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Records Retention, Untimely Audits And Cost Allowability

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As the Defense Contract Audit Agency slowly works its way through its growing backlog of incurred cost audits, Government contractors are increasingly facing the prospect of contract audits being conducted long after the expiration of the Federal Acquisition Regulation records retention period. At the end of fiscal year 2011, DCAA had a backlog of nearly 25,000 incurred cost proposals totaling more than \$573 billion.¹ Against this monumental backlog, DCAA completed only 349 incurred cost audits in FY 2011.²

At this rate, as COSTS, PRICING & ACCOUNTING REPORT advisory board member Nick Sanders pointed out, even ignoring the thousands of new incurred cost submissions that DCAA receives each year, it will take DCAA nearly 70 years to work through its existing incurred cost backlog.³ But are contractors really required to retain records until DCAA gets around to conducting an audit? If a contractor does not retain supporting documentation beyond the specified records retention period, is the Government entitled to disallow costs for inadequate support under FAR 31.201-2(d)?

Contractor Record-Keeping Requirements

FAR subpt. 4.7 prescribes policies and procedures for contractor records retention to meet the Govern-

ment's records review requirements.⁴ It applies to contracts that contain one of the Audit and Records clauses, i.e., FAR 52.214-26, Audit and Records—Sealed Bidding; or FAR 52.215-2, Audit and Records—Negotiation,⁵ which means that it applies to sealed bid contracts for which certified cost or pricing data are required, negotiated contracts in excess of the simplified acquisition threshold, and other specified categories of contracts and subcontracts.⁶

FAR 4.703 requires contractors to make available records and other supporting evidence to satisfy contract negotiation, administration and audit requirements for three years after final payment, or the period specified in FAR 4.705–4.705-3, whichever period expires first.⁷ There are three important exceptions to the standard records retention period. First, if a contract clause specifies a longer retention period, that period applies.⁸ Second, if the contractor, for its own purposes, retains the records or supporting evidence for a longer period, the retention period is the contractor's retention, or three years after final payment, whichever period expires first.⁹ Third, if the contractor fails to meet the original due date for submission of final indirect cost rates proposals specified in subparagraph (d)(2) of the Allowable Cost and Payment clause at FAR 52.216-7, the retention period is automatically extended one day for each day that the proposal is not submitted after the original due date.¹⁰

As noted, the retention period may be extended by contract clause. Both of the Audit and Records clauses extend the retention period in certain circumstances. FAR 52.215-2 requires the contractor to make available the records, materials and other evidence described in the clause "until 3 years after final payment under this contract or for any shorter period specified in Subpart 4.7 ..., or for any longer period required by statute or other clauses of this contract."¹¹ In addition, FAR 52.215-2 contains two provisions extending the records retention period:

(a) if the contract is terminated in whole or in part, the contractor must make available records relating to the terminated work until three years after any resulting final termination settlement; and (b) the contractor must make available records relating to appeals under the Disputes clause or to litigation or settlement of claims arising under or relating to the contract until the appeal, litigation or claim is finally resolved.¹²

FAR 52.215-2 is a mandatory “flow down” clause for any subcontract that exceeds the simplified acquisition threshold and meets any of the following conditions: (1) is flexibly priced, (2) requires the submission of certified cost or pricing data, or (3) requires the subcontractor to furnish cost, funding or performance reports.¹³ FAR 52.214-26 incorporates by reference FAR subpt. 4.7, in effect on the date of the contract, in its entirety, and makes it a part of the contract.¹⁴ It also contains the same two provisions extending the records retention period that FAR 52.215-2 contains, i.e., in the event of a termination, for records relating to the terminated portion of the contract, and in connection with disputes, appeals, settlements or litigation.¹⁵ FAR 52.214-26 is a mandatory “flow down” clause for all subcontracts expected to exceed the threshold for submission of certified cost or pricing data.¹⁶

By contrast, none of the standard FAR clauses prescribed for use in flexibly priced contracts contains any provision extending the record retention period. FAR 52.216-7, for example, simply incorporates implicitly the FAR subpt. 4.7 requirements by including in the definition of reimbursable allowable costs the qualification, “as shown in the records maintained by the Contractor for purposes of obtaining reimbursement under Government contracts.”¹⁷ The Payments Under Time-and-Materials and Labor-Hour Contracts clause at FAR 52.232-7 requires contractors to substantiate *vouchers* with evidence of actual payment, individual daily timekeeping records, records verifying that the employees meet the specified labor qualifications and other substantiation approved by the contracting officer, but does not state that the contractor must retain these substantiating records longer than the period prescribed in FAR subpt. 4.7.¹⁸

Generally speaking, the FAR retention periods are calculated from the end of the contractor’s fiscal year

in which an entry is made charging or allocating a cost to a Government contract or subcontract.¹⁹ However, there are three exceptions to this rule. First, if a record contains a series of entries, the retention period is calculated from the end of the fiscal year in which the final entry was made.²⁰ Second, if the contractor relies on records generated during one contract as certified cost or pricing data in negotiating another contract, the retention period runs from the date of the latter contract.²¹ And third, if two or more of the record categories described in FAR 4.705 are interfiled and it is impractical to screen the records for disposal, the entire record series must be retained for the longest period prescribed for any of the categories.²²

The three subsections of FAR 4.705 specify retention periods for three broad categories of records: financial and cost accounting records, pay administration records, and acquisition and supply records.²³ Each category has numerous subcategories. FAR 4.705 notes that records are identified in terms of their purpose or use, and not by specific name or form number.²⁴ Thus, although the names may differ from those used by the contractor, the retention periods apply to any contractor records that fall within the description.

The specified retention period for most financial and cost accounting records, and acquisition and supply records, is four years.²⁵ Consequently, with the exception of labor-related costs, records for most of the costs included in a typical incurred cost submission are subject to a four-year retention period. The specified retention period for time cards and evidence of payment for services rendered by employees is two years, whereas the retention period is four years for payroll sheets, registers of salaries and wages paid to individual employees, and tax withholding statements.²⁶

There is, of course, a cost for retaining records, regardless of whether the records are retained in paper or electronic form. Because these costs are allowable costs of contract administration, extending the records retention period simply adds to the Government’s cost of acquiring needed goods and services. For that reason, the Government as well as its contractors benefit from recognizing the limits imposed by FAR subpt. 4.7 on contractor records retention.

FAR 31.201-2(d)

FAR 31.201-2(d) states,

A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is inadequately supported.

Paragraph (d) was added to FAR 31.201-2 by a final rule that took effect Aug. 19, 1996.²⁷ According to the drafters' comments, paragraph (d) was added to make explicit what was already considered implicit in the FAR cost principles, namely, "that contractors must maintain adequate cost records in order to be reimbursed for all claimed costs," and "the contracting officer has the authority to disallow costs which are determined to be inadequately supported."²⁸ FAR 31.201-2(d) did not, however, purport to change any contractor records retention requirements.

Nor did FAR 31.201-2(d) change the burden of proof, as, for example, the FAR Councils did for questions of reasonableness in revising FAR 31.201-3(a). FAR 31.201-3(a) states in pertinent part, "If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable."

FAR 31.201-2(d), on the other hand, does not say anything about the burden of proof; it simply describes the conditions under which costs may be disallowed, much like other cost principles. It is well established that when the Government disallows costs based on a cost principle—and not on the basis of reasonableness or allocability—the burden is on the Government to prove that the costs are unallowable.²⁹ Thus, the Government bears the burden of proving that inadequately supported costs are unallowable.

Case Law Interpretation

Consistent with the FAR Councils' view that FAR 31.201-2(d) merely made explicit what was already implicit, even before FAR 31.201-2(d) was added to

the cost principles, the U.S. Court of Appeals for the Federal Circuit held in *JANA, Inc. v. U.S.*, that the Government could recoup apparent overcharges on two time and materials contracts because the contractor failed to retain labor recap sheets supporting the number of hours invoiced for the four-year records retention period specified in the Armed Services Procurement Regulation.³⁰ DCAA had conducted an audit of the two contracts after the expiration of the two-year retention period for employee time cards, but before the expiration of the four-year retention period for payroll sheets and salary registers, and discovered a discrepancy between the number of hours invoiced and the information shown on some of the underlying employee time records. It was undisputed that at the time of the audit, JANA Inc. could not produce records substantiating all of the hours invoiced under the two contracts, including in particular the labor recap sheets summarizing the time recorded on individual employee time cards. In the trial, the U.S. Claims Court construed the labor recap sheets as essentially equivalent to time cards, and because the two-year retention period expired before DCAA conducted its audit, the court held that the Government did not prove that JANA was overpaid.³¹

The Federal Circuit began its analysis by noting, "[t]he real issue in this case then is *how long* JANA was required to maintain the records that supported labor charges it issued."³² The Federal Circuit agreed with the Government that the labor recap sheets should have been classified as the type of records subject to a four-year retention period.³³ The court reasoned that reading the two retention periods "together suggests the logic between them: While a shorter retention period is imposed on voluminous records, like individual employee time cards, a longer period is required for records of a more summary nature, e.g., the labor recap sheets."³⁴

Accordingly, the court held, JANA was required to retain the labor recap sheets for four years. And because it was undisputed that JANA could not produce the labor recap sheets at the start of the audit commenced within the four-year retention period, the Federal Circuit held that JANA was liable to the Government for overpayment.³⁵

Consistently, in *Analytical Assessments Corp.*, the Armed Services Board of Contract Appeals held that

the Government could recoup amounts provisionally paid to a contractor for subcontract costs because neither the contractor nor subcontractor retained any records supporting the costs for the specified retention periods.³⁶

On the other hand, in cases in which there was no issue of the contractor failing to retain records for the specified retention period, the ASBCA has consistently rejected Government attempts to disallow costs for inadequate documentation. For example, in *BearingPoint, Inc.*, the ASBCA stated,

We reject [the U.S. Agency for International Development's] central argument that the disputed labor charges are unallocable for insufficient documentation. The contract clauses do not impose the stringent requirements of either "nice neat little files" that [the CO] sought..., or the contemporaneous records for which AID appears to be arguing.³⁷

In *BearingPoint*, the contractor relied on testimonial evidence and corroborating documentation to support labor charges in the absence of time cards that were lost or destroyed.

Similarly, in *Lockheed-California Co.*, a case involving a contractor's claim for interest, the ASBCA rejected the Government's "Audit and Records clause defense ... that Lockheed 'has failed to comply with an express condition precedent to further payment' by failing to provide various records that it was required to maintain by the clause."³⁸ The ASBCA found that "Lockheed has produced documentation 'sufficient to reflect properly' the claimed interest costs."³⁹

Conclusion

If DCAA conducts an audit after the specified retention periods have expired, the contractor's costs cannot be disallowed based solely on the failure to retain adequate supporting documentation in accordance with FAR 31.201-2(d). At the very least, contractors may rely on alternative evidence. In the absence of evidence either supporting or challenging the costs, the costs' allowability is likely to depend on the basis for the disallowance and on which party, the Government or the contractor, bears the burden of proof on that issue. Thus, DCAA's growing incurred cost audit backlog not only threatens to render many potential Government claims time-barred by the Con-

tract Disputes Act's six-year statute of limitations,⁴⁰ it may also impair the Government's ability to *prove* its timely cases.

❖ Endnotes

- * Karen L. Manos is a partner in the law firm Gibson Dunn, and co-chair of the firm's Government and Commercial Contracts Practice.
- 1 See *Defense Contracting: DOD Initiative to Address Audit Backlog Shows Promise, But Additional Management Attention Needed to Close Aging Contracts* (GAO-13-131) at 2, available at www.gao.gov/assets/660/650970.pdf; *Actions to Align Defense Contract Management Agency and Defense Contract Audit Agency Functions* (DODIG-2013-015) at 12, available at www.dodig.mil/PUBS/documents/DODIG-2013-015.pdf; *Defense Contract Audit Agency, Report to Congress on FY 2011 Activities at the Defense Contract Audit Agency* at 5, available at www.dcaa.mil/DCAA_FY2011_Report_to_Congress.pdf.
 - 2 See DCAA Report to Congress, *supra* n. 1, at 4.
 - 3 See Apogee Consulting, Inc., "A Frontal Attack on DCAA from a Long-time Supporter" (May 28, 2012), available at www.apogeeconsulting.biz/index.php?option=com_content&view=article&id=688:a-frontal-attack-on-dcaa-from-a-long-time-supporter&catid=1:latest-news&Itemid=55.
 - 4 FAR 4.700.
 - 5 FAR 4.702(a).
 - 6 See FAR 14.201-7(a)(1) (prescribing use of FAR 52.214-26); FAR 15.209(b) (prescribing use of FAR 52.215-2).
 - 7 FAR 4.703(a).
 - 8 FAR 4.703(b)(1).
 - 9 FAR 4.703(b)(2).
 - 10 FAR 4.703(b)(3).
 - 11 FAR 52.215-2(f).
 - 12 *Id.*
 - 13 FAR 52.215-2(g).
 - 14 FAR 52.214-26(d).
 - 15 *Id.*
 - 16 FAR 52.214-26(e).
 - 17 FAR 52.216-7(b)(1)(F).
 - 18 FAR 52.232-7(a)(5).
 - 19 FAR 4.704(a).
 - 20 *Id.*
 - 21 FAR 4.704(b).
 - 22 FAR 4.704(c).
 - 23 See generally FAR 4.705-1–4.705.3.
 - 24 FAR 4.705.
 - 25 See FAR 4.705-1, 4.705-3.
 - 26 See FAR 4.705-2.
 - 27 See 61 Fed. Reg. 31655 (June 20, 1996).
 - 28 61 Fed. Reg. at 31656.
 - 29 See *Space Gateway Support, LLC*, ASBCA 56592, 12-1 BCA ¶ 34941 ("The government bears the burden of establishing that a cost is unallowable by operation of a specific contract provision."); *Lockheed Martin W. Dev. Labs.*, ASBCA 51452, 02-1 BCA ¶ 31803 (the Government bears the burden of establishing that a statute, regulation or contract provision renders a cost unallowable); *Johnson Controls World Servs., Inc.*, ASBCA 46674 et al., 96-2 BCA ¶ 28464 ("Where there is no dispute

over the reasonableness in nature or amount of costs incurred, nor over the allocability of amounts charged to a contract, and the Government seeks to disallow costs solely upon the basis they are 'unallowable,' ... the Government bears the burden of proving that the costs are of the type made specifically unallowable by regulation or contract provision.") (citations omitted).

30 See *JANA, Inc. v. U.S.*, 936 F.2d 1265 (Fed. Cir. 1991).

31 936 F.2d at 1266 (citing *JANA, Inc. v. U.S.*, No. 650-87 C (Cl. Ct. Aug. 23, 1990) (oral bench ruling)).

32 936 F.2d at 1268.

33 936 F.2d at 1269.

34 936 F.2d at 1265.

35 *Id.*

36 See *Analytical Assessments Corp.*, ASBCA 52393 et al., 01-2 BCA ¶ 31483.

37 *BearingPoint, Inc.*, ASBCA 55354, 09-2 BCA ¶ 34289.

38 *Lockheed-California Co.*, ASBCA 28618, 96-1 BCA ¶ 27979.

39 *Id.*

40 See generally Schulze and Manos, "The Contract Disputes Act Statute Of Limitations: Take Your Time, DOD," 6 CP&A Rep. ¶ 71.