Understanding Government Contract Audits

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Session 4 · 3:00pm-4:00pm Eastern Time

Audits Virtual Conference
Thursday, March 28, 2013 · 12:00pm-4:00pm Eastern Time

Overview

• Introduction to Government Contract Audits
• Insight into the DCAA Audit Process
• Strategies for a Successful Audit
• Incurred Cost Audits and Cost Principles
• Issues Related to Unfavorable Audits
Introduction to Government Audits

Vincent J. Napoleon

The Government obligates hundreds of billions of dollars in the acquisition of goods and services each year:
- Spending has increased by more than 5 times the rate of inflation
- Spending over the last decade was driven by the September 11th attacks
- An increase focused on issues related to national security and the Global War on Terrorism (Overseas Contingency Operations)
- Spending ranging from $200B in the pre-9/11 period to more than $540B in post-9/11

Given this level of spending, the Government has an obligation to the taxpayer to ensure:
- That it is contracting at fair and reasonable prices
- Against the occurrence of fraud and overpayment
Introduction to Government Audits

• Because of its obligations to the taxpayer and the growth in defense related acquisitions since 9/11, the Government has:
  - Entered into an era of unprecedented oversight of contractors
  - Held contractors more accountable and viewing them as the source of widespread fraud, waste and abuse
  - Increased the number of employees dedicated to contract oversight and enforcement
  - Increased the number of audits conducting more rigorous evaluations of contractor data
  - Focused on ensuring contractor business practices and procedures are in accordance with the
    • Federal Acquisition Regulations (FAR)
    • Defense Federal Acquisition Regulations Supplement (DFARS)
    • Cost Accounting Standards (CAS)
    • Other applicable Government laws and regulations

The Government fulfills its obligations through the conduct of audits

  - In the DOD context, the Government primarily draws on Defense Contract Audit Agency (DCAA) audit findings throughout a procurement
    • During acquisition process: DCAA findings can directly impact the price that the Government pays for contracted work
    • During contract performance: DCAA findings may address issues where the Government may overpay, uncover potential fraud or discover inadequacies in contractor accounting systems
    • After contract completion: DCAA may assess if a contractor's final incurred costs are allowable and reasonable
Introduction to Government Audits

• In recent years, the DCAA has been criticized by the Government Accountability Office (GAO) GAO-08-857:
  - Failing to comply with the Generally Accepted Government Auditing Standards (GAGAS)
  - Issues with auditor independence
  - Insufficient audit testing
  - Internal audits not meeting professional standards
• In an effort to address GAO concerns, DCAA in FY2011 implemented a number of strategies:
  - To improve audit quality
  - Ensure fair and reasonable prices
  - Minimize the occurrence of fraud and overpayment

• Notwithstanding these strategies, the GAO in a recent report criticized the DCAA professionalism and audit quality
  - DCAA did not exercise professional judgment in 37 out of 50 reports completed in 2010
  - DCAA audits demonstrate a pattern of noncompliance among all regions and field detachments and among all engagement types
  - DCAA audit reports are riddled with errors and problems, including inadequate planning, poor communications with contractors and government officials, insufficient evidence, unsupported or untimely reports and poor documentation
What is the DCAA

• Purpose and Role
  - Provide objective, independent opinion on financial assertions made by defense contractors
  - Provide recommendations to government contracting officers, ensuring that the Government gets the best value
  - Determine whether contract costs are allowable, allocable, and reasonable

• Mission
  - Perform necessary audits, primarily for the DOD
  - Provide accounting and financial services
    • Provided in connection with negotiation, administration, and settlement of contracts and subcontracts
  - Ensure taxpayer dollars are spent on fair and reasonable contract prices
  - Provide audit services to other federal agencies
What is the DCAA

- Fulfilling its Mission
  - DCAA evaluates whether contractor business practices and procedures are in accordance with:
    - Federal Acquisition Regulation (FAR)
    - Defense Federal Acquisition Regulation Supplement (DFARS)
    - Other applicable government laws and regulations
  - DCAA provides recommendations and advice to government officials (contracting officers) who are responsible for the acquisition of goods and services

DCAA Organizational Structure

[Diagram of DCAA organizational structure]
The DCAA in 2011

- Audits in 2011
  - DCAA examined more than $125B in defense contractor costs
  - Issued more than 7,000 audit reports recommending $11.9B in cost reductions
  - Net savings to the Government of $3.5B

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<th>Number of Audit Reports</th>
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<th>Dollar Value of Unsupported Costs (Millions)**</th>
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<td><strong>$11,929</strong></td>
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Source: FY2011 DCAA Report to Congress

Percentage of Questioned Cost to Dollars Examined by Fiscal year

Source: FY2011 Report to Congress
Types of Audits

• **Forward Pricing**
  - Completed before contract award: DCAA evaluates a contractor’s estimate of how much it will cost the contractor to provide goods or services to the Government

• **Special Audits**
  - Conducted before or after contract award (or during contract performance): Results from requests for an independent financial opinion on specific elements of a contract or a contractor’s accounting business system

• **Incurred Cost Audits**
  - Primarily after contract award: Determine whether costs charged to Government contracts are allowable, allocable, and reasonable

DCAA Audit Focus

• As part of its risk-based planning process, DCAA directs its audit resources on the highest payback areas to the Government
  - Audits of Overseas Contingency Operations
  - Contractor Pricing Proposal Audits (Setting the stage for fair and reasonable prices)
  - Incurred Cost Audits (Determining the accuracy of contractor cost representations)
  - Equitable Adjustment and Termination Claim Audits (Evaluation of costs when contracts are changed or terminated)
  - Financial Liaison Assistance (Advisory support services to Contracting Officers)
  - Investigative Support (Providing Data which reveal indicators of potential fraud, waste and abuse)
More Recent DCAA Focus

• GAO Report (GAO 12-88) expressed a heightened level of interest in pursuing greater access to contract or internal audit materials
  - Conducted a performance audit from September 2010 through December 2011 assessing the role of defense contractor internal audit department and their ability to provide DCAA with information on company internal controls, business systems and policies affecting government contracts
  - Concluded that limited access to and use of internal audit information, potentially inhibits the Agency from assessing contractor internal controls
    • Greater access to internal audit materials would improve the DCAA’s audit efficiency
    • Enables the DCAA to meet auditing standards for effectively evaluating a contractor’s internal controls

More Recent DCAA Focus

• DCAA guidance issued in direct response to GAO Report
  - Directing auditors to take steps to facilitate and expand access to contractor internal audit reports
  - Guidance exists in contrast to longstanding judicial precedence
    • Newport News Shipbuilding & Dry Dock Co. and a line of cases which limits the government auditor’s access to contractor internal audit materials and records to those materials which are tied to and pertain to a government contract
  - Recent legislative approach
    • Section 832 of the 2013 National Defense Authorization Act (NDAA) allows auditors to ask contractors for internal reports
    • Contractors are not required to provide internal reports
    • Internal audit reports can only be used for evaluating and testing the efficacy of contractor internal controls and reliability of associated contractor business systems
Strategies for a Successful Audit

• Understand DCAA Audit Philosophy
  - DCAA’s Contract Audit Manual (DCAAM 7640.1)
  - FAR and contract terms

• Walk-through
  - Provides a greater audit context and focuses the auditor
    • At beginning of the audit, the contractor should walk government representative through its assertions
    • The walk-through should take place after the auditor performs initial adequacy review of assertions
    • At these meetings, the contractor should fully explain its assertion and allow the audit team to ask questions

• Entrance Conference
  - Develop a common understanding as to audit ground rules
    • Ensures everyone understands the specific scope of the audit
    • Understand the auditor’s approach
    • Establish time expectations
    • Understand any unique parameters associated with the audit
  - Appoint an internal liaison
  - Establish an accurate and accessible record-keeping system
  - Be responsive to the auditor
  - Do not allow the audit to exceed the agreed upon scope
  - Ensure that the auditor provides and facilitates an exit conference
Signs of a Successful DCAA Audit

- Audit procedures are applied objectively by DCAA auditors
  - The audit is conducted in a manner consistent with the audit plan and the contractor’s plan to support the audit
  - The audit is balanced – highlighting the positive and negative aspects of the areas being audited
  - The audit findings are adequately, fairly and appropriately documented and reported
- The audit minimizes interference with the contractor’s normal operations
- The audit results in no “significant” findings
- The contractor is found to be in compliance with all pertinent procurement regulations and statutes

Incurred Cost Audits and Cost Principles

D. Grayson Yeargin
Overview

- Incurred Cost Audits
- Federal Acquisition Regulations (FAR) Cost Principles
  - Allowable
  - Allocable
  - Reasonable
  - Consistent

Incurred Cost Audits

- Contracting Officers typically perform incurred cost audits before the close-out of a cost-reimbursement (or similar type) contract or at the end of the fiscal year of such a contract.
- The purpose of an incurred cost audit is to ensure that the costs charged to the Government contract meet the cost principles of the Federal Acquisition Regulations (FAR) and the Cost Accounting Standards (CAS).
Incurred Cost Audits

- The FAR and CAS require that costs charged to Government contracts are:
  - Allowable
  - Allocable
  - Reasonable
  - Consistent

Cost Principles

**Allowable under regulations and contract terms**
- Reasonable and necessary
- Allocable
- Within terms and conditions of contract

**Allocable and Verifiable**
- Benefits the project
- Easily identified and assigned
- Proportional to relative benefit received by the project

**Reasonable and Necessary**
- Prudent person test
- Necessary for performance of the project
- Consistent with contractor’s established practices

**Consistently Treated**
- Consistency in estimating, charging, and reporting of direct costs and F&A
Allowable

• All costs that are charged to a Government contract must be allowable. In order for a cost to be allowable, it must be:
  - Reasonable and necessary
  - Allocable to a Government contract
  - Permitted per the terms of the contract
  - Adhere to the Cost Accounting Standards and other generally accepted accounting principles and practices
  - Treated in a consistent manner that is appropriate to the circumstances of the contract

Examples of allowable costs
  - Compensation and related benefits costs of employees for work under the contract
  - Costs of materials used in the performance of the contract
  - Equipment used in the performance of the contract
  - Subcontractor costs
Allowable

- Examples of unallowable costs
  - Alcoholic beverages
  - Entertainment (shows, sporting events, social meals) costs
  - Lobbying
  - Gifts
  - Losses on other contracts
  - Advertising
  - Goods or services for personal use of the company or employee
  - Fines and penalties
  - Memberships in civil or social clubs/organizations
  - Any costs that do not have sufficient documentation

Allocable

- A cost is allocable to a Government contract if it can be charged to one or more of the cost objectives of the contract on the basis of the benefits received under the contract. The determination of allocability depends on whether:
  - The cost is incurred specifically for purposes of the contract
  - The incurred cost has a direct benefit to the contract being charged
  - The cost is necessary for the overall operation of a business even if a direct relationship to a particular cost objective cannot be identified
  - If the cost benefits two (or more) projects, whether the cost can be distributed in reasonable proportion among the projects
Allocable

• Allocation considerations
  - Companies cannot shift allocated costs to other Government contracts if the reason for moving the costs is improper, such as:
    • Meeting deficiencies caused by overruns
    • Avoiding restrictions imposed by law or by the terms of the contract
    • Reasons of convenience
  - Costs also cannot be allocated based solely on having a balance remaining in the budget of a contract

Examples of unallocable costs
  - Charging 100% of a maintenance contract for a piece of equipment to one contract when the equipment is used only 50% of the time on work for that contract
  - Charging as a direct cost rent and utilities, office supplies, Internet access, etc. (these costs should be treated as indirect costs and recovered as part of the indirect costs rate)
  - Purchasing equipment at the end of Government contract that is not used or necessary
  - Charging as a direct cost the salary of an administrative staff member who does not work specifically on a Government contract
Reasonable

• A cost is reasonable if the goods or services acquired and the cost of the acquisition is consistent with the actions of a prudent person in the conduct of competitive business
• Whether a cost is reasonable is dependent upon the unique considerations and circumstances of each contract and is determined by the contracting officer. The following factors should be considered in determining reasonableness:
  - Whether the cost is of the type that generally is ordinary and necessary for the performance of the contract or conduct of the contractor’s business
  - Any restraints or requirements imposed by factors such as state or federal laws and regulations, specific contract terms, generally accepted business practices, and arms-length bargaining
  - If the cost has been determined to be consistent with the established practices and policies of the contractor
  - Whether the cost has been determined to be reasonable by individuals concerned with acting with due diligence

Consistency

• The CAS requires that government contractors be consistent in allocating costs for the same purpose as direct or indirect (Facilities and Administrative (F&A)) costs
• Therefore, government contractors must be consistent in treating like costs the same across and within contracts
• This consistency is required in all aspects of financial management: estimating, accumulating, reporting, and allocating costs
Consistency

- Sample list of F&A costs
  - Administrative and clerical salaries, wages, fringe benefits
  - General purpose equipment
  - General purpose equipment maintenance/repair
  - Printing
  - Postage
  - Office supplies

Unacceptable Practices for Costs

- Rotation of charges among projects
- Charging a cost to a project before the cost is incurred
- Charging projects that have the largest remaining balance
- Misrepresenting a cost (e.g., coding staples as “lab supplies”)
- Charging items to a project that is nearing completion without regard to whether the expense is appropriate
- Charging the budgeted amount rather than the actual amount of a cost item
- Charging as a direct cost those costs that typically are indirect (F&A) expenses
**Why does this matter?**

- The DCAA currently is facing a backlog of hundreds of billions of dollars worth of Government contracts that have not undergone an incurred cost audits
- This has not gone unnoticed by Congress
  - The Senate Homeland Security and Government Affairs Subcommittee on Contract Oversight held hearings on the issue in 2011
  - The FY 2012 National Defense Authorization Act requires DCAA to prepare an annual report of its activities, including information about incurred cost audits, such as the number of audit reports completed and pending
- Given this political pressure, DCAA has a renewed focus on completing incurred cost audits

**Why does this matter?**

- As discussed further in the next section, if the DCAA finds problems when conducting its incurred cost audits, the consequences for the contractor can be severe
- If the DCAA finds that unallowable, unallocable, or unreasonable costs have been charged to a Government contract, the penalties can range from an administrative resolution, to a False Claims Act case, to criminal charges
  - The penalties under the False Claims Act are civil penalties of $5,500 to $11,000 per violation and treble damages
Issues Related to Unfavorable Audits: The Dispute Process

Louis E. Dolan, Jr.
Audit Results

• What to Expect?
  – The Final Report
    • Auditor will prepare a report detailing findings and recommendations.
      – Customized
      – Objectives and methodology
      – Discuss results
    • A completed DCAA audit will have one of the following types of reports
      – Unqualified
      – Qualified
      – Adverse opinion
      – Disclaimer opinion

After the Report is Issued

• If the DCAA Auditor identifies unallowable costs that should be suspended or disallowed, the Auditor will:
  – Issue the Form 1, “Suspending or Disallowing Costs to Contractor” and “Copy of Contractor Acknowledged Form”
  – Issue advisory report to the Contracting Officer (CO)
• If the CO agrees with the DCAA Auditor:
  • The CO will assess any applicable penalties and interest
  • At this point, the CO will take no further action unless contractor disputes finding
Audit Penalties

- Federal Acquisition Regulations (FAR) 42.709
  - If indirect costs are expressly unallowable under a cost principle:
    - Penalty = Disallowed Costs + Interest
  - If indirect cost was determined to be unallowable for that contractor before the proposal submission
    - Penalty = \((\text{Disallowed Costs} + \text{Interest}) \times 2\)
- Other laws under which penalties might be assessed:
  - False Claims Act (FCA)
  - False Statements and Other Criminal Laws

Navigating Around an Unfavorable Decision

After the Form 1 Has Been Issued
- Informal DCAA Auditor or Contracting Officer Facilitated Negotiation
- Submit a Written Request to Contracting Officer
- File a Claim Under the Dispute Clause
Informal DCAA Auditor or Contracting Officer Facilitated Negotiation

- **Negotiate**
  - Contractor may try to speak, informally, with the DCAA Auditor or contracting officer in order to reach an agreement

- **Waiver**
  - As part of the negotiation process, the contractor might request that the contracting officer waive the penalties if:
    - The amount of the unallowable costs subject to the penalty is $10,000 or less; or
    - The unallowable costs subject to the penalty were inadvertently incorporated into the proposal

Initiating a Claim

- If informal negotiation fails, a waiver is not available, or other methods, such as ADR, are unsuccessful, the contracting officer’s decision is considered final.
- In response, the contractor may:
  - Request in writing that the contracting officer consider whether the unreimbursed costs should be paid; or
  - File a claim under the Disputes clause, which the contracting officer will process in accordance with agency procedures; or
  - Both of the above
Initiating a Claim: After Submitting Written Request to the Contracting Officer

Submit Written Request to Contracting Officer

Informal Contracting Officer Facilitated Negotiation Agreement

Formal Contracting Officer Facilitated Negotiation Agreement (Possibly Using ADR)

Final Decision from Contracting Officer

Contracting Officer Decision

- If the contractor submits written notice to the contracting officer, the contracting officer must, within 60 days (or established target dates):
  - Fully consider all DCAA findings and recommendations
  - Attempt to negotiate amount with contractor using formal ADR
  AND/OR
  - Issue a final decision
    - Document in the memorandum for record (MFR) stating agreement or disagreement with audit Finding(s);
    - Obtain Contracts Director approval and any required legal opinions;
    - Issue written determination and/or Withdraw of Notice
The Claim Process

- Contracting Officer Final Decision
  - Contracting Officer facilitated Negotiation Agreement (Possibly Using ADR)
  - Board of Contract Appeals
  - U.S. Court of Federal Claims

Appealing the Final Decision

- You may, solely at your election and within 90 days, appeal to the agency board of contract appeals and proceed under the board’s
  - (1) Small claim procedure for claims of $50,000 or less or, in the case of a small business concern (as defined in the Small Business Act and regulations under that Act), $150,000 or less; or
  - (2) Accelerated procedure for claims of $100,000 or less.
- Instead of appealing to the agency board of contract appeals, you may bring an action directly in the United States Court of Federal Claims within 12 months of the date you receive the decision.
The Dispute Process

Unfavorable Audit Finding

- DCQA Auditor Discusses with Contractor
- DCQA Auditor Issues Form 1 and Provides CO with Advisory Report

Informal Negotiation and Initiating a Claim

- If No Negotiation Agreement, CO reviews DCQA Audit Findings and Assesses Penalties
- If Contractor Disagrees with CO Decision and Cannot Reach Favorable Negotiation, Contractor may Submit Written Request to CO

Final Decision and Formal Negotiation

- If No Negotiation Agreement, the CO Issues a Final Decision
- CO May Use ADR to Reach Agreement, Even After Final Decision is Issued

The Appeal

- Board of Contract Appeals
- U.S. Court of Federal Claims

Avoiding Audit Problems

- Minimize Conflicts with Government Auditors
  - Create Internal Audit Department
  - Engage in Risk Management Reviews
  - Develop Employee Training Programs
  - Initiate Antifraud Compliance Programs
  - Participate in Exit Conferences
  - Utilize Sarbanes-Oxley Act Section 404 (SOX 404) Compliance Program
    - Confer with external and internal auditors
Contact Information

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QUESTIONS?

Press the “Raise Hand” icon to ask a phone question.

To sync your phone line and Internet connection, go to the tabs above the PowerPoint slide and click on “info” to access your site session and attendee id numbers.

or

Type your question into the Q&A panel.
Thank you for participating in today’s program.