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Focus

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FEATURE COMMENT: A Brave New World Redux—Recent Developments On DCAA Access To Contractor Internal Audits

Earlier this year, our FEATURE COMMENT in THE GOVERNMENT CONTRACTOR discussed a Government Accountability Office report recommending that the Defense Contract Audit Agency more actively seek access to contractor internal audit reports and related working papers (collectively internal audit material). See Lemmer and Bareis, Feature Comment, "A Brave New World—Managing DCAA Requests For Internal Audits," 54 GC ¶ 34. As the article predicted, this GAO report is resulting in significant changes to the role of internal audit material in Government audits. Subsequent to the GAO report, DCAA issued guidance that is focused on access to internal audit material. Moreover, the Senate has proposed legislation that purports to give the Government access to contractor internal audit material in order to assess contractor business systems, thereby tying such access to contractor business system adequacy.

This FEATURE COMMENT discusses these significant new Government actions and the impacts that they may have on contractors. These impacts not only require action by individual contractors, but they also suggest that industry should consider presenting a united front to resist these counterproductive Government actions.

The GAO Report—In December 2011, GAO issued *Action Needed to Improve DCAA's Access to and Use of Defense Company Internal Audit Reports* (GAO-12-88). It states that DCAA should more vigorously seek contractor internal audit material, which GAO believes would enhance the efficiency and effectiveness of DCAA audits.

The GAO report implies that DCAA is entitled to access internal audit material under 10 USCA § 2313 (and related case law), which gives agencies and their representatives, including DCAA, the ability to access contractor records, including "books, documents, accounting policies and procedures, and other data, regardless of type and regardless of whether such items are in written form, in the form of computer data, or in any other form." Under 10 USCA § 2313, agencies may access such records in order to "audit ... a contractor performing a cost-reimbursement, incentive, time-and-materials, labor-hour, or price-redeterminable contract, or any combination of such contracts." 10 USCA § 2313(a)(1). Section 2313 goes on to note,

> The head of an agency, acting through an authorized representative, is authorized, for the purpose of evaluating the accuracy, completeness, and currency of certified cost or pricing data required to be submitted pursuant to [the Truth in Negotiations Act] with respect to a contract or subcontract, to examine all records of the contractor or subcontractor related to—
> (A) the proposal for the contract or subcontract;
> (B) the discussions conducted on the proposal;
> (C) pricing of the contract or subcontract; or
> (D) performance of the contract or subcontract.

10 USCA § 2313(a)(2). The GAO report concludes that this language provides DCAA with broad access to contractor internal audit material if such material is "relevant to carrying out [DCAA's] audit responsibilities."

As discussed in detail in the earlier FEATURE COMMENT, the GAO report misstates the authority that 10 USCA § 2313 grants to agencies and their representatives to access contractor internal audit material. Rather than having the authority to access any internal audit material that DCAA deems relevant to its audit responsibilities, 10 USCA § 2313 grants agencies and DCAA (when acting as

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an agency representative) the ability to access only objective, factual material, which does *not* include internal audit material.

Specifically, *U.S. v. Newport News Shipbldg. & Dry Dock Co.*, 837 F.2d 162 (4th Cir. 1988), held that 10 USCA § 2313 and its predecessors "are clearly aimed at access to *objective* data supporting cost charges paid by the government" (emphasis added). The U.S. Court of Appeals for the Fourth Circuit reemphasized this holding in *U.S. v. Newport News Shipbldg. & Dry Dock Co.*, 862 F.2d 464 (4th Cir. 1988), by stating that 10 USCA § 2313 and its predecessors "provide DCAA access to *objective factual material* useful in verifying the actual costs, including general and administrative overhead costs, charged by companies performing cost-type contracts for the government." These decisions resulted from the court interpreting the term "records," as used in 10 USCA § 2313 (see definition above), to mean "factual documents." Accordingly, the court determined that the task of inspecting and evaluating records involves access to only factual material. These decisions further noted that internal audit material is typically subjective in nature, and they *explicitly* found such material to be one of the categories of documents outside of DCAA's authority to access.

DCAA Guidance for Auditor Access to Internal Audit Material—On August 14, DCAA issued Memorandum for Regional Directors No. 12-PPS-019(R), "Audit Guidance on Access to Contractor Internal Audit Reports," and related changes to the DCAA Contract Audit Manual (DCAAM). DCAA issued this guidance in direct response to the GAO report discussed above.

The DCAA guidance sets forth the structure that DCAA will use to seek audit material from contractors and track contractor responses to such requests. Under this structure, the DCAA contract audit coordinator offices and field audit offices at major contractor locations are to identify an internal point of contact to request contractor audit material and monitor contractor responses to such requests. To this end, the designated point of contact is to obtain semiannually a list of all contractor internal audits with sufficient detail to determine whether the audit "may affect" Government contracts. Audit personnel are to review this list and request all internal audit material—*including working papers*—considered pertinent. The guidance suggests that the point of contact will serve as a conduit for all auditor requests for internal audit material. The point of contact is also responsible for tracking requests for access to contractor internal audit material, and providing DCAA headquarters with semiannual summaries of the material requested and the contractor's responses to such requests.

In instances in which contractors do not provide access to requested internal audit material, the guidance directs auditors to follow the same denial of access process as would be followed for any other record sought by DCAA. When such efforts fail to result in the production of the requested documents, the guidance directs regional directors to consider whether use of DCAA's subpoena power is appropriate.

Importantly, the scheme set forth above applies only to major contractors. Nevertheless, the guidance states that internal audit material relating to non-major contractors remains useful and that auditors should request such material "when warranted."

Unsurprisingly, the DCAA guidance and DCAAM changes do not address the agency's regulatory or statutory basis for seeking contractor internal audit material. Instead, the guidance simply adopts the GAO report's premise that "DCAA cannot request unlimited access to all internal company materials *but should have access to materials relevant to its audit responsibilities*."

Proposed Senate Action Tying Access to Internal Audits and Business System Compliance—Separately from the DCAA guidance, the Senate is considering changes to 10 USCA § 2313 that purport to give the Government access to contractor internal audit material in order to assess a contractor's compliance with the Department of Defense's 2011 business systems rule. As most readers already know, DOD's business systems rule sets forth detailed compliance requirements for certain business systems of covered contractors, including accounting, estimating and purchasing systems. The Defense Contract Management Agency and DCAA are responsible for auditing covered contractors to ensure compliance with these criteria. If these agencies identify contractor noncompliance with the business systems rule, and the contracting officer agrees that a noncompliance exists, the relevant contractor business system is "disapproved" and the CO is *required* to withhold five percent of payments to the contractor until the noncompliance is corrected.

The proposed language of § 843 of the present Senate version of the National Defense Authorization Act for Fiscal Year 2013, S. 3254, for the first time incorporates the Government's ability to access contractor internal audit material into DOD's busi-

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ness systems rule structure. First, § 843 purports to modify 10 USCA § 2313(a)(2) to allow DCAA access to contractor records in order to evaluate "the efficacy of contractor or subcontractor internal controls and the reliability of contractor or subcontractor business systems." The draft NDAA further requires that DCAA issue guidance to clarify that the agency has

> sufficient access to contractor internal audit reports and supporting materials in order to (A) evaluate and test the efficacy of contractor internal controls and the reliability of associated contractor business systems; and (B) assess the amount of risk and level of testing required in connection with specific audits to be conducted by the Agency.

Finally, and most troubling, the draft 2013 NDAA would require DOD to revise the business systems rule to

> (1) ensure that any assessment of the adequacy of contractor business systems takes into account the efficacy of contractor internal controls, including contractor internal audit reports *and supporting materials*, that are relevant to such assessment; and
>
> (2) provide that the refusal of a contractor to permit access to contractor internal audit reports *and supporting materials* that are relevant to such an assessment is a basis for disapproving the contractor business system or systems to which such materials are relevant and taking the remedial actions.

(Emphasis added.) In other words, this change would allow the Government to use the remedial mechanisms of the business systems rule, i.e., withhold contract payments, as a means of forcing contractors to provide the Government with access to internal audit material, and punishing those contractors that do not provide such access.

Interestingly, while § 843 gives DCAA a weapon to compel contractors to provide internal audit material, the NDAA does not change the definition of records or the fact that 10 USCA § 2313 provides the Government with access to records only for the purpose of evaluating the accuracy, completeness and currency of certified cost or pricing data or cost submissions. As discussed above, it was these factors that led the *Newport News* decisions to determine that the Government may access only objective information relating to specific contracts under 10 USCA § 2313. As the proposed language of § 843 does not change this language, DCAA and DCMA still likely only have a limited statutory right to request the information that § 843 contemplates.

A Common Theme: Government Access to Working Papers in Support of Internal Audits—A common, and troubling, feature of the DCAA guidance and § 843 of the 2013 NDAA is Government auditor access to working papers relating to contractor internal audits. Such access is particularly alarming because internal audit working papers are the quintessential example of the subjective material that the *Newport News* decisions conclude are outside of DCAA's authority to access. Indeed, as noted above, *the work product of internal auditors was one of the specific categories of material that the Newport News decisions determined DCAA could not access*.

DCAA access to auditor working papers is especially troubling because such material may include interview notes and other casual observations that may not even relate to the specific matter addressed by the associated internal audit. Such observations often are not investigated or verified, and have not undergone audit scrutiny. Indeed, the fact that information is contained in audit working papers and not in a subsequent internal audit (presumably the category of information that DCAA would be most interested in because DCAA would not need to access working papers for information incorporated into audits) suggests that (a) the information has no relevance to the ultimate audit, or (b) the accuracy of the information could not be confirmed. Under either of these circumstances, whether the working papers can assist a DCAA auditor in the performance of his duties is highly questionable. Rather, disclosure of such information to an auditor is more likely to lead to costly and unproductive fishing expeditions on the part of DCAA than to a material improvement in the quality of DCAA audits.

The Government focus on auditor access to internal audit working papers further heightens the need for contractors to have updated policies regarding interaction with Government auditors and related protocols governing the disclosure of internal audit material. At a minimum, contractor policies must provide the Government with material which an auditor has a statutory right to access. Beyond such material, it is a business decision on the part of the contractor whether to allow additional access to subjective internal audits or audit working papers. While having such a policy will not ensure auditor acceptance of a

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contractor position, at a minimum, it will ensure that company actions are consistent and avoid situations in which companies have provided information to auditors in the past, but now wish to withhold certain similar information.

The Government's push to access internal audit reports and working papers also suggests that contractors should rethink their approach to conducting internal audits, developing and retaining working papers, and documenting audits through audit reports. As DCAA itself does, contractors that do not already do so should consider limiting working papers to those that directly support the conclusion of the related internal audit report.

Adapting to a New World of Government Audit Access—Despite their questionable legal basis, the Government actions discussed in this FEATURE COMMENT, as well as DCAA's preexisting authority (such as the ability to issue Forms 1), will provide Government auditors with a range of mechanisms for pressuring contractors into providing internal audit material. If § 843 is enacted, an auditor might determine that a failure to provide internal audit material represents a deficiency under the business systems rule, and recommend that the CO disapprove the relevant business system and institute mandatory withholds. Even if § 843 is not enacted, the DCAA guidance will encourage auditors to issue denial of access letters and question the reasonableness and support of related costs if internal audit material is not provided.

Contractor options for fighting back against these Government actions on an individual basis are limited. One option is to negotiate access with DCAA. This is unlikely to be productive, however, because DCAA appears to feel compelled by GAO to force complete access. Another option is to maintain the access protocol that has existed to date. Absent a legislative change, there is no reasonable basis for DCAA to insist on broader access. Adopting this option positions the contractor to argue to the administrative CO that DCAA actions based on a failure to alter the protocol are arbitrary and, if implemented, are a breach of contract.

Conclusion—Ultimately, whether § 843 is enacted or not, a contractor viewed as denying access to internal audit material will be faced with an ACO final decision, either through a cost disallowance or the disapproval of a business system, that may be appealed under the Contract Disputes Act. Similarly, if a contractor business system were to be disapproved, and the disapproval impacts the contractor's competitive position, the contractor may file a bid protest. Although such actions may be resource intensive and time consuming, they also present the only reasonable option for an individual contractor seeking to prevent Government access to internal audit material in the face of an aggressive DCAA audit position.

The limited nature of cost-effective options available to individual contractors, and the near universal contractor belief that unfettered Government access to internal audit reports and work papers is overreaching and counterproductive to effective internal controls, suggest that the best option may be a unified industry approach not to alter current access protocols. Of course, for this to be effective, industry also needs to ensure that Congress understands that legislation increasing Government access rights is bad policy, will have negative impacts on contractors, and will likely not improve the quality of DCAA audits.

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