

## DCAA's Focus On Internal Audits Could Incite Legal Battles

By Dietrich Knauth

*Law360, New York (August 28, 2012, 7:43 PM ET)* -- Facing criticism for failing to make use of contractors' internal audits, the Defense Contract Audit Agency has adopted new policies for requesting such records that could put it on a collision course with a pair of influential Fourth Circuit decisions that limited the agency's ability to subpoena records, according to attorneys.

The DCAA published new guidance Aug. 14 indicating that it is preparing to seek more records from contractors' own internal audits when evaluating companies. The new guidance requires auditors to establish a process and a central point of contact to obtain contractor internal audits and monitor the DCAA's access to and use of those audits. It also says the DCAA should track its requests for internal audit reports and working papers and contractors' responses to those requests, and establish policies that initiate DCAA "access to records" procedures when contractors deny requests for audit reports.

The DCAA's policy could set it up for future court battles, as contractors have long relied on two 1988 decisions in the Fourth Circuit when denying requests for internal audits, according to Thomas Lemmer, a partner at McKenna Long & Aldridge LLP.

Both cases involved the DCAA requesting information, including tax records and internal audit reports, to support indirect costs that Newport News Shipbuilding & Dry Dock Co. had reported as overhead on U.S. Navy shipbuilding contracts. Taken together, the decisions held that the DCAA could not use its statutory subpoena power to obtain internal audits not tied to a specific contract or proposal, and could not subpoena company tax returns in an effort to corroborate a company's computation of direct and indirect costs.

The DCAA's new policy to seek more internal audit records is at odds with the cases' limits on its ability to get those records, and the fact that contractors may choose stand their ground could lead to legal challenges that will address the scope of the DCAA's authority, experts said.

"Contractors need to have a policy regarding release of reports that they're going to follow consistently. They need to be prepared to implement that policy consistently, even if DCAA is pushing them harder for records," Lemmer said. "Newport News is still good law."

While those decisions still hold sway, a December 2011 U.S. Government Accountability Office report on DCAA's use of contractor internal audits "basically tells DCAA that it should ignore Newport News," according to Lemmer. The DCAA has been responsive to GAO criticism recently, greatly slowing the pace of its own audits after it was sharply criticized in 2007 and 2008 for poor documentation, a too-cozy relationship with contractors and employee performance ratings that prized speed over recovering money for the government.

Contractors are now concerned that the pendulum has swung too far the other way, with a focus on documenting every judgment and scrutinizing every claim for payment. But the DCAA's renewed focus on companies' internal audits is no surprise, given that the agency asked Congress for more authority to access such records in March, according to David Nadler of Dickstein Shapiro LLP.

"This is an issue that has been brewing for some time," Nadler said. "This policy gets the word out that they're going to be more aggressive about it, but we already knew that."

When the DCAA comes calling for internal audit reports, it doesn't have to be an all-or-nothing proposition, Nadler said. Contractors are often able to negotiate a mutually agreeable solution, turning over relevant records while holding back records that they deem irrelevant or sensitive. Still, increased pressure from the GAO could make such negotiations more difficult, according to Lemmer and Nadler.

"In my opinion, [the GAO reports] put DCAA in a box where if DCAA doesn't react to what GAO is saying, then they're going to be hit hard again, as they have been in the past," Lemmer said. "This will almost certainly lead to another Newport News."

If contractors refuse a DCAA record request, they could be hit with a denial-of-access letter, which allows the DCAA to withhold or suspend contract payments and call for criminal sanctions or subpoenas.

"The fact that they haven't done it since Newport News doesn't mean they can't," Nadler said. "This is a way of hitting contractors in the pocketbook."

Even without subpoena power over the internal audits, the DCAA has recently been given a powerful new tool to coerce contractors that withhold records, Lemmer said. A new rule allows the DCAA to withhold payments from contractors if it finds material weaknesses in the company's business and accounting systems, and the DCAA could use withholds as leverage, arguing that it needs access to more records to ensure that the business systems are not deficient.

"I think DCAA is just going to take the money and say, 'Sue me if you want to,'" Lemmer said. "I do think [the new rule] will lead to increases in withholds and even subpoenas."

However, it should be noted that while there are some inconsistencies between the guidance and the Newport News decisions, many contractors voluntarily provide some internal audit reports to the DCAA, and the agency simply doesn't have a good way to track those, according to Steve McBrady, a government contracts counsel with Crowell & Moring LLP.

"This is an inevitable response to [the] 2011 report, and that report was pretty complimentary of contractors," McBrady said. "The focus of the report was on how DCAA can take advantage of that information. ... If DCAA doesn't track its requests, and field offices don't coordinate with contract audit coordinator, then the right hand doesn't know what the left hand is doing."

The DCAA can gain two advantages from greater access to internal audits: It can highlight problematic areas for further review, or it can speed up the DCAA's work and reduce duplicative audits, if the agency trusts the quality of the internal audit.

But contractors have been skeptical of turning over more documents to the DCAA, saying that internal audits that aren't relevant to particular contract could reveal sensitive business information, including chain of command or management structure, or even information that falls under attorney-client privilege.

And it remains to be seen whether the benefits to the agency outweigh the risk of legal clashes with contractors, since more record requests could slow the DCAA down even further at a time when its pace of completed audits was less than two per auditor per year, according to recent statistics reported by the agency.

"Getting all of these internal audit reports is probably going to send them down all these rabbit trails, but in the big picture, it's probably not going to get them very far," Lemmer said. "If they're not going to rely on them, it's not going to save any time."

And the new push for internal audits shows that the increasingly contentious relationship between DCAA and defense contractors isn't about to get any friendlier, Nadler said.

"It was never a good relationship, but now, it's never been worse," Nadler said. "This is going to continue to be an issue, and companies are going to struggle with what to provide and what not to provide. At some point, it's reasonable to expect that there's going to be litigation on the issue."

--Editing by Elizabeth Bowen and Katherine Rautenberg.

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