

What is the Difference between: Subcontractor v Vendor v Temp Labor v Consultant & Consultant v Employee [& Properly Categorizing Suppliers...It Matters!]

Presented by
Association of Government Accountants
and
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What is the Difference between an Independent Contractor, Subcontractor, Consultant, and Temporary Worker?

Cathy Akin
Akin & Associates

Independent Contractor Terms

- Subcontractor
- Consultant

Independent Contractor

- Self-employed
- No benefits
- Sets own hours and how the assignment is completed
- May have client contact
- Pays own taxes per IRS Form 1099
- ***Provides services that are not core competencies of business***

Subcontractor Definition

- Independent Contractor in all legal respects including tax obligations, 1099
- Accepts an assignment working for another independent contractor/Company who has a larger contract to complete a project
- Profits from helping to meet needs and provide solutions for another I.C.'s client
- Works within the contract terms of the general contractor (SOW)
- Has no direct contact with client

Consultant Definition

- Generally, a Consultant is a self-employed independent businessperson who has a special field of expertise or skill.

The consultant provides professional or expert opinion, advice or services regarding information or materials in his or her field of knowledge or training to assist others in making decisions or in performing tasks.

Subcontractor vs. Consultant Similarities

- Both are independent contractors
 - Not employees or agents for the Contractor
 - Do not establish direct employment relationships
 - Limits potential liability of the Contractor to just the explicit agreement
 - Offer expertise that Contractor does not have
- Both potentially offer reduced cost and risk mitigation to the Contractor
 - Posses expertise or facilities the Contractor does not have

Subcontractor vs. Consultant Differences

- Scope of Work
 - Subcontractor: defined scope of work and/or an identifiable segment of a project
 - Consultant: very specific area based on expertise, specific problem to solve
 - Subcontractor: the end results of entire project are the goal
 - Consultant: Project may have shorter milestones
- Contract type
 - Subcontractor: firm fixed, time & material, cost type

Temporary Workers

- Provides ‘another pair of hands’
- May contribute to the core business
- Hired through third party agency
- Agency provides workers, benefits and payroll
- Co-Employment

1099 vs W-2

Independent Contractor (Self-Employed) or Employee?

Top 3 Determining Factors

- **Behavioral:** Does the company control or have the right to control what and how the worker does his/her job?
- **Financial:** Are the business aspects of the job controlled by the payer?
- **Type of Relationship:** Are there contracts or benefits? Will the relationship continue after completion of assignment? Is the work performed a key aspect of the business?

IRS is currently putting more weight on the financial aspects of the relationship

Behavior Control

- **Instructions the business gives the worker**
 - An **employee** is generally subject to the business' instructions about when, where, and how to work. All of the following are examples of types of instructions about how to do work:
 - When and where to do the work
 - What tools or equipment to use
 - What workers to hire or to assist with the work
 - Where to purchase supplies and services
 - What work must be performed by a specified individual
 - What order or sequence to follow

Behavior Control (Cont'd)

- **Training the business gives the worker**
 - An **employee** may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.
- **Independent Contractors do not provide skills that are core to the business**

Financial Control

- **The extent to which the worker has unreimbursed business expenses**

Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. CAUTION: **employees** can incur unreimbursed expenses in connection with the services they perform for the business.

Examples include (not limited to):

Computer/cell phone, employment related education, passport for business trip, tools & supplies, medical exam

Financial Control (Cont'd)

- **The extent of the worker's investment**

An employee usually has no investment in the work other than his own time.

An independent contractor often has a significant investment in the facilities he uses in performing services for someone else and can suffer a financial loss.

However, a significant investment is not necessary for independent contractor status.

Financial Control (Cont'd)

- **The extent to which the worker makes services available to the relevant market**

An *independent contractor* is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

Financial Control (Cont'd)

- **How the business pays the worker**

An ***employee*** is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission.

An ***independent contractor*** is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

Financial Control (Cont'd)

- **The extent to which the worker can realize a profit or loss**

Since an employer usually provides **employees** a workplace, tools, materials, equipment, and supplies needed for the work, and generally pays the costs of doing business, employees do not have an opportunity to make a profit or loss.

An **independent contractor** can make a profit or loss.

Type of Relationship

- **Written contracts describing the relationship the parties intended to create**

This is probably the least important of the criteria, since what really matters is the nature of the underlying work relationship, not what the parties choose to call it.

However, in close cases, the written contract can make a difference.

Type of Relationship (Cont'd)

- **Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay**

The power to grant benefits carries with it the power to take them away, which is a power generally exercised by employers over ***employees***. A true ***independent contractor*** will finance his or her own benefits out of the overall profits of the enterprise.

Type of Relationship (Cont'd)

- **The permanency of the relationship**

If the company engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that the intent was to create an employer-**employee** relationship.

Type of Relationship (Cont'd)

- **The extent to which services performed by the worker are a key aspect of the regular business of the company**

If a worker provides services that are a key aspect of the company's regular business activity, it is more likely that the company will have the right to direct and control his or her activities.

For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work.

This would indicate an employer-**employee** relationship.

How Do I Know the Difference?

There is no 'magic' or set number of factors that 'makes' the worker an employee or an independent contractor, and no one factor stands alone in making this determination.

Also, factors which are relevant in one situation may not be relevant in another.

Benefits and Risks

■ Contractor:

- ❑ No OT or minimum wage
- ❑ No employee benefits
- ❑ No Federal, state and Social Security (FICA) taxes
- ❑ **If misclassified employer will be held liable for taxes (IRS Voluntary Classification Settlement Program VCSP)**
- ❑ **Short-term relationship / commitment**
- ❑ **Can be more expensive for long projects**

Benefits and Risks (Cont'd)

■ **Employee:**

- ❑ Control over work, hours and resources
- ❑ Long-term relationship
- ❑ Beneficial for company culture / retention
- ❑ **Must pay taxes**
- ❑ **Turnover costs**
- ❑ **Risk of “bad hire”**

References

- <http://www.irs.gov/pub/irs-pdf/p15a.pdf>
- <http://www.irs.gov/businesses/small/article/0,,id=99921,00.html>

The IRS advises that if after reviewing the three determining factors, it is still unclear whether a worker is an employee or an independent contractor,

Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding (PDF) can be filed with the IRS. The form may be filed by either the business or the worker. The IRS will review the facts and circumstances and officially determine the worker's status.

For more information visit www.irs.gov



Classifying Workers Correctly

There are three main categories of worker: Employee, Temporary Worker, and Independent Contractor

Determine what the worker will be doing:

- What are the specific tasks?
- How will the worker be measured?
- How much direction will the worker receive?
- Is the worker contributing to the core business of the company?
 - For example: An engineering company which engages a marketing, IT or Human Resources worker does not violate the 'core business' rule and can classify the worker as an Independent Contractor if other requirements are met. Also, if the engineering company engages an engineer with an expertise that the company does not have (and doesn't intend to have in the future), the worker can be classified as an I.C.
 - However, if the engineering company engages an engineer to perform tasks that are part of the company's core business, the worker is not an Independent Contractor.

Employee:

- Receives work direction from the employer.
- Has an indefinite term of engagement.
- Has no contractual agreement.
- Can contribute to the core business of the company.
- Suffers no financial risk.
- Receives reimbursement for expenses.
- Receives W-2.

Temporary Worker: (Note: a temporary employee is included in the company payroll, a temporary worker is an employee of a third party firm.)

- Additional staff is needed to cover a spike in work "Another pair of hands".
- Acquired through third party agency which is responsible for taxes, benefits, etc.
- Beware: Co-employment
 - Employer has joint responsibility with the agency for legal issues such as discrimination, sexual harassment, bullying, etc.



- Recent case: NLRB charge against McDonald's Corporation (Franchise situation)

Independent Contractor:

- Has a bona fide business (business license, insurance, own equipment, etc.)
- Has a contract describing the relationship. However, the nature of the underlying work relationship is what matters, not what the parties choose to call it in a contract.
- Can suffer a financial risk.
- Receives more than one 1099 in a calendar year.
- Has no set hours and doesn't use the client's equipment, etc.
 - Note: Minimal use of client's resources is not a big risk; again it's the 'whole picture'.
- Determines how the assignment is completed.
- Has own benefits.
- Pays own expenses. If the contract stipulates, an I.C. can bill for expenses that she has paid for.
- Receives IRS Form 1099.

Consultant and independent Contractor terms are used interchangeably. Some say that a consultant is only an advisor and an I.C. performs the work. I use the term Independent Contractor for both scenarios.

Risks of misclassification:

- DFEH and/or DOL charges.
- IRS Audit and Penalties (back taxes for employer and I.C. plus penalties, interest).
 - Note: IRS Voluntary Classification Settlement Program (VCSP)
- Independent Contractors may sue the employer for misclassifying them and causing them to owe the IRS for taxes.
 - *"A common complaint made by misclassified ICs is that they paid more in self-employment taxes than would have been withheld from their paychecks if they had been treated as employees. A related issue occurs when the IC is unaware of the requirement that they pay self-employment taxes and are liable for late payment penalties. Although there is not a lot of case law on the topic, employees will frequently seek—and receive—payment for these taxes and penalties based on common law theories like fraud and misrepresentation (regarding the employer's statements to the employee regarding the classification), negligence (regarding the employer's decision to make the*



employee an IC), and breach of the implied covenant of good faith and fair (with respect to the IC agreement).” Sebastian Miller Law

What to do?

- Do your research about the company’s needs and what this worker will be doing.
- Consider whether this worker should be an employee (indefinite period of employee), temporary employee (an employee for a designated period of employment), temporary worker through a third party agency or an Independent Contractor.
- Do not create an I.C. relationship because an employee requests it.
- Consider the three areas of an Independent Contractors
 - Behavioral: Does the company control what and how the worker does his job?
 - Financial: Are the business aspects of the job controlled by the payer? Does the I.C. carry the burden of possible financial loss? (P&L) Note: Recently the IRS has emphasized the financial aspects of the relationship above behavioral and relationship.
 - Type of Relationship: Are there contracts or benefits? Will the relationship continue after completion of assignment? **Is the work performed a core part of the business?**
- Use the IRS 20 question checklist as a guide, but remember that some items carry more weight than others. There is no ‘magic’ number of criteria that assures your decision to classify a worker as an I.C. Just being able to check the boxes does not relieve you of your responsibility to ‘drill down’ and determine the ‘whole picture’.
- IRS Form SS88 is very helpful to determine I.C. status.
- Do not automatically consider someone an Independent Contractor because that person or the company chooses to do this. A flag for the IRS is a worker who has gone from an employee (W-2) to an Independent Contractor (1099), especially in one calendar year.
- Consider ‘payrolling’ the worker through a third party agency at a greatly reduced mark-up fee. This action is justified because the employer has provided the worker rather than the agency sourcing the worker for the employer. If your agency balks, find another agency. Also, negotiate the mark-up and terms of future hiring.

Properly Categorizing Your Suppliers - It Matters

Subcontractors, Temps, Consultants, and Other Suppliers

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This is just my personal opinion!

- This presentation is my personal opinion and does not reflect the opinion of any other entity or person

Why This Topic Matters

- Indirect rate burdening
 - Some contractors apply an overhead burden to job shoppers and temporary employees, but they do not apply the same burdens to consultants or to suppliers that provide services
 - Value-Added G&A base excludes Direct Material and Subcontract dollars
 - You need to know what a subcontract is to exclude those dollars from the application of G&A expense
 - Are consultants subcontractors?

Why This Topic Matters

- Contract/Subcontract Administration
 - Subcontracts must receive appropriate prime contract flow-downs.
 - What about suppliers that provide services to indirect functions? If they receive flow-downs, from which contract do the flow-downs come? Which DPAS rating gets assigned?
 - Subcontracts valued in excess of the TINA threshold may require cost & price analysis, or certified cost & pricing data
 - Does a consulting agreement likely to be valued in excess of the TINA threshold require CAPA?

Why This Topic Matters

- Supplier categorization will impact how you choose a supplier and determine price reasonableness.
- Examples:
 - Most consultants are not chosen on the basis of low price in a competition. Price may not be a selection factor. Consultants are most often chosen via single source, based on quality and past performance factors.
 - On the other hand, competitions with price as an evaluation factor likely will be the norm for other supplier awards.
 - Subcontract awards will almost certainly require consent from the cognizant contracting officer (52.244-2)
 - Is a contractor required to obtain CO consent to award a landscaping contract that will be charged to overhead? If not, why not?

Why This Topic Matters

So:

- Proper supplier categorization facilitates contract compliance. ***Improper categorization leads to disallowed costs and disapproved Purchasing Systems***

First Topic

Temporary Labor

What is Temporary Labor?

- AKA: “Job Shoppers,” “Purchased Labor,” or “Temp Agency Labor”
- Individuals acquired from outside companies via Purchase Order or other contractual agreement
- Not employees, but performing the work of employees
 - Adds to existing resources/capacity *without adding new capabilities*
 - Almost certainly complete a timesheet
 - Probably subject to same timekeeping rules as employees

Challenges with Temporary Labor

- DCAA audit guidance suggests that contractual agreements with outside companies to provide temp labor are “subcontracts” but acknowledges disparate treatment between contractors (See Selected Cost Guide, Chap. 59)
 - “... some contractors classify purchased labor as direct labor costs when the work is performed in the contractor’s facilities and under their supervision These contractors cost such effort using the average labor rate incurred by their own employees for comparable work. Differences between the amounts derived and purchased labor prices are treated as overhead costs.... Other contractors classify purchased labor as subcontract costs.”
- If so, need to report on ICE Schedule J?
 - If not, why not? (To be discussed later....)

Challenges with Temporary Labor

- **Burdening Temp Labor – DCAA’s position (quoted)**
 - A fundamental requirement of CAS 418 is that pooled costs shall be allocated to cost objectives in a reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor must share in an allocation of indirect expenses where there is a causal or beneficial relationship, and the allocation method must be consistent with the contractor's disclosed accounting practices.
 - In accordance with CAS 418, a ***separate allocation base*** for purchased labor may be necessary to allocate significant overhead costs to purchased labor such as supervision and occupancy costs, or to eliminate other costs not benefiting purchased labor such as fringe benefits costs.
 - Where the effort of purchased labor is ***performed in-house using the contractor's supervision and facilities***, overhead exclusive of fringe benefits and other employee related costs, if material in amount, should be allocated to purchased labor.
 - Conversely, where the effort of purchased labor is ***performed offsite under the supervision and control of an entity other than the contractor***, none of the contractor's labor overhead costs may be allocable to purchased labor.

Challenges with Temporary Labor

- Burdening challenges (cont'd.)
 - If the temp labor is acquired via subcontract (as DCAA suggests) then is the cost burdened as labor (see previous slide) or as a subcontract cost?

 - If the contractor has a Value-Added G&A Base (which excludes Direct Material and Subcontractor dollars) should the temp labor costs be in the G&A allocation base, or not?

Challenges with Temporary Labor

- New SBA rules (5/31/2016) impact distinctions between temp labor and subcontracts
 - Impacts Limitation on Subcontracting calculations! (52.219-14)
 - Requires small business to perform at least 50% of proposed personnel costs (direct labor plus overhead)
 - “performance by an independent contractor is considered a subcontract” but won’t count if the subcontractor is a “similarly situated entity”
 - If not similarly situated, then temp labor will count as subcontracted labor—i.e., labor not performed by the small business

Temporary Labor - Summary

- Acquisition of temporary labor must be treated as a subcontract in certain circumstances
 - E.g., to comply with 52.219-14 requirements under the new SBA rules
- However, I hope to show that a generic contract to acquire temp labor need not always be treated as a subcontract unless all acquired labor will be charged directly to one prime contract. Otherwise, contractual agreements to acquire temp labor are supplier agreements – though the burdening of the costs needs to be established and consistently followed
 - Stay tuned for more on subcontracts!

Second Topic

Consultants

What is a Consultant?

- A consultant is not: (1) an employee (2) temp labor
- Outside *individuals* or *firms* that are members of a particular profession or possess a special skill—*brings new capabilities*
 - Generally services acquired to enhance company's legal, economic, financial, or technical position – *the “Why”*
 - Examples include outside accountants, lawyers, actuaries, and marketing consultants
 - But not bookkeepers, not proposal writers, not individuals who are “integrated as an inherent part of operations” (Chap. 58, FAQs)
- Consultants may be direct or indirect charging
 - The test is whether the individual/firm meets the definition not where they charge time
 - If a direct-charging consultant, not a subcontractor

Challenges with Consultants

- Cost allowability (31.205-33).
 - Factors to be evaluated:
 - The nature and scope of the service rendered in relation to the service required
 - *The necessity* of contracting for the service, considering the contractor's capability in the particular area
 - The past pattern of acquiring such services and their costs, particularly in the years prior to the award of Government contracts
 - The impact of Government contracts on the contractor's business
 - Whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly when the services rendered are not of a continuing nature and have little relationship to work under Government contracts
 - Whether the service can be performed more economically by employment rather than by contracting ← *Reasonableness*
 - The qualifications of the individual or concern rendering the service and the customary fee charged, especially on non-Government contracts
 - Adequacy of the contractual agreement for the service (e.g., description of the service, estimate of time required, rate of compensation, termination provisions)

Challenges with Consultants

- Cost allowability (Cont'd.)
 - DCAA's required audit evidence:
 - An agreement that explains what the consultant will be doing for the contractor
 - A copy of the bill for the actual services rendered. This should include sufficient evidence as to the time expended and nature of the services provided to determine what was done in exchange for the payment requested, and that the terms of the agreement were met.
 - This documentation does not need to be included on the actual invoice and can be supported by other evidence provided by the contractor
 - Explanation of what the consultant accomplished for the fees paid – this could be information on the invoice, a drawing, a power point presentation, or some other evidence of the service provided

Challenges with Consultants

- Cost allowability (Cont'd.)
 - Out-of-Pocket Expenses
 - Airfare
 - Lodging
 - Meals & Incidentals
 - Alcohol
- DCAA tends to take the position that consultants' out-of-pocket expenses are subject to FAR Part 31 allowability rules
 - Not necessarily true. *What does the consulting agreement say?*
 - Privity of contract
 - 52.216-7 is not a mandatory flow-down for many contract types
 - Would never flow-down if consultant is charging indirect
 - What is your company's position?

More Challenges with Consultants

- **Determining Price Reasonableness**
 - Typically consultants are not chosen via a competition
 - Often price is not a significant factor
 - What matters – or what *should matter* – is quality and performance expectations
- **Given that, how does a contractor establish price reasonableness?**
 - Comparison to previous prices paid to similar consultants
 - Have the consultant disclose rates/prices paid by other clients in similar circumstances
- **Consulting as a commercial item/service?**
 - FAR 2.101 definition might fit attorneys, accountants, actuaries, many other professions

Consultants - Summary

- The key question is “why?”
 - Why the need/requirement?
 - Will the results enhance company’s position? If so, how?
- Is the consultant a member of a recognized profession?
 - What about IT consultants? Are they consultants or what?
- Where time is charged is not dispositive
 - A consultant is a consultant even if charging direct to a government contract
 - May be limitations on use of direct-charging consultants
 - Need not be reported on ICE Schedule J
- Therefore, consultant agreements do not require prime contract flow-downs (but it may be a good idea)

Consultants - Summary

■ Additional thoughts

- Direct-charging consultants are not subcontractors and I don't think you need to flow-down prime contract clauses into the consulting agreement; however, it may be wise to consider doing so.
 - *Establish a position*
- Given the audit focus and evidentiary requirements, may be a good idea to establish a separate GL account to record costs of consultants
- Make sure consultant's business purpose is allowable
 - Sandia M&O contract extension efforts violated Byrd Amendment → \$4.7M DoJ settlement
- Consultants performing lobbying are not only unallowable but will also require additional management & reporting
 - Lobbying Disclosure Act

Third Topic

Subcontracts / Subcontractors

What is a Subcontractor?

- There is no definition of “subcontractor” in FAR 2.1
 - The term is defined 15 separate times in the FAR and the definition varies
- FAR Part 44
 - “Subcontract” means any contract as defined in Subpart 2.1 entered into by a subcontractor to furnish supplies or services **for performance of a prime contract or a subcontract**. It includes but is not limited to purchase orders, and changes and modifications to purchase orders.
 - “Subcontractor” means **any** supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime contractor or another subcontractor.
- **So which is it?**

What is a Subcontractor?

- The proposal to establish final billing rates (aka “incurred cost proposal” or “claim”) requires a listing of all subcontracts (ICE Model Schedule J)
 - Instructions for completing Schedule J state:
 - Subject schedule is to provide identification of subcontracts you have awarded to companies for which you are the prime or upper-tier contractor. ← ***Does this mean all prime contracts or upper-tier subcontracts, regardless of type?***
 - This information is required for all cost type, flexibly priced, T&M, and labor hour subcontract awards/agreements ... ← ***Does this mean FFP agreements are excluded?***
 - ... and may include significant intracompany work orders if they are subject to the requirements of the Allowable Cost and Payment clause (52.216-7). ← ***Inter-organizational transfers may be subcontracts and may have to be listed? But only if they are subject to 52.216-7, which implies flow-down from a prime contract. Do you have to flow-down prime clauses in inter-organizational transfers?***

What is a Subcontractor?

- Incurred Cost Proposal Adequacy Checklist states
 - Does the schedule include ***all types of subcontracts*** (e.g., cost-type, T&M/LH, IDIQ with a variable element, and FFP) and [***all***] inter-company costs claimed by the contractor on **flexibly priced** prime contracts and/or upper-tier subcontracts?

- So which is it?

What is a Subcontractor?

■ FAR Part 3

- “Subcontract” means any contract entered into by a subcontractor to furnish supplies or services **for performance of a prime contract or a subcontract.**
- “Subcontractor” means any supplier, distributor, vendor, or firm that furnished supplies or services **to or for a prime contractor or another subcontractor.**

■ FAR Part 12

- “Subcontract,” as used in this part, includes, but is not limited to, a transfer of commercial items between divisions, subsidiaries, or affiliates of a contractor or subcontractor.

■ FAR Part 15

- “Subcontract” (except as used in 15.407-2) also includes a transfer of commercial items between divisions, subsidiaries, or affiliates of a contractor or a subcontractor.
- **15.407-2: “Make item,”** as used in this subsection, means an item or work effort to be produced or performed by the prime contractor or its affiliates, subsidiaries, or divisions. ← NOT subject to consent requirements

What is a Subcontractor?

- FAR 19.7 (Small Business Subcontracting)
 - “Subcontract” means **any agreement** (other than one involving an employer-employee relationship) entered into by a Government prime contractor or subcontractor calling for supplies and/or services **required for performance of the contract, contract modification, or subcontract.**
- Excessive Pass-through Charges (52.215-23)
 - “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.
- **And so we are back full circle to where we started**

What is a Subcontractor?

■ T&M Payment Clause (52.232-7, Aug. 2012)

(a)(1) Hourly rate means the rate(s) prescribed in the contract for payment for labor that meets the labor category qualifications of a labor category specified in the contract that are—

(i) Performed by the Contractor;

(ii) **Performed by the subcontractors;** or

(iii) **Transferred between divisions, subsidiaries, or affiliates of the Contractor under a common control**

(4) The hourly rates shall include wages, indirect costs, general and administrative expense, and profit.

(b)(1) For the purposes of this clause—

(ii) Materials means—

(A) Direct materials, **including supplies transferred between divisions, subsidiaries, or affiliates of the Contractor under a common control;**

(B) **Subcontracts for supplies and incidental services for which there is not a labor category specified in the contract;**

(C) Other direct costs (e.g., incidental services for which there is not a labor category specified in the contract, travel, computer usage charges, etc.); and

(D) Applicable indirect costs

What is a Subcontractor?

- A supplier may be a subcontractor based on the circumstances in which the award is made, where the charges will be recorded (direct or indirect), and depending on which FAR requirement you are attempting to comply with
- Which is to say ... ***“It Depends”***
- Best defense is to have a robust Procurement Policy that defines ***for your company*** when you call a supplier agreement a “subcontract” and when you call a supplier a “subcontractor” – and then follow it consistently.
 - Knowing that you may have to explain to a CPSR reviewer or DCAA auditor what your rationale is

Subcontractor Challenges

- **Pre-award and post-award management**
- FAR 42.202(e)(2) states—
 - The prime contractor is responsible for managing its subcontracts. The CAO's review of subcontracts is normally limited to evaluating the prime contractor's management of the subcontracts (see Part 44).
- So Part 44 describes the prime or higher-tier subcontractor responsibilities with respect to subcontractor management
 - What are they?

Subcontractor Challenges

■ FAR Part 44.303:

□ Pre-award

- The results of market research accomplished
- The degree of price competition obtained
- Pricing policies and techniques, including methods of obtaining certified cost or pricing data, and data other than certified cost or pricing data
- Methods of evaluating subcontractor responsibility
- Treatment accorded affiliates and other concerns having close working arrangements with the contractor
- Policies and procedures pertaining to small business concerns, including small disadvantaged, women-owned, veteran-owned, HUBZone, and service-disabled veteran-owned small business concerns
- Appropriateness of types of contracts used (see 16.103)
- Compliance with Cost Accounting Standards in awarding subcontracts

□ Post-award

- Planning, award, and postaward management of **major subcontract programs**
- Management control systems, including internal audit procedures, to administer progress payments to subcontractors
- Implementation of higher-level quality standards

Subcontractor Challenges

■ What are the real risks?

- “From 2008 through 2013, NetCracker allegedly used employees without security clearances to perform work when it knew the contract required those individuals to have security clearances, resulting in CSC recklessly submitting false claims for payment to DISA.” – DoJ press release 11/02/2015
- “For nearly 6 years, Northrop Grumman did not properly charge labor rates for the Counter Narco-terrorism Technology Program. Specifically, Northrop Grumman submitted labor charges performed by 360 of 460 DynCorp employees ... that did not meet the qualifications specified in the contract. Northrop Grumman officials submitted labor charges for an additional 33 DynCorp employees that may not have met the qualifications specified in the contract. Additionally, Northrop Grumman charged Army Contracting Command–Redstone Arsenal (ACC-RSA) 215,298 labor hours in excess of 8 hours per day. ... As a result, ACC-RSA authorized questionable costs of \$91.4 million for labor performed by unqualified contractor employees. ACC-RSA may have authorized additional questionable costs of \$10 million for 33 DynCorp employees that were not reviewed. Additionally, ACC-RSA authorized questionable costs of \$21.7 million for labor performed in excess of 8 hours per day ...” – DoD IG 5/13/2014

Subcontractor Challenges

- What are the real risks?

- “The Defense Contract Management Agency wrote in a June internal assessment that Pratt & Whitney’s ‘continued poor management of suppliers is a primary driver for the increased potential problem notifications.’ The incidents ‘have resulted in delinquent deliveries of engines,’ the agency said. ‘This trend will continue until the contractor improves its management of subcontractors and suppliers.’ Bates, the Pratt & Whitney spokesman, said ‘the vast majority’ of problem notifications ‘are minor issues or no issues at all’ and ‘do not have any impact on specifications or field performance’ of engines. ... The Pentagon’s F-35 program office said in a statement that Pratt & Whitney’s ‘persistent problems stem from the supply chain’ because 80 percent of the engine is produced by many different subcontractors.” – Bloomberg 9/2014

Subcontractor Challenges

- What are the real risks?
 - “The United States filed a False Claims Act complaint against DynCorp International Inc. (DynCorp) alleging that it knowingly submitted inflated claims in connection with a State Department contract to train Iraqi police forces (CIVPOL contract) ... in its complaint, the United States alleges that DynCorp knowingly allowed one of its main CIVPOL subcontractors to charge excessive and unsubstantiated rates for hotel lodging, translator, security guard and driving services and overhead expenses, and included these charges in the claims it submitted under the CIVPOL contract to the State Department. The complaint also alleges that DynCorp added its own markup to its subcontractor’s excessive charges, thereby further inflating the claims it submitted to the government.” – DoJ press release 7/19/2016

Subcontractor Challenges

- So ... risks are found in the ***actual post-award management*** of subcontracts, including
 - Screening cost-type subK invoices for unallowable costs
 - Screening T&M subK invoices for unqualified personnel
 - Managing government property in possession of subKs
 - Counterfeit electronic parts/other product substitution issues

- And:
 - Theft of trade secrets/commercial espionage
 - Export control violations
 - FCPA violations

- And?

Subcontractor Challenges

■ Specific issues

- Claims for increased costs from indirect rate adjustments
 - Provisional billing rate adjustments / Establishment of final billing rates
 - L-3 Corp (Virginia Circuit, 12/20/2010)
 - Failure to pay subK rate adjustment vouchers without DCAA audit of final rates
- Claims for increased costs related to changes (e.g., differing site conditions, increased scope, delay/disruption, etc.)
 - IT Corp (ASBCA No. 54136, 7/17/2006)
 - Failure to recognize subK claim as contract costs; violation of Limitation of Cost clause
- Close-out of cost-type subcontracts without a government audit report
 - USEC (CoFC No. 13-365-C, 7/28/2014)
 - “USEC entered into separate agreements with [other] contractors [and] those agreements are controlling. To recover additional indirect costs, USEC must comply with the mechanisms set forth in those agreements and applicable regulations. See 48 C.F.R. § 52.216–7(d)(5) (‘The completion invoice or voucher shall include settled subcontract amounts and rates. The prime contractor is responsible for settling subcontractor amounts and rates included in the completion invoice or voucher and providing status of subcontractor audits to the contracting officer upon request.’)

Subcontractor Challenges

- Not all risks are post-award
 - Kellogg, Brown & Root (KBR) (CoFC, 9/27/2012)
 - Subcontractor price evaluation contained errors
 - Change order pricing carried error forward and so final subK price was overstated
 - “KBR has not shown that it employed sound business practices and acted as a reasonably prudent business in accepting ABC’s proposed prices for CO 1. The court accepts KBR’s decision not to hold a competition [for the changed work] as reasonable, given the sense of urgency conveyed by ... the Army. ***That urgency, however, is insufficient to justify the acceptance of unreasonable prices.*** Moreover, while it does appear that KBR—whether pursuant to its request or not—received additional information from ABC supporting the prices in the latter’s proposal, this, too, is insufficient to establish reasonableness. This information did not illuminate the costs of the components that ABC would provide; rather, the documents ... submitted ... in July 2004 merely identified the numbers of each component that would be provided, the number of laborers for each job title that would be necessary, the layout of the new DFAC, and a schedule of materials to be used.”
 - **May have cost KBR ~ \$8 million in lost subK reimbursements**

Subcontractor Challenges

- Not all risks are post-award
 - SBA is sensitive to false subK certifications
 - Reckless disregard standard
 - SBA is sensitive to “ostensible subcontractors”
 - Appeal of Modus Operandi, Inc. (MOI), SBA No. SIZ-5716, 2016)
 - Follow-on contract set aside for small businesses; incumbent contractor was BAE (large)
 - BAE made MOI a subcontractor on existing contract; MOI proposed as prime on follow-on
 - MOI proposed as prime with 10 of 20 FTEs as former BAE employees moving to MOI
 - MOI “unduly reliant on BAE for performance” and “would contribute nothing more than its small business status”
 - Four factor test for affiliation and “ostensible subcontractor”:
 - Proposed subcontractor is the incumbent contractor and cannot compete for follow-on award
 - SB plans to hire majority of its workforce from the large subcontractor
 - SB prime’s management team previously served with the large subK on incumbent contract
 - SB prime lacks relevant experience; will have to rely on more experienced subK to win
 - Thus, BAE was an ostensible subcontractor and was really the prime
 - MOI was affiliated with BAE and no longer qualified as a small business for the procurement

Subcontractor Summary

- Who are your subcontractors – what's your policy position?
- How do you assure price reasonableness, especially re: change orders?
- How do you manage subcontractors post-award?
- If cost-type, how will you handle requests for price adjustments?
- How will you close-out?
- Will you close-out cost-type subKs without a final DCAA audit report?

Fourth Topic

The other suppliers

What is a Supplier?

- Not a consultant
- Not a subcontractor
- ***It's all entities left over!***
 - Including agreements with temporary labor entities (unless your policy states otherwise or unless your agreement is to support only one contract)
- Generally FFP agreements with standard P.O. Ts & Cs
 - What might drive a different approach?

Supplier Challenges

- Make vs. Buy
- Inter-organizational Transfers
 - Transfers at cost
 - Transfers at price
- Direct vs. Indirect
 - CAS 402
 - Split orders
- Material vs. ODC
- Lease vs. Buy

Conclusion

- ***Proper categorization of your suppliers matters***
- Categorization drives burdening
- Categorization drives pre-award activities
 - Evaluation criteria
 - Source selection decisions
 - Consent requirements
- Categorization drives post-award management approaches
 - Flow-downs
 - Reporting
- Categorization drives close-out decisions

Thank You!

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