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THE NASH & CIBINIC REPORT
government contract analysis and advice monthly from professors ralph c. nash and john cibinic

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¶ 70 CAN GOVERNMENT AUDITORS DO THAT?: Two Board Decisions Construe Scope Of Government Audit And Adjustment Rights

A special column by Amanda Sherwood, Senior Associate in the Government Contracts and National Security practice group at Arnold & Porter. The following article presents the author's views and should not be attributed to any colleagues, friends, or acquaintances.

For decades, this Report has covered the maze of case law, regulations, and policies that surround the Government's rights to audit contractor books and records. See *Postscript: Auditing Incurred Costs*, 32 NCRNL ¶ 9; *Negligent Government Audits: A Discretionary Function?*, 29 NCRNL ¶ 55; *Auditing Incurred Costs: A Forgotten Task?*, 29 NCRNL ¶ 15; *Reliving History: The New DoD Policy on Resolution of Contract Audit Recommendations*, 24 N&CR ¶ 3; *Negligent Auditing: The Pits*, 10 N&CR ¶ 41; *Audit of Contractors' Records: "Everything I've Got Belongs To You,"* 5 N&CR ¶ 5; *Keeping Audit Reports Away From the Auditee: What You Don't Know Can Hurt You*, 4 N&CR ¶ 21; *Auditor Interviews of Contractor Employees: Wolf in Sheep's Clothing*, 1 N&CR ¶ 92; *Role of the Auditor: Any Room Left for the Contracting Officer?*, 1 NC&R ¶ 66. As detailed in 5 N&CR ¶ 5, audits can take a variety of shapes and sizes, authorized by a web of statutory and regulatory authorities. Among the most common yet vexing audits contractors encounter is an incurred cost audit, which can result in requests that contractors turn over records relating to incurred costs and in Contracting Officer final decisions that adjust the contractor's allowable costs.

While the Government's audit and adjustment rights are broad, they are not unlimited, but rather cabined by a series of standard contract clauses set forth in the Federal Acquisition Regulation and agency supplements. A pair of recent board decisions, one from the Civilian Board of Contract Appeals and one from the Armed Services Board of Contract Appeals, are valuable reminders for contractors and the Government of the necessity of examining the relevant contract terms (whether they are stated expressly in the contract or incorporated by law) before audit activities begin.

In the first decision, the CBCA held that the Government has broad authority to audit the firm-fixed-price portion of a hybrid contract that contained cost-reimbursement elements. While one of

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the benefits of FFP contracts is usually a lower level of scrutiny of cost data, if FFP elements are combined with cost reimbursable line items, the Government will nonetheless have broad authority to examine those FFP cost inputs. In the second decision, the ASBCA held the Government lacked authority to reduce fixed-rate labor-hour charges under a time-and-materials contract based on indirect cost rate issues.

These cases illustrate the importance of contractors, auditors, and COs understanding the scope of audit and adjustment provisions in their contracts (and in the FAR generally). They also reveal some of the procedural mechanisms available to contractors that believe the Government has overstepped the bounds of its audit and adjustment rights.

HPM Corp.

In *HPM Corp. v. Department of Energy*, CBCA 7559, 2023 WL 4839050 (July 12, 2023), the contractor (HPMC) held a hybrid cost-reimbursement and FFP contract with the Department of Energy. That contract contained three clauses giving the DOE the ability to audit relevant records:

1. The "Audit and Records—Negotiation" clause at FAR 52.215-2, (which applies to a "a cost-reimbursement, incentive, time-and-materials, labor-hour, or price redeterminable contract");
2. The "Allowable Cost and Payment" clause at FAR 52.216-7 (expressly noted in this contract as "Applies to Cost-Reimbursement"); and
3. The "Access To and Ownership Of Records" clause at DOE Acquisition Regulation 970.5204-3 (paragraph (d) of which requires the contractor to make records "acquired or generated by the Contractor under this contract" available to the DOE for audit).

The contract also contained a "Disputes" clause requiring the parties to negotiate any dispute in good faith.

As part of a yearly incurred cost audit, the DOE requested that the contractor provide data regarding the fixed-price portion of the contract (specifically, details regarding the contractor's actual labor costs charged under a FFP line item), to which the contractor objected, arguing that the audit clause only gave the DOE the right to access data regarding the cost-reimbursement part of the contract. The contractor understandably wished to take advantage of one of the major benefits of FFP contracts: a greater ability to protect sensitive cost, pricing, and profit information from scrutiny, as compared to cost-reimbursement contracts. Fixed-price contracts are just that—fixed at "a price that is not subject to any adjustment on the basis of the contractor's cost experience in performing the contract," which "places upon the contractor maximum risk and full responsibility for all costs and resulting profit or loss." FAR 16.202-1. In exchange, the contractor receives certain flexibilities, including lesser Government scrutiny of its cost information.

The contractor asserted these principles meant that the Government had no authority to audit FFP elements of its contract, even though that contract also contained cost-reimbursement line items. The DOE declined to participate in alternative dispute resolution on this issue, which the contractor also contended violated the "Disputes" clause requirement to negotiate in good faith. The contractor presented a two-count nonmonetary claim requesting a contract interpretation of both the audit clauses and the "Disputes" clause.

Regarding the "Disputes" clause, the CBCA held it had jurisdiction to interpret the clause but

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found that the DOE had not breached it. The DOE clearly did not agree with the contractor's interpretation of the contract's various audit clauses; it was unclear what the contractor thought ADR would accomplish. The CBCA reasoned that the contractor "appears to want to pull the Board into the minutiae of contract administration and have the Board direct the positions that the DOE must take in the negotiation process," which "is not the purpose of the [Contract Disputes Act's] nonmonetary claim review process."

The CBCA also held it had jurisdiction to interpret the audit clauses, over the DOE's objection. The board explained that although the contractor could wait until the conclusion of an audit (in which it declined to provide documentation) and then file a monetary claim challenging any resulting indirect cost reductions, the contractor "is not obligated to wait until the DOE takes such action in order to seek a decision interpreting its audit production obligations under the contract." Rather, where "[r]esolution of that contract interpretation issue may assist HPMC in its continuing contract performance," the CDA permits the contractor to submit nonmonetary claims for early resolution, even if they may later have monetary impacts.

On the merits, the CBCA disagreed with the contractor's arguments that the contract's various audit clauses "only authorize DOE and its auditors to access information regarding the cost-reimbursement [contract line item numbers] in its contract and that information associated with the FFP CLINs are completely off-limits." While the "Allowable Cost and Payment" clause was expressly tied to the cost-reimbursement portions of HPMC's contract, the audit clause at FAR 52.215-2 had no such limitation and clearly provides for audits of "cost-reimbursement contracts." The CBCA found it unnecessary to decide whether that clause "applies only to the cost-reimbursement CLINs…or to the contract as a whole" because the "DOE's auditors have not requested documents that would fall outside the context of a normal incurred-cost audit." The DOE explained in briefing that "[a] well-known audit risk is misallocation and/or cost shifting between fixed price, cost reimbursable, and indirect work/costs," and that "[t]he audit in question is being undertaken to ensure that indirect costs being charged to the cost-reimbursement CLINs are appropriately allocated to those CLINs and have not been, through some type of accounting mechanism, moved away from FFP CLINs." The CBCA thus reads the FAR audit clauses as permitting the Government to fully audit FFP portions of hybrid contracts, so long as there is any cost-reimbursement portion to which the contractor could improperly be shifting costs.

Even without the FAR 52.215-2 clause, the CBCA found that the DOE-specific audit clause at DEAR 970.5204-3 had no limitation to only cost-reimbursement contracts or CLINs, giving the DOE full authority to request the information. The board concluded that it "is in no position to impose some type of myopic limitation on the scope of documentation that auditors need to support an audit of the cost-reimbursement aspects of this contract or of HPMC's indirect cost rates."

The contractor's apparent concern with providing the DOE with the requested FFP information is understandable: the DOE had requested information regarding its FFP labor costs, which the contractor presumed that the DOE planned to make use of in its development of the follow-on solicitation for the same FFP services the contractor was performing. It is easy to see why a contractor would not wish to disclose its profit and cost information in advance of such a competition. But, the CBCA dismissed these concerns regarding "inappropriate use of its proprietary information" as "wholly speculative," and said that the DOE was contractually entitled to information regarding the FFP portion of the hybrid FFP/cost-reimbursement contract (which would include profit and cost information).

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The CBCA offered a likely difficult-to-implement solution to contractors hoping to avoid this situation: negotiate the scope of the Government's audit rights before signing a contract. The CBCA cited 40-year-old Court of Claims precedent proclaiming that "[i]f plaintiff desires to keep the contracting officer in the dark as to the identities of its suppliers [or about other information in its accounting files],…it should not have contracted with the Government on a cost-reimbursement basis necessitating audit of plaintiff's…costs." *SCM Corp. v. United States*, 645 F.2d 893, 902 (Ct. Cl. 1981). The CBCA agreed, and opined that had the contractor here "wanted to create some kind of clear limitation on DOE's audit rights or demarcation of what documents could be requested under this hybrid FFP/cost-reimbursement contract, it should have insisted on those limitations, written in clear language, *before* it executed the hybrid contract." Whether the Government would have been receptive to such negotiations before signing this contract is, of course, far from certain. The echo of industry concerns with COs' unwillingness to depart from standard contract terms dates back to the Armed Services Procurement Regulation (ASPR), at least. See Stone, *Contract by Regulation*, 29 Law & Contemp. Probs. 32 (1964).

In sum, while the CBCA agreed that "the Government's audit rights under these clauses are not limitless and do not provide a basis for wide-ranging document requests for corporate records unrelated to the verification of actual costs," the contractual audit clauses here provided more than sufficient authority for the DOE to request access to the contractor's incurred cost information for FFP CLINs. This is an important practice point to remember both when analyzing the scope of a contractor's risk when signing up for a hybrid cost-reimbursement/FFP contract, or any contract with expansive audit rights, and when deciding how to respond to Government audit requests. While there may be a good argument that FFP data is outside of a necessary audit scope, the relevant tribunals may find broad audit clauses to nonetheless give the Government the right to access such data.

Allard Nazarian Group, Inc.

Whereas the Government auditors acted within their regulatory bounds in *HPM Corp.*, a recent ASBCA case found the Government exceeded its authority to impose contract adjustments. The appeal of *Allard Nazarian Group, Inc. dba Granite State Manufacturing*, ASBCA 62413, 2023 WL 5199773 (July 27, 2023), involved two CO final decisions and demands for payment arising from the contractor's alleged failure to submit final indirect cost rate proposals for fiscal years 2009 to 2014. The CO applied either a 16% or a 20% decrement to all invoices the contractor submitted during that period, including the contractor's direct, fixed price labor costs under four T&M contracts. The contractor appealed the Government claim for reimbursement to the ASBCA and, in a motion for partial summary judgment, argued that the CO's application of the decrement to direct labor hour charges under a T&M contract had no regulatory basis. The ASBCA agreed.

All four contracts included the "Payment Under Time-and-Material and Labor-Hour Contracts" clause at FAR 52.232-7, which requires payment of the hourly rate specified in the contract multiplied by the direct labor hours performed and reimbursement for material costs that includes certain allocable indirect costs. Although only one contract of the four included the "Allowable Cost and Payment" clause at FAR 52.216-7, governing the process for reimbursing costs and setting final indirect cost rates, the ASBCA held that all four contracts contained the clause under the *Christian* doctrine, because FAR 16.307(a) requires the clause be included in T&M contracts. *G. L. Christian & Associates v. U.S.*, 312 F.2d 418 (Ct. Cl. 1963). This ruling reminds contractors of the importance of understanding the regulatory structure of the FAR, which mandates inclusion and operation of

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certain clauses for certain types of contracts and can have large implications for the balance of Government and contractor rights. Even if a T&M contract omits the FAR 52.232-7 or FAR 52.216-7 clauses, tribunals will often read them in by operation of law under the mandates of FAR 16.307. Notably here, the board invoked *Christian* to incorporate the mandatory clauses by operation of law without even mentioning the second factor of the *Christian* doctrine, which generally requires that a clause be both (1) mandatory and (2) reflect an important strand of procurement law. Pangia, *The Unpredictable and Often Misunderstood Christian Doctrine of Government Contracts: Proposed Approaches for Removing Harmful Uncertainty*, 49 Pub. Cont. L.J. 617 (Summer 2020).

On the merits of the motion for partial summary judgment, the Government contended that its decrement to direct labor hour charges was permitted under FAR 52.216-7(g), which gives the Government the authority to "have the Contractor's invoices or vouchers and statements of cost audited" and to "adjust[]" any payment "for prior overpayments." The ASBCA disagreed, finding the language of FAR 16.307(a) limited the application of FAR 52.216-7 only to material costs in T&M contracts:

> The contracting officer shall insert the clause at 52.216-7, Allowable Cost and Payment, in solicitations and contracts when a cost-reimbursement contract or a time-and-materials contract…is contemplated. *If the contract is a time-and-materials contract, the clause at 52.216–7 applies* in conjunction with the clause at 52.232–7, *but only to the portion of the contract that provides for reimbursement of materials*…at actual cost. [Emphasis added.]

Consequently, FAR 52.216-7 only authorized adjustment of the material costs in the T&M contracts and not the contractor's direct labor hour billings. The ASBCA explained: "[T]he government applied a decrement to appellant's *direct labor rate* costs based upon appellant's alleged failure to submit auditable *indirect cost rate* proposals. FAR 52.216-7(g) does not provide a proper justification, or regulatory authority, for the government's actions taken here."

Neither does the Government's power to audit and establish indirect rates include any authority to adjust billings that have no connection to indirect rates or cost-reimbursement contract elements. The ASBCA held that FAR 42.703-2(c), which authorizes the Government unilaterally to establish final indirect cost rates where the contractor provides no indirect cost rate proposal, also "does not grant the contracting officer authority to apply the unilaterally-established final indirect cost rates as a decrement to a contractor's direct labor costs," which "are determined by contractually mandated and agreed upon hourly labor rates." The board concluded:

> The government's imposition of an indirect cost rate decrement upon appellant's fixed labor costs is unreasonable as not supported by the regulatory authorities cited by the government and contrary to the traditional demarcation between direct and indirect costs and the separate treatment of those costs.

The ASBCA made "no determination about the propriety of the Government's decrement as applied to appellant's indirect costs, as that issue [wa]s not before the Board for consideration as part of appellant's motion for partial summary judgment."

The ASBCA explained that the Government does have the power to audit and, if appropriate, adjust direct labor hour billings on T&M contracts—under FAR 52.232-7 or under any authority or procedure the Government invoked in this case. For this reason, the ASBCA found unpersuasive the Government's complaint that it was unable to "validate, through audit, the number of hours and categories of labor claimed and paid," which it claimed on its own justified the decrement to the direct labor hour billings. The board reasoned that FAR 52.232-7 grants the Government the right

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to request at any time before final payment on a T&M contract an "audit of the invoices or vouchers and substantiating material," and if appropriate, to reduce previously paid amounts. The board found this provision "squarely protect[s] the government's interest regarding previous payment of fixed hourly labor rate charges pursuant to time and material contracts." If the Government wished to audit the contractor's direct labor costs, it had the power to do so under the FAR 52.232-7(f) clause, by requesting "vouchers and supporting documentation." If that audit revealed direct labor overpayments, the Government had the power to adjust prior payments for direct labor. What the Government did not have the power to do was to adjust prior direct labor payments for supposed issues with indirect cost rate support, where those indirect rates were never applied to the invoiced fixed rate direct labor.

Conclusion

The differing outcomes in these cases prove that the extent of the Government's incurred cost audit and adjustment powers come down to the language in the FAR and agency supplements, which differs based on contract type. For cost-reimbursement contracts, or even hybrid contracts with cost-reimbursement elements, the Government's audit and adjustment powers are broad, and can even extend to fixed price elements of the contract. That is, just because some contract elements are FFP does not necessarily mean that a contractor can escape any Government scrutiny of cost data related to those FFP elements where a cost-reimbursement portion of the contract requires an incurred cost audit (to establish indirect rates and verify claimed costs). In such a hybrid contract, the Government may reasonably audit the FFP contract portion as well to ensure the contractor is not improperly claiming reimbursement for costs covered by FFP line items or trying to recoup FFP losses through indirect costs.

By contrast, the standard FAR clauses do not grant the Government such broad powers to audit and adjust fixed rate direct labor portions of T&M contracts. When a contractor allegedly fails to support its incurred indirect costs, the FAR only gives the Government the ability to audit and adjust the "materials" portion of a T&M contract and not a firm-fixed-price labor-hour portion (which is only subject to adjustment based on audit of the vouchers and other support for those precise direct labor hours, under FAR 52.232-7(f)).

These cases highlight the importance of both contracting parties carefully reading and understanding the Government's contractual authority to take the broad audit and adjustment actions it so often claims to have. While the Government's audit and adjustment powers are certainly expansive, they are not limitless. *Amanda Sherwood*

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