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GAO Prods DCAA on Internal Audits

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The Government Accountability Office (GAO) recently released a report that essentially chastised the Defense Contract Audit Agency (DCAA) for failing to obtain access to the internal audit reports of defense contractors.[1] For reasons set forth below, this report undoubtedly will spawn litigation when DCAA issues subpoenas to obtain contractors' internal audit reports.

This article addresses many of the problems with GAO's report and the likely consequences of such an initiative, consequences that GAO failed to mention and may have failed to consider. In particular, the GAO either did not understand or chose to ignore established case law that denies DCAA access to companies' internal audit reports.

I. Background. In response to earlier GAO criticisms, DCAA imposed rigorous new timelines for companies responding to auditor requests for records and deprived field auditors of discretion. DCAA's audit guidance now includes procedures to quickly escalate pressure on contractors who either fail to immediately comply with record requests, or who deny auditors access to personnel (despite the fact that auditors have no discernable legal basis to demand access to personnel).[2] Recent DCAA guidance also provided a problematic rule in the audits of contractors' internal control systems, whereby an auditor may not find a contractor system inadequate ''in part,'' but must find the entire system inadequate and take action to suspend payment of invoices where a single internal control objective is not met.

These policies manifest a fundamental policy shift away from cooperatively resolving contract administration matters with government contractors, to a more adversarial posture that will be exacerbated by GAO's insistence on DCAA's access to contractors' internal audit reports.

II. Audits.

a. DCAA Audits.

Audits of defense contractors are performed by DCAA. There are a wide variety of audits, depending on their scope and purpose. For example, there are incurred cost audits, compensation reviews, Cost Accounting Standards (CAS) compliance reviews, audits of pricing proposals, audits of claims, and so on.

Unlike the Securities and Exchange Commission or other investigative government auditors, DCAA auditors do not perform an audit to render an opinion on the contractor's financial statements. While the nature and scope of government audits vary widely, most DCAA audits are in the nature of compliance audits, i.e., verification of compliance with applicable government cost accounting requirements, such as the exclusion of unallowable costs, allocations in accordance with CAS, compliance with agency recordkeeping and reporting requirements, and so on.

b. Internal Audits.

Internal audits are done by larger corporations that have internal audit departments. (As a practical matter, few government contract practitioners have even met an internal auditor.) Because internal audits generally involve sensitive financial information related to the contractor's performance, the reports invariably are restricted to upper management and the board of directors. As a rule, internal audit reports are not intended to be shared outside a company. Moreover, internal auditors are employees of the company so they are not independent. Because independence is a fundamental requirement for outside auditors, this is a major difference between internal auditors and CPAs with accounting firms. This lack of independence notwithstanding, where government contracts are involved,

[1] - Report No. GAO-12-88, Report to the Senate Armed Services Committee, ''*Actions Needed to Improve DCAA's Access to and Use of Defense Company Internal Audit Reports*,'' December 2011.

[2] - In its audit guidance DCAA provided no authority for a demand for access to contractor personnel, and relevant statutes and regulations suggest there is no legal support for this position. *See* FAR 52.215-2, 10 USC § 2313 and 41 USC § 254(d), which provide only for the examination of records.

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GAO wants government auditors to avail themselves of the work internal auditors have performed, and that is the genesis of the issue the GAO report addressed.

An internal auditor does not need a CPA license to practice, and therefore most do not have such a license. Rather, many internal auditors are members of the Institute of Internal Auditors (IAA), a large non-profit international professional organization. Among its many activities, the IAA establishes industry guidance and administers the Certified Internal Auditor's examination.

The scope of internal audits spans the activities of an organization. While internal audit reports frequently involve questions of economy and efficiency in various departments or programs, since the Sarbanes-Oxley Act[3] internal audit departments have had their responsibilities expanded to include routine compliance with requirements related to financial statement reporting. While infrequent, it does happen that internal auditors may uncover a case of suspected embezzlement or other wrongdoing. As discussed more fully below, where government funds are involved, a contractor must self-disclose material misconduct in a report to the government. After receiving this disclosure, a federal fraud investigation may be initiated. When this occurs, government investigators will normally begin where the internal audit left off and use their law enforcement powers to uncover the full scope of the fraudulent conduct.

As the GAO report noted, many defense contractors ''have internal audit departments to monitor policies and procedures established by their management to ensure the integrity of their business systems, including those related to their government contracts.''[4] However, the focus of an audit performed by internal auditors is quite different from an audit done by DCAA. To begin with, because of the expense, only the larger government contractors even have an internal audit department. Second, internal auditors receive training specifically related to their field. Third, the reports of internal auditors go to company management, and are not intended for use outside an organization. Finally, internal audits traditionally concern matters of economy and efficiency, and do not normally consider questions of cost allowability and/or cost allocability specific to government contracts. Nonetheless, since the passage of the Sarbanes-Oxley Act, some internal audit departments have also been tasked with gauging the operation of business systems, with a view toward financial statement valuation and disclosure issues, not compliance with government cost accounting requirements. In other words, the focus of concern is the ability of the business system to support the creation of periodic financial statements. This work would be outside the scope of a DCAA audit because, to repeat, DCAA audits are compliance audits.

c. Internal Investigations.

Internal investigations are significantly different from the work routinely performed by internal auditors. Since at least 1981, the Supreme Court has recognized that effective corporate governance requires companies to be able to conduct internal investigations at the direction of counsel, in order to provide legal advice and to allow companies to ensure their compliance with applicable laws.[5] Records of a corporate investigation into potential wrongdoing under the direction of counsel are protected by the attorney-client privilege, barring some action that forfeits the privilege. As such, reports of internal investigations are clearly beyond DCAA's subpoena authority, and Department of Justice attorneys' arguments notwithstanding, they are also unavailable to other government investigators.

Since November 2008, government contractors are required to report to the government, in connection with a government contract or subcontract, credible evidence of criminal violations involving fraud, conflict of interest, bribery or gratuities under Title 18 of the U.S. Code, violations of the Civil False Claims Act (FCA), and significant overpayments.[6] Failure to comply with this mandatory reporting obligation can have serious consequences, including debarment. Obviously, this reporting obligation is at tension with the protections afforded to internal corporate investigations. Accordingly, it is important to understand that records of such internal investigations are not audits, and corporate counsel should ensure that the internal audit and internal investigation functions are clearly separate.

III. The GAO Report. As a threshold observation, the GAO report noted: ''Both DCAA and company internal auditors have the critical responsibility of assessing the quality of company internal controls.''[7] One significant distinction, however, is that DCAA audits examine internal controls or business systems as they are used *in the execution of government contracts*. On the other hand, internal audits review internal controls and business systems *for purposes of financial statement reporting*. This crucial difference is nowhere mentioned in the GAO report. To the contrary, GAO noted that DCAA's audit manual requires ''an evaluation of internal controls, which includes internal audits, to provide a basis for efficiently and effectively planning an audit.''[8] Because DCAA and internal auditors both examine internal controls, GAO simplistically concluded that such internal audit reports automatically contain information relevant to DCAA audits. The GAO report then said that defense contractors had performed hundreds of internal audits that it conclusorily stated were ''related to,'' ''associated with,'' or ''pertained to'' defense contracts. Whether this determination was accurate or not, GAO's real point was that DCAA had been lax in its requests for access to these internal audit reports.

The most glaring deficiency in the GAO report was its cursory treatment of the fundamental legal obstacle that DCAA auditors face in this area. Specifically, in 1988 the Fourth Circuit Court of Appeals determined in no uncertain terms that ''internal audits are not the type of documents that fall within the scope of DCAA's subpoena power.''[9] Unfortunately, in a two-page Appendix to its report, GAO misquoted and miscited the two key *Newport News* cases that analyzed the scope of DCAA's authority to review contractor records. GAO read these cases as creating some ambiguity that could support

[3] - Pub. L. 107-204, 116 Stat. 745, July 30, 2002.
[4] - GAO report, p. 1.
[5] - *See Upjohn Co. v. United States*, 449 U.S. 383 (1981).
[6] - *See* FAR 9.406-2(b)(vi); FAR 52.203-13(b)(3)(i).
[7] - GAO report, p. 4.
[8] - GAO report, p. 15.
[9] - *United States v. Newport News Shipbuilding and Dry Dock Company* (''*Newport News I*''), 837 F.2d 162 (4th Cir. 1988).

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DCAA review of contractor internal audits. However, the *Newport News I and II* decisions provide no justification for GAO's insistence that DCAA ignore what has been settled law for nearly a quarter century.

GAO attributed DCAA's lack of aggressiveness in making requests for access to the *Newport News* decisions, and this conclusion was probably correct. But GAO apparently believed that the DCAA could obtain access to internal audit reports despite the *Newport News* decisions, judging by how the cases were dismissively summarized in Appendix IV of the GAO report as follows:[10]

> DCAA's use of its access authority has been addressed in at least two court decisions, generally known as Newport News I and Newport News II, both decided in 1988. In both cases, DCAA sought to enforce subpoenas for access to internal documents of Newport News Shipbuilding and Drydock Company. In the first case (Newport News I), Newport News challenged the scope of DCAA's subpoena power as it related to Newport News' internal audits [footnote omitted]. The court held that the statutory subpoena power of DCAA extends to cost information related to government contracts but that DCAA does not have unlimited power to demand access to all internal corporate materials of companies performing cost type contracts for the government. Because the materials sought by DCAA were not within the scope of its statutory authority, the court affirmed the district court's order denying enforcement of the subpoena.
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> In the second case (Newport News II), DCAA subpoenaed the company's tax returns, financial statements, and supporting schedules [footnote omitted]. The court decided to uphold enforcement of the Subpoena, concluding that the requested material was relevant to an audit and provided evidence of the consistency of costing methods and the reconciliation of costs claimed for tax purposes. Further, the court decided that access to the documents would allow DCAA to corroborate the company's computation of direct and indirect costs. The court contrasted the two cases, stating the subpoena at issue in the first case did not extend to internal audits, which contain the subjective assessments of Newport News' internal audit staff. In the second case, DCAA requested production of objective financial and cost data and summaries, not the subjective work product of Newport News' internal auditors. To the extent that the materials subpoenaed would assist DCAA in verifying and evaluating the cost claims of the contractor, the court determined they were within DCAA's statutory subpoena authority.

The GAO report leaves readers with the misimpression that the two cases created some ambiguity about whether DCAA may rightfully demand access to internal audit reports. *Newport News II* certainly provides DCAA auditors a basis to request tax returns and raw cost and pricing data which may have been used by internal auditors, and it established that DCAA may investigate the funding of internal audit functions. But, as discussed below actual internal audit reports are beyond DCAA's subpoena authority.[11]

IV. The Newport News Cases. In the first of two cases brought by Newport News Shipbuilding and Dry Dock Company, the Fourth Circuit Court of Appeals determined that Congress intended to limit the DCAA's subpoena power to those materials which were related to costs incurred in the negotiations, proposals and performance of particular contracts.[12] The Fourth Circuit upheld the lower court's decision, which had found that Congress did not license the DCAA for any ''fishing expeditions through corporate records.''[13] In addition to examining the legislative history of DCAA's subpoena power, the lower court cited pertinent excerpts from a Presidential Commission report that said:

> Government action should not impede efforts by contractors to improve their own performance. . . . [O]verzealous use of investigative subpoenas by Defense Department agencies may result in less vigorous internal corporate auditing. Government actions should foster contractor self-governance. DOD should not, for example, use investigative subpoenas to compel such disclosure of contractor internal auditing materials as would discourage aggressive self-review.[14]

The court also found that the relevant FAR implementing regulations limited DCAA's subpoena authority to cost-related data. The court then noted that internal audit reports were used mainly for internal management control and were not actually pricing data subject to DCAA's subpoena. Because the government pays for these internal audits through indirect cost allocations, the payments were not related to any specific government contract.

The court finished its analysis by noting that the DOD Inspector General was empowered by statute with virtually unlimited investigatory power—including the power to subpoena. In fact, the DOD Inspector General could even tap DCAA personnel in initiating, conducting or supervising audits and other investigations.[15] Comparing DCAA's statutory purpose and subpoena power to the Inspector General's statutory purpose and subpoena power, the Fourth Circuit found that the DCAA's subpoena power was necessarily limited and did not include access to internal audit reports.

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[10] - GAO report, p. 35.

[11] - A single case from the United States Court of Appeals for the District of Columbia Circuit has questioned the result in *Newport News I*. *See Director of the Office of Thrift Supervision v. Ernst & Young*, 786 F. Supp. 46, 50-51 (D.C. Cir. 1992). But that case acknowledged that the Department of Defense is unique in that DCAA auditors have a discrete purpose which is different from the Department of Defense Office of Inspector General.

[12] - Federal courts will enforce an administrative subpoena *duces tecum* if: (1) the inquiry is within the authority of the agency and is for a proper purpose; (2) the matter requested is reasonably relevant to the inquiry; and (3) the demand is not unreasonably burdensome or broad. *See e.g., United States v. Powell,* 379 U.S. 48, 57-58, 13 L. Ed. 2d 112, 85 S. Ct. 248 (1964); *United States v. Morton Salt Co.,* 338 U.S. 632, 652-63, 94 L. Ed. 401, 70 S. Ct. 357 (1950); *see also United States v. Westinghouse Electric Co*., 788 F.2d 164, 170 (3d Cir. 1986) (subpoena must be relevant to agency's lawful purpose) (citing *Endicott Johnson Corp. v. Perkins,* 317 U.S. 501, 509, 87 L. Ed. 424, 63 S. Ct. 339 (1943)).

[13] - *Newport News Shipbuilding and Dry Dock Company v. United States*, 655 Fed. Supp. 1408, 1412 (E.D. Va. 1987) (citing 131 Cong. Rec. § 6966 (Daily ed. May 23, 1985) (Statement of Senator Byrd)). *Newport News Shipbuilding and Dry Dock Company v. United States*, 655 Fed. Supp. 1408, 1412 (E.D. Va. 1987) (citing 131 Cong. Rec. § 6966 (Daily ed. May 23, 1985) (Statement of Senator Byrd)).

[14] - *Id.,* quoting final report by the President's Blue Ribbon Commission on Defense Management, ''A Quest for Excellence,'' at xxviii, xxix.

[15] - *Id.* (citing *United States v. Westinghouse Electric Corp., 615 F. Supp. 1163, 1180, aff'd*, 788 F.2d 164 (3d Cir. 1986)).

In the second *Newport News* case[16], the Fourth Circuit began by affirming the holding of *Newport News I*, stating: ''We affirmed the district court's refusal to enforce the subpoena and held that DCAA's statutory subpoena power extends to objective cost information related to government contracts, but not to all corporate materials such as the internal, subjective evaluations at issue there.'' Then the court went on to conclude: ''The scope of DCAA's statutory subpoena authority also must be read against a practical understanding of the defense procurement process and sound auditing practice. Reviewed in this light, we disagree with the district court's conclusion that NNS's federal income tax returns, financial statements, and supporting schedules must fall outside the scope of DCAA's subpoena power.''

V. Analysis. In response to the GAO report's findings, DCAA was ''skeptical'' that implementing GAO's recommendations would lead to greater access to internal audit reports, because companies place limits on access to internal audit information based on interpretations of DCAA's access authority and related court cases.[17] Surely, DCAA well knows that defense contractors will not respond to its requests for access with unbounded enthusiasm. DCAA may have believed that it could not say no inasmuch as it had recently endured harsh criticism from GAO. Specifically, two recent GAO evaluations of DCAA audits found massive non-compliance with applicable audit standards.[18] As a result, DCAA did not pass its required peer review and cannot now issue unqualified audit opinions. DCAA's inability to issue unqualified audit reports is a significant problem in government contracts, and possibly the most significant problem facing DCAA today.[19] Although these earlier GAO reports did not concern the issue of access to internal audit reports, these developments may be related to the GAO report that is the subject of this article, i.e., they may have contributed to DCAA's unwillingness to challenge GAO's recommendations.

To illustrate the likely consequences DCAA's demands for access to internal audit reports would have, assume a defense contractor is trying to determine whether to replace its timekeeping and reporting system. Assume further that replacing the current system would be administratively burdensome and expensive. Under these circumstances, management may task the internal audit office to study the operation of the timekeeping system, with a view toward using that information to decide whether the current system needs to be replaced, and if so, with what. Shortly after the internal audit report is submitted, assume that a DCAA auditor arrives to perform an audit of labor charging. He subsequently learns of the internal audit report, and, spurred on by the GAO report, requests a copy of both the report and the work papers of the internal auditors. Should the contractor release the internal audit report and the work papers?

If the contractor decides to deny the request for access, it might be inviting costly and protracted litigation. But if the contractor grants the request, DCAA may use some of the information contained in the report to initiate adverse actions against the contractor (current argot calls these dilemmas lose-lose situations). Either way, experienced practitioners know that the contractor's decision is fraught with significant risks. At least the contractor has favorable law on its side.

VI. Conclusion. GAO's view of the two *Newport News* decisions was incorrect. Certainly, its conclusion that internal audit reports may be available to DCAA would require considerably more legal analysis than Appendix IV of the GAO report provided. Also, the GAO report apparently sought to foster the view that troves of contractor data are available merely for the asking. In fact, there are substantial legal and policy issues in this area that the GAO report entirely ignored. Congress had these issues in mind when it accorded DCAA limited subpoena authority, as explained in *Newport News I*.

The government contracting environment has significantly changed since 1988 when the *Newport News* holdings were decided. As noted above, the roles and responsibilities of internal audit departments have considerably expanded since the Sarbanes-Oxley Act of 2002. Since 1988, there have also been numerous other legislative, regulatory, and judicial developments affecting the compliance regime in which government contractors operate. If GAO believes these changes call into question the rationale or findings of the *Newport News* decisions, it might advocate such a position in Congress or the courts, but may not simply ignore the state of the law. Moreover, while the government has a legitimate interest in ferreting out waste, fraud and abuse in government contracts, this initiative to seek access to internal audit reports will ironically lead to less contractor introspection.

While DCAA may try to obtain greater access to internal audit reports (as a result of the GAO report), these actions will undoubtedly result in litigation with affected contractors. Consequently, activity in this area will lead to increased friction between DOD and its contractors at a time when business relationships are already strained (e.g., budget retrenchment, increased regulatory oversight, the lengthening shadow of self-disclosure requirements, and so on). In short, it will be necessary for the courts (or Congress) to resolve the significant legal issues arising from such DCAA requests, issues the GAO report ignored.

Finally, should the *Newport News* decisions be either legislatively or judicially overturned, it would surprise no one if defense contractors simply scaled back the scope of their internal audits. Obviously, internal audits can no longer be beneficial to management when their reports may be used punitively by DCAA. Indeed, defense contractors that have a choice may choose to scale back or eliminate their internal audit departments. Where this occurs, contractors would operate more and more inefficiently, and in the award of its contracts DOD would continually subsidize that inefficiency (read: DOD loses).

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[16] - *United States v. Newport News Shipbuilding and Dry Dock Company* (''*Newport News II*''), 862 F.2d 464 (4th Cir. 1988).

[17] - GAO report, p. 30.

[18] - *See* GAO report No. GAO-09-1009T, September 23, 2009 and GAO report No. 09-468, September 2009.

[19] - *See* ''Collateral Damage: The Impact on Contactors of GAO's DCAA reports,'' by John A. Howell and Peter A. McDonald, BNA *Federal Contracts Report*, Vol. 93, Issue No. 81, February 2, 2010. Reprinted in *The Clause*, Vol. XXI, Issue No. 3, March 2010.

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