



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PPD 730.5.27.1

July 31, 2007
07-PPD-023(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Time-and-Materials (T&M) and Labor Hour (LH) Contracts

Summary

For DoD (noncommercial) T&M and LH contracts awarded on or after February 12, 2007, the FAR and DFARS have been clarified to ensure that subcontract and intercompany labor effort will be based on its own rates, and not the rates of the prime contractor, which is consistent with our current audit position. Subcontract and intercompany labor effort will be priced and billed using separate labor rates for each subcontractor and intercompany transfer for each labor category. These requirements also pertain to non-DoD contracts awarded without competition. For non-DoD contracts that are competitively awarded, FAR 52.216-29 allows for pricing and billing prime, subcontract and intercompany labor rates either as separate rates or blended rates. A blended rate represents one rate per labor category which is comprised of the prime, subcontract and/or intercompany rates.

During contractor billing reviews and incurred costs audits covering T&M/LH contracts, auditors should selectively verify that the contractor's claimed amounts comply with the applicable contract terms. Audit procedures should include reconciling claimed prime, subcontract and intercompany labor hours to the respective source documents. For example, claimed subcontractor hours should be reconciled to subcontractor invoices and/or timesheets.

For T&M/LH contracts awarded prior to February 12, 2007, auditors should continue to review claimed cost in accordance with existing contract terms. Auditors should ensure that the contractor billings and claimed incurred costs reflect subcontract and intercompany labor transfers at cost, unless otherwise specified in the contract.

Also effective February 12, 2007, FAR Part 12 was revised to allow for commercial acquisition of services using T&M or LH contracts. Similar to the FAR competitively awarded contracts, commercial contracts may include labor hours based on separate subcontractor/intercompany labor rates, blended labor rates or any combination thereof.

Background

Effective February 12, 2007, Federal Acquisition Circular (FAC) 2005-15 amended FAR Subpart 16.6, Time and Materials and Labor Hour Contracts, and established three new solicitation provisions at FAR 52.216-29, 30 and 31 applicable to T&M and LH contracts. FAR 16.601 expanded the definition of "hourly rate" to "the rate(s) prescribed in the contract for payment of labor that meets the labor category qualifications of a labor category specified in the contract that are:

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- performed by the contractor,
- performed by the subcontractors, or
- transferred between divisions, subsidiaries, or affiliates of the contractor under a common control.”

FAR 16.601(c)(2)(ii) requires noncommercial contracts awarded without adequate price competition to specify separate fixed hourly rates for each category of labor to be performed by (i) the contractor, (ii) each subcontractor, and (iii) each division, subsidiary, or affiliate of the contractor under a common control. In addition, DFARS Change Notice (DCN) 2006-1212 established DFARS 252.216-7002, Alternate A, (effective 2/12/2007) which requires all competitively awarded DoD T&M/LH contracts to also include separate hourly rates by labor category for the prime contractor, each subcontractor, and each division, subsidiary and affiliate of the contractor under a common control. Blended rates are not permissible on DoD noncommercial contracts.

For non-DoD contracts that are competitively awarded, FAR 52.216-29 allows for pricing and billing prime, subcontract and intercompany rates either as separate rates or blended rates.

FAC 2005-15 also revised FAR Part 12 to provide for commercial T&M and LH contracts (FAR Part 12.207 – Special Requirements for the Acquisition of Commercial Items – Contract Type). Blended rates are permissible on commercial contracts. FAR 52.212-4 addresses the new contract terms and conditions covering commercial T&M and LH contracts.

A summary of the significant FAR/DFARS changes is contained in the Enclosure.

Guidance

Incurring Cost Audits/Contractor billing reviews

During incurred cost audits and contract billing reviews (covering T&M/LH contracts awarded on or after February 12, 2007), auditors should review contract briefs to ascertain the applicable contract clauses and develop the appropriate audit procedures to ensure claimed costs are in compliance with contract terms. FAR 52.232-7, Payments Under Time and Materials and Labor-Hour Contracts, was revised to allow for payments to be made in accordance with the labor categories specified in the contract that are (1) performed by the contractor, (2) performed by the subcontractor(s), or (3) transferred between divisions, subsidiaries, or affiliates of the contractor under a common control. Payments of materials include subcontracts for supplies and incidental services for which there are no labor categories specified in the contract. Payments for materials are subject to the FAR 52.216-7, Allowable Cost and Payment.

Audit procedures should include verifying claimed/billed labor rates to the contractual rates by labor category and auditing claimed/billed material costs for allowability, allocability and reasonableness. Audit procedures covering labor hours should include selectively verifying the billed/claimed prime, subcontract and intercompany labor hours are supported by the

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applicable timekeeping records/invoices identifying the hours worked by labor category under the contract. For example, billed subcontract labor should be supported by subcontractor invoices/timekeeping records evidencing the hours expended by labor category. Auditors should also ensure that claimed/billed direct labor effort meets the labor category qualifications specified in the contract. For non-DoD competitively awarded contracts, the contract may include blended labor rates. In these cases, auditors still need to reconcile claimed hours to supporting contractor labor hour records. The contractor's labor hour records should include evidence of prime, subcontractor and/or inter-company hours worked by labor category.

Forward Pricing Audits

During forward pricing audits covering DoD T&M/LH pricing actions, auditors should selectively verify that the subcontract and intercompany direct labor is proposed and supported using separate hourly labor rate(s) and are not included as part of the prime contractor's labor rates. The subcontract labor rates, separately proposed by the prime contractor, should include the prime's subcontract costs and applied indirect costs and profit. In addition, intercompany labor rates shall not include profit of the transferring organization (an exception applies to commercial items – refer to FAR 16.601(c)(2) summarized in the Enclosure), but may include profit for the prime contractor.

Auditors with questions should address them to their regional office. Regional questions concerning this memorandum should be directed to Policy Programs Division, at (703) 767-2270.

/s/ Terry M. Schneider
/for/ Kenneth J. Saccoccia
Assistant Director
Policy and Plans

Enclosure:

Summary FAR/DFARS Revisions Related to
Time-and-Materials and Labor Hour Contracts

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**Summary FAR/DFARS Revisions
Related to Time-and-Materials and Labor Hour Contracts
Effective February 12, 2007**

The following summarizes significant revisions to the FAR and DFARS, effective February 12, 2007, related to T&M/LH contracts:

FAR Subpart 16.6 – Time and Materials, Labor Hour, and Letter Contracts

FAR 16.601(a) – The definition of “Hourly rate” and “Materials” has been revised as follows:

- Hourly rate(s) means the rate(s) prescribed in the contract for payment of labor that meets the labor category qualifications of a labor category specified in the contract that are:
 - performed by the contractor,
 - performed by the subcontractors, or
 - transferred between divisions, subsidiaries, or affiliates of the contractor under a common control.
- Materials means:
 - direct materials, including supplies transferred between divisions, subsidiaries, or affiliates of the contractor under a common control;
 - subcontracts for supplies and incidental services for which there is not a labor category specified in the contract;
 - 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
 - applicable indirect costs.

FAR 16.601(c)(2) – Fixed hourly labor rates shall be established as follows:

- Contracts shall specify fixed hourly rates that include wages, overhead, general and administrative expenses, and profit for each category of labor.
- Contracts for non-commercial items awarded using noncompetitive procedures shall specify separate fixed hourly rates for each category of labor to be performed by the contractor, each subcontractor, and each division, subsidiary and affiliate of the contractor under a common control.
- For contracts that are not awarded using competitive procedures, the fixed hourly rate for services transferred between divisions, subsidiaries, or affiliates of the contractor under a common control:
 - shall not include profit for the transferring organization (see exception below) but may include profit for the prime contractor.

**Summary FAR/DFARS Revisions
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- Exception: The fixed hourly rates for services that meet the definition of commercial item at FAR 2.101 that are transferred between divisions, subsidiaries, or affiliates of the offeror under a common control may be the established catalog or market rate when it is the established practice of the transferring organization to price intercompany transfers at other than cost for commercial work.

FAR 16.601(e) – Requires the use of one of the solicitation provisions identified below to describe how fixed hourly labor rates shall be established (blended or separate hourly rates) in the contract.

DFARS 216.601 Time-and-materials contracts – requires use of DFARS 252.216-7002, Alternate A with the provision at FAR 52.216-29 (described below), in solicitations contemplating the use of a time-and-materials or labor-hour contract type for non-commercial items if the price is expected to be based on adequate competition.

FAR/DFARS SOLICITATION PROVISIONS:

FAR 52.216-29 – Time-and-Materials/Labor-Hour Proposal Requirements—Non-Commercial Item Acquisition With Adequate Price Competition

Offeror must:

- specify whether fixed hourly rates for each labor category applies to labor performed by the offeror, subcontractors, and/or divisions, subsidiaries, or affiliates of the offeror under a common control; and
- establish fixed hourly rates using –
 - Separate rates for each category of labor to be performed by the offeror, each subcontractor and each division, subsidiary, or affiliate of the offeror under a common control;
 - Blended rates for each category of labor including labor to be performed by the offeror, subcontractors and affiliates of the offeror under a common control; or
 - Any combination of separate and blended rates for each category of labor to be performed by the offeror, subcontractors, and affiliates of the offeror under a common control

(**Note:** DFARS 252.216-7002 Alternate A, Time-and-Materials/Labor-Hour proposal Requirements – Non-Commercial Item Acquisition with Adequate Price Competition, requires ALL non-commercial DoD T&M/LH acquisitions use separate labor rates by labor category for each subcontractor and each organization under a common control.)

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FAR 52.216-30 – Time-and-Materials/Labor-Hour Proposal Requirements—Non-Commercial Item Acquisition Without Adequate Price Competition

Offeror:

- must specify separate fixed hourly rates for each category of labor to be performed by the offeror, each subcontractor and each division, subsidiary, or affiliate of the offeror under a common control; and
- shall not include profit for the transferring organization (unless transferring organization meets exception noted below), but may include profit for the prime contractor.

Exception: The fixed hourly rates for services that meet the definition of commercial item at FAR 2.101 that are transferred between divisions, subsidiaries, or affiliates of the offeror under a common control may be the established catalog or market rate when it is the established practice of the transferring organization to price inter-organizational transfers at other than cost for commercial work.

FAR 52.216-31 – Time-and-Materials/Labor-Hour Proposal Requirements—Commercial Item Acquisition

Offeror must:

- specify whether fixed hourly rates for each labor category applies to labor performed by the offeror, subcontractors, and/or division, subsidiaries, or affiliates of the offeror under a common control.

DFARS 252.216-7002 Alternate A, Time-and-Materials/Labor-Hour proposal Requirements – Non-Commercial Item Acquisition with Adequate Price Competition – requires all competitively awarded DoD T&M/LH contracts to establish fixed hourly rates using separate rates for each category of labor to be performed by the prime contractor, each subcontractor, and each division, subsidiary and affiliate of the contractor under a common control. Note that noncompetitively awarded contracts (DoD and non-DoD) are required to include separate hourly rates by labor category for all subcontractors and intercompany labor.

FAR PAYMENT CLAUSE:

The FAR Payment clause (FAR 52.232-7) incorporates the changes to FAR 16.601 and solicitations clauses noted above.

FAR 52.232-7 – Payments under Time-and-Materials and Labor-Hour Contracts Non-commercial T&M/LH Contracts

Hourly labor rates and materials have been defined as follows:

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- Hourly Labor Rates means the rates prescribed in the contract for payment for labor that meets the labor category qualifications of the labor category specified in the contract that are
 - Performed by the contractor,
 - Performed by the subcontractors, or
 - Transferred between division, subsidiaries, or affiliates of the contractor under a common control (intercompany rates).
- Materials means—
 - Direct materials, including supplies transferred between divisions, subsidiaries, or affiliates of the Contractor under a common control;
 - Subcontracts for supplies and incidental services for which there is not a labor category specified in the contract;
 - 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
 - Applicable indirect costs.

The Government will pay the contractor as follows upon the submission of vouchers approved by the Contracting Officer or the authorized representative:

- The hourly labor rates shall be paid for all labor performed on the contract that meets the labor qualifications specified in the contract.
- Labor hours incurred to perform tasks for which labor qualifications were specified in the contract will not be paid to the extent the work is performed by employees that do not meet the qualifications specified in the contract, unless specifically authorized by the Contracting Officer.
- Subcontracts for supplies and incidental services, for which there is not a labor category specified in the contract, will be paid at cost.
- Intercompany labor rates shall not include profit for the transferring division (except for commercial items as described in FAR 16.601(c)(2) summarized above), subsidiary or affiliate (the prime contractor, however, may include profit).
- Payment for materials is subject to the Allowable Cost and Payment clause. The Contracting Officer will determine allowable costs of materials in accordance with Subpart 31.2 of the Federal Acquisition Regulation (FAR) in effect on the date of the contract.

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The Contractor shall substantiate vouchers (including any subcontractor hours reimbursed at the hourly rate in the schedule) by evidence of actual payment and by—

- Individual daily job timekeeping records;
- Records that verify the employees meet the qualifications for the labor categories specified in the contract; or
- Other substantiation approved by the Contracting Officer.

FAR PART 12 AND COMMERCIAL CLAUSES:

In addition, FAR 12.207 was revised and a new FAR 52.212-4, Alternate I clause was established allowing use of T&M contracts for commercial acquisitions and covering payments under commercial T&M/LH contracts, as summarized below:

FAR 12.207 – Contract Type – Allows use of T&M and LH contracts for acquiring commercial services (certain limitations apply – refer to FAR 12.207(b)(1)).

FAR 52.212-4 – Contract Terms and Conditions – Commercial Items (Alternate I):

Alternate I states that

- 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
 - Performed by the contractor;
 - Performed by the subcontractors; or
 - Transferred between divisions, subsidiaries, or affiliates of the contractor under a common control.
- Hourly rates will be paid at the rate specified in the contract – allows use of blended labor rates by labor category.
- Hourly rates will be paid for all labor performed on the contract that meets the labor qualifications specified in the contract.
- Other direct costs will be reimbursed based on actual cost if listed by type (e.g., travel, computer usage charges) in the contract.
- Indirect cost, as applicable, will be reimbursed at a fixed amount prescribed in the contract on a pro-rata basis over the contract period.
- At any time before final payment under this contract, the Contracting Officer (or authorized representative) will have access to the following (access shall be limited to the listing below unless otherwise agreed to by the Contractor and the Contracting Officer):

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- Records that verify that employees meet the qualifications of a labor category specified in the contract;
- For labor hours (including any subcontractor hours reimbursed at the hourly rate in the schedule) when timecards are required as substantiation for payment, Original timecards (paper-based or electronic), contractor timekeeping procedures, contractor records that show distribution of labor between jobs or contracts, and access to employees whose time has been included in any invoice for the purpose of verifying that these employees have worked the hours shown on the invoices; and
- Material invoices and/or subcontract agreements and any documents supporting payment of actual costs.