its “added value” functions as asserted during the initial proposal evaluation. If not, the auditor should complete the testing as part of this assignment. If Alternate I is not in the contract and the subcontracted effort exceeds 70 percent, the auditor should request the contractor to provide a description and demonstration of the “added value” by the contractor related to the subcontracted work. The auditor should evaluate the functions to determine if the “added value” functions are consistent with the

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definition in the contract clause and perform testing to determine if the contractor performed the “added value” functions and the costs are reasonable.

If the contractor cannot demonstrate its “added value” efforts, then the indirect costs (and profit) added by the contractor to the subcontracted work should be questioned as excessive pass through charges based on FAR 52.215-23 and FAR 31.203(i). Excessive pass through charges as defined by FAR 52.215-23 are only indirect costs and profit applicable to the subcontracted work.

These FAR provisions create an allowability issue on excessive pass through costs, not an allocability issue. The excessive pass through costs are still allocable to a contract, but will not be paid by the Government (i.e., unallowable) if the contracting officer determines the contractor does not provide “added value” to the subcontracted portion of the work. Auditors are reminded that functions and related costs not determined excessive in accordance with FAR 31.203(i) are still subject to FAR 31.2, Allowability, Allocability, and Reasonableness and should be audited accordingly.

Audit Guidance is being added to CAM Chapter 7. The Incurred Cost (10100), Price Proposal (21000), and Evaluation of Final Vouchers (15400) audit programs will also have audit steps to address testing contractor compliance with the FAR 52.215-22 and 23. The Proposal Adequacy Checklist will also have a step added to determine if the proposal includes a contractor description of “added value”.

CLOSING COMMENTS

Field audit office personnel should direct questions regarding this memorandum to their regional offices. Regional offices should direct their questions to Program Manager, Pricing and Special Projects, at (703) 767-3290 or by e-mail at dcaa.psp@dcaa.mil.

/s/
Kenneth J. Saccoccia
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Enclosures: 4

DISTRIBUTION: C

15.408(n) Limitations on Pass-Through Charges.

(1) The contracting officer shall insert the provision at 52.215-22, Limitations on Pass-Through Charges-Identification of Subcontract Effort, in solicitations containing the clause at 52.215-23.

(2)(i) Except as provided in paragraph (n)(2)(ii), the contracting officer shall insert the clause 52.215-23, Limitations on Pass-Through Charges, in solicitations and contracts including task or delivery orders as follows:

(A) For civilian agencies, insert the clause when—

(1) The total estimated contract or order value exceeds the simplified acquisition threshold as defined in section 2.101 and

(2) The contemplated contract type is expected to be a cost-reimbursement type contract as defined in Subpart 16.3; or

(B) For DoD, insert the clause when—

(1) The total estimated contract or order value exceeds the threshold for obtaining cost or pricing data in 15.403-4; and

(2) The contemplated contract type is expected to be any contract type except—

(i) A firm-fixed-price contract awarded on the basis of adequate price competition;

(ii) A fixed-price contract with economic price adjustment awarded on the basis of adequate price competition;

(iii) A firm-fixed-price contract for the acquisition of a commercial item;

(iv) A fixed-price contract with economic price adjustment, for the acquisition of a commercial item;

(v) A fixed-price incentive contract awarded on the basis of adequate price competition; or

(vi) A fixed-price incentive contract for the acquisition of a commercial item.

(ii) The clause may be used when the total estimated contract or order value is below the thresholds identified in 15.408(n)(2)(i) and for any contract type, when the contracting officer determines that inclusion of the clause is appropriate.

(iii) Use the clause 52.215-23 with its Alternate I when the contracting officer determines that the prospective contractor has demonstrated that its functions provide added value to the contracting effort and there are no excessive pass-through charges.

52.215-22 – Limitations on Pass-Through Charges—Identification of Subcontract Effort.

As prescribed in [15.408\(n\)\(1\)](#), use the following provision:

Limitations on Pass-Through Charges—Identification of Subcontract Effort (Oct 2009)

(a) Definitions. “Added value, excessive pass-through charge, subcontract, and subcontractor,” as used in this provision, are defined in the clause of this solicitation entitled “Limitations on Pass-Through Charges” (FAR 52.215-23).

(b) General. The offeror’s proposal shall exclude excessive pass-through charges.

(c) Performance of work by the Contractor of a subcontractor.

(1) The offeror shall identify in its proposal the total cost of the work to be performed by the offeror, and the total cost of the work to be performed by each subcontractor, under the contract, task order, or delivery order.

(2) If the offeror intends to subcontract more than 70 percent of the total cost of work to be performed under the contract, task order, or delivery order, the offeror shall identify in its proposal—

(i) The amount of the offeror’s indirect costs and profit/fee applicable to the work to be performed by the subcontractor(s); and

(ii) A description of the added value provided by the offeror as related to the work to be performed by the subcontractor(s).

(3) If any subcontractor proposed under the contract, task order, or delivery order intends to subcontract to a lower-tier subcontractor more than 70 percent of the total cost of work to be performed under its subcontract, the offeror shall identify in its proposal—

(i) The amount of the subcontractor’s indirect costs and profit/fee applicable to the work to be performed by the lower-tier subcontractor(s); and

(ii) A description of the added value provided by the subcontractor as related to the work to be performed by the lower-tier subcontractor(s).

(End of Provision)

52.215-23 – Limitations on Pass-Through Charges.

As prescribed in [15.408\(n\)\(2\)](#), use the following clause:

Limitations on Pass-Through Charges (Oct 2009)

(a) *Definitions.* As used in this clause--

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

“Excessive pass-through charge,” with respect to a Contractor or subcontractor that adds no or negligible value to a contract or subcontract, means a charge to the Government by the Contractor or subcontractor that is for indirect costs or profit/fee on work performed by a subcontractor (other than charges for the costs of managing subcontracts and any applicable indirect costs and associated profit/fee based on such costs).

“No or negligible value” means the Contractor or subcontractor cannot demonstrate to the Contracting Officer that its effort added value to the contract or subcontract in accomplishing the work performed under the contract (including task or delivery orders).

“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 a subcontract. It includes but is not limited to purchase orders, and changes and modifications to purchase orders.

“Subcontractor,” as defined in FAR 44.101, means any supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime Contractor or another subcontractor.

(b) *General.* The Government will not pay excessive pass-through charges. The Contracting Officer shall determine if excessive pass-through charges exist.

(c) *Reporting.* Required reporting of performance of work by the Contractor or a subcontractor. The Contractor shall notify the Contracting Officer in writing if—

(1) The Contractor changes the amount of subcontract effort after award such that it exceeds 70 percent of the total cost of work to be performed under the contract, task order, or delivery order. The notification shall identify the revised cost of the subcontract effort and shall include verification that the Contractor will provide added value; or

(2) Any subcontractor changes the amount of lower-tier subcontractor effort after award such that it exceeds 70 percent of the total cost of the work to be performed under its subcontract. The notification shall identify the revised cost of the subcontract effort and shall include verification that the subcontractor will provide added value as related to the work to be performed by the lower-tier subcontractor(s).

(d) *Recovery of excessive pass-through charges.* If the Contracting Officer determines that excessive pass-through charges exist;

(1) For other than fixed-price contracts, the excessive pass-through charges are unallowable in accordance with the provisions in FAR subpart 31.2; and

(2) For applicable DoD fixed-price contracts, as identified in 15.408(n)(2)(i)(B), the Government shall be entitled to a price reduction for the amount of excessive pass-through charges included in the contract price.

(e) *Access to records.*

(1) The Contracting Officer, or authorized representative, shall have the right to examine and audit all the Contractor's records (as defined at FAR 52.215-2(a)) necessary to determine whether the Contractor proposed, billed, or claimed excessive pass-through charges.

(2) For those subcontracts to which paragraph (f) of this clause applies, the Contracting Officer, or authorized representative, shall have the right to examine and audit all the subcontractor's records (as defined at FAR 52.215-2(a)) necessary to determine whether the subcontractor proposed, billed, or claimed excessive pass-through charges.

(f) *Flowdown.* The Contractor shall insert the substance of this clause, including this paragraph (f), in all cost-reimbursement subcontracts under this contract that exceed the simplified acquisition threshold, except if the contract is with DoD, then insert in all cost-reimbursement subcontracts and fixed-price subcontracts, except those identified in 15.408(n)(2)(i)(B)(2), that exceed the threshold for obtaining cost or pricing data in accordance with FAR 15.403-4.

(End of clause)

Alternate I (OCT 2009). As prescribed in [15.408\(n\)\(2\)\(iii\)](#), substitute the following paragraph (b) for paragraph (b) of the basic clause:

(b) *General.* The Government will not pay excessive pass-through charges. The Contracting Officer has determined that there will be no excessive pass-through charges, provided the Contractor performs the disclosed value-added functions.

31.203 -- Indirect Costs.

(a) For contracts subject to full CAS coverage, allocation of indirect costs shall be based on the applicable provisions. For all other contracts, the applicable CAS provisions in paragraphs (b) through (h) of this section apply.

(b) After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to intermediate or two or more final cost objectives. No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective.

(c) The contractor shall accumulate indirect costs by logical cost groupings with due consideration of the reasons for incurring such costs. The contractor shall determine each grouping so as to permit use of an allocation base that is common to all cost objectives to which the grouping is to be allocated. The base selected shall allocate the grouping on the basis of the benefits accruing to intermediate and final cost objectives. When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation.

(d) Once an appropriate base for allocating indirect costs has been accepted, the contractor shall not fragment the base by removing individual elements. All items properly includable in an indirect cost base shall bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs. For example, when a cost input base is used for the allocation of G&A costs, the contractor shall include in the base all items that would properly be part of the cost input base, whether allowable or unallowable, and these items shall bear their pro rata share of G&A costs.

(e) The method of allocating indirect costs may require revision when there is a significant change in the nature of the business, the extent of subcontracting, fixed-asset improvement programs, inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances.

(f) Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives.

(g) A base period for allocating indirect costs is the cost accounting period during which such costs are incurred and accumulated for allocation to work performed in that period.

(1) For contracts subject to full or modified CAS coverage, the contractor shall follow the criteria and guidance in 48 CFR 9904.406 for selecting the cost accounting periods to be used in allocating indirect costs.

(2) For contracts other than those subject to paragraph (g)(1) of this section, the base period for allocating indirect costs shall be the contractor's fiscal year used for financial reporting purposes in accordance with generally accepted accounting principles. The fiscal year will normally be 12 months, but a different period may be appropriate (*e.g.*, when a change in fiscal year occurs due to a business combination or other circumstances).

(h) Special care should be exercised in applying the principles of paragraphs (c), (d), and (e) of this section when Government-owned contractor-operated (GOCO) plants are involved. The distribution of corporate, division or branch office G&A expenses to such plants operating with little or no dependence on corporate administrative activities may require more precise cost groupings, detailed accounts screening, and carefully developed distribution bases.

(i) Indirect costs that meet the definition of "excessive pass-through charge" in [52.215-23](#), are unallowable.