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Government Contract

COMMENTARY

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Government Auditors as Whistle-Blowers: Preparation for Government Audits

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Most government contractors are fully aware of the dangers of fraud allegations. Even an unfounded allegation can result in an extended and costly government investigation, exposure to criminal and civil remedies, and the risk of suspension from doing business with the government. Given this exposure, contractors are appropriately careful in responding to inquiries from government investigators or prosecutors.

Surprisingly, however, contractors often regularly ignore adequate preparation and procedures in responding to government auditors despite the auditors' role as skilled, well-trained and diligent whistle-blowers with access to virtually all aspects of a company's business. This commentary recommends against such a practice and provides fundamental procedures that will protect the contractor from allegations of fraud or misconduct while fully supporting the audit process.

Auditors as the Ultimate Whistle-Blower

Although government auditors are not investigators, they are among the most highly trained and vigilant whistle-blowers on a wide scope of alleged illegal activity. The Defense Contract Audit Agency's contract audit manual describes an auditor's responsibilities for detecting and reporting fraud as follows:

Auditors are responsible for being aware of fraud indicators, vulnerabilities, and potentially illegal expenditures and acts associated with an audit area. When an auditor obtains information that raises a reasonable suspicion of fraud or other unlawful activity that has not been previously disclosed to the government, an investigative referral should be initiated.¹

In addition to fraud, auditors look for other "unlawful activity," including improper gifts and gratuities, kickbacks, anti competitive actions and illegal political contributions.² Auditors have a broad mandate to uncover any "willful and conscious wrongdoing, including, but not limited to, [the following] acts of cheating or dishonesty" that could cause injury to the government:

- Falsification of documents such as time cards or purchase orders;
- Charging personal expenses to government contracts;
- Submitting false claims such as invoices for services not performed or materials not delivered;
- Intentional mischarging or misallocation of costs;
- Deceit by suppression of the truth;
- Bribery;
- Making corrupt payments that violate the Foreign Corrupt Practices Act;
- Theft;
- A government employee acquiring a financial interest in or seeking employment with a contractor over whom the employee exercises oversight;
- Kickbacks;
- Any unlawful or fraudulent acts resulting from accounting classification practices designed to conceal the true nature of expenses, e.g., classifying

unallowable advertising or entertainment costs as office supplies;

- Product substitution or false certification that tests were performed; and
- Any attempt or conspiracy to engage in, or use, the above devices.³

In addition, the Department of Defense inspector general provides government auditors with detailed descriptions of fraud schemes, indicators and methods for uncovering fraud.⁴

An auditor will seek information about fraud from all possible sources and through any means of discovery. Auditors will “[t]reat as a possible lead” allegations received from “company employees, disgruntled participants,” or outside or anonymous sources provided by “letter, telephone, personal visit or a third party.”⁵

The Government’s Use of the Audit As an Investigatory Tool

Government audits are an important investigatory tool, starting and assisting numerous fraud investigations each year. Auditors do not wait for an allegation of illegal activity but use the audit process to actively pursue fraud and other illegal activities.

Government standards require auditors to “design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, abuse or illegal acts” and demand “constant alertness to the possibility of fraudulent activity.”⁶ Auditors “exercise a proper degree of professional skepticism to achieve reasonable assurance that material unlawful activities or improper practices are detected.”⁷ Professional skepticism requires that an auditor neither assume “that management is dishonest” nor “unquestioned honesty.”⁸

Auditors evaluate “conditions observed and evidential matter obtained” to determine if there is a reasonable suspicion of fraud.⁹ While avoiding the “appearance of an investigation,” auditors will continue to request information from the contractor until “satisfied either that an innocent explanation of the irregularity is not likely or no further relevant information can be generated through audit techniques.” Auditors will modify planned audit procedures when necessary to obtain more reliable or corroborating evidence of fraud.¹⁰

Auditors will report in writing a reasonable suspicion of fraud that has corroborating evidence to the inspector general or other government investigators.¹¹ If no cor-

roborating evidence is uncovered, the auditor will make a fraud hotline referral.¹²

After referral of an audit to an investigating agency, the auditor will consult with the investigators on the scope of the continuing audit before issuing any findings within the area of investigation.¹³ Auditors will also audit areas specifically requested by the investigator.¹⁴ An auditor will also suspend or defer audit activity outside the area of investigation upon written request by the investigators. Finally, the auditor will provide the investigators with a copy of the audit report and work papers.¹⁵

Thus, in addition to being alert for indicators of fraud, an auditor will modify procedures to investigate fraud, conduct an audit at the direction of the investigator to support the investigation, and defer to the investigator on the issuance of a report and resolution of audit procedures once a formal investigation has been instituted.

Auditors’ Access to Information

The government has audit rights over essentially all aspects of a traditional contractor’s business, including cost accounting, cost estimating, pricing agreements, and corporate and management policies. Government auditors even have significant access to data and information relevant to contracts for commercial items and services administered by the General Services Administration, including commercial sales practices, commercial contracts, pricing and invoicing. Thus, the auditor has regular and more meaningful access to a contractor’s information than does a government investigator.

Defense Contract Audit Agency

The Defense Contract Audit Agency’s major audit areas include:

- Internal control systems;
- Management policies;
- Accuracy and reasonableness of cost representations;
- Adequacy and reliability of records and accounting systems;
- Financial capability; and
- Compliance with pricing, accounting and financial requirements, including the cost principles in Federal Acquisition Regulations part 31, the cost accounting standards and the Truth in Negotiations Act.¹⁶

Generally, DCAA focuses its audit efforts on firm fixed-price contracts during the proposal and negotiation of the contract. For cost contracts, the agency generally audits after cost incurrence.¹⁷

DCAA's primary authority for access to contractor records is found at FAR § 52.215-2, Audits and Records – Negotiation, which provides auditors with access to all cost and pricing records, broadly defined as follows:

Records include books, documents, accounting procedures and practices, 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.

DCAA has taken an expansive view of this clause, arguing that it provides authority for access to "policies, procedures, systems, management reports, personnel, minutes of board-of-directors meetings, charter and bylaws, and any other information source which affects and reflects the incurrence, control and allocation of costs to contracts."¹⁸

General Services Administration

There are two main types of GSA audits:

- Pre-award pricing audits, which examine the pricing, sales and other data provided during negotiations to ensure that the data is accurate, current and complete; and
- Post-award compliance audits under the "examination of records" clause, which examine a contractor's records to check for overbillings or billing errors and to verify compliance with the contract's price reduction and "industrial funding fee" clauses.¹⁹ Both are generally conducted by the Office of Inspector General's Office of Audits.

In addition to pre- and post-award audits, GSA also conducts periodic "contractor assistance visits" using its industrial operations analysts. Regardless of the name, these visits are intended to "evaluate the contractor's performance" to assist GSA personnel in making decisions about exercising contract options and awarding additional contracts.²⁰ The operations analysts ensure that products being provided are within the scope of work, the accuracy of the industrial funding fee included in prices and compliance with the Trade Agreements Act.²¹

GSA's right to access records during a pre-award audit is governed by FAR § 52.215-20 (Alt. IV) (Var. I):

By submission of an offer in response to this solicitation, the offeror grants the contracting

officer or an authorized representative the right to examine, at any time before initial award, books, records, documents, papers and other directly pertinent records to verify the pricing, sales and other data related to the supplies or services proposed in order to determine the reasonableness of price(s). Access does not extend to offeror's cost or profit information or other data relevant solely to the offeror's determination of the prices to be offered in the catalog or marketplace.²²

The primary authority for a post-award audit lies in the clause titled "examination of records by GSA (multiple award schedule)," which says:

The administrator of general services or any duly authorized representative shall have access to and the right to examine any books, documents, papers and records of the contractor involving transactions related to this contract for overbillings, billing errors, compliance with the price reduction clause, and compliance with the industrial funding fee and sales reporting clause of this contract.²³

The Ground Rules for Responding to an Audit

Observing proper procedures in responding to audits is essential to avoiding a fraud referral when possible, determining when an auditor has made a fraud referral and fully responding to an investigation.

Avoiding a referral is largely a matter of convincing the auditors that any concerns they might have do not rise to the level of fraud. A contractor will be more likely to be successful in such an effort if it has developed a plan for educating the auditors about its position and has provided complete and accurate information to support its position.

In addition, an understanding of the scope of the audit, the requests for information and the information provided the auditors is essential in accurately determining when an auditor has referred an issue for investigation. Finally, a contractor requires a complete record of *all* information provided to the auditors as the starting point for an internal investigation to assess liability and prepare a defense.

Contractor Preparation for Audit

A contractor about to be audited should take the following preliminary steps:

- Ask for the audit request in writing. The request should include a statement of the objectives,

- identification of the government's team and an anticipated time span for the audit;
- Establish a primary point of contact for the government to respond to information requests during the audit;
- Provide the auditor with a suitable workspace, monitored by the designated point of contact;
- Arrange pre- and post-audit conferences with the auditors;
- Request that questions that may have compliance implications be put in writing, and make arrangements to provide written responses promptly; and
- Make a copy and create a record of each document provided to the auditor.

These procedures should be followed throughout the course of the audit.

The contractor should also develop and implement a plan to educate the auditors concerning the nature of the contract and the company's position and justification for the positions or policies being audited. Prior to the audit the contractor should identify the company personnel who will be involved in this effort and should consult with legal counsel if appropriate.

Entrance Conference

To understand the parameters of the audit, contractors should arrange an entrance conference with the auditors before they begin their work. As part of that conference the auditors should, at a minimum, explain the purpose of the audit, the overall plan for its performance including the estimated duration, and generally the types of books, records and operations data with which the auditors will be concerned.

The conference should also cover the following areas:

- Arrangements for any necessary work space and administrative support;
- Designation by the contractor of its point(s) of contact;
- Discussion of the contract and the nature and location of relevant records;
- Tour of office and/or plant operating areas used in performing current and proposed contracts;
- Arrangements to review the planning documents, working papers and audit reports of the contractor's internal and external auditors for any audits or reviews performed or planned that may curtail the planned scope of work;
- Arrangements for any needed IT audit assistance; and
- When the audit involves a subcontractor's cost representation(s), resolution of any restrictions on release of audit findings and report information to higher-tier contractors per FAR § 9-106.4.²⁴

Auditors may take the position that designation of a point of contact does not preclude access to other knowledgeable contractor personnel and that it should not cause delays or extra audit work. Auditors may take the position that contractor actions that unreasonably restrain, restrict or delay the audit may be deemed a denial of access to records.²⁵

Contractors should insist on the auditors acting through the designated point of contact. Contractors should also avoid any unnecessary delays in responding to reasonable requests. However, a contractor should not sacrifice reasonable control over its information and an accurate record of the information reviewed by the auditors.

Conduct of Audit

The contractor should make sure that its preparation procedures are followed throughout the audit. There should continue to be a primary point of contact handling auditor requests. The auditors should be escorted throughout the premises. The contractor should respond as promptly as reasonably possible to auditor requests to prevent any claim that it is unreasonably delaying or restricting the audit. It should make copies and keep a record of all information provided to the auditors.

The contractor should also make sure that auditor requests fall within the scope of their audit authority. Although auditors generally have broad discretion in requesting information, such information must be relevant to the specific audit.

For example, a request for cost or pricing data would be inappropriate for a commercial pricing audit. If a contractor believes that the request goes beyond the scope of the audit or is unduly burdensome in scope, it is reasonable to respectfully decline the request by providing the rationale in writing.

A contractor should be willing, however, to negotiate the scope of information that is relevant to the audit. Keep

in mind that an auditor will have access to subpoena authority to compel the production of relevant information.²⁶

Exit Conference

Contractors should arrange for an exit conference with the auditors. Auditors will generally provide an exit conference to a contractor even when there are no adverse findings as "a minimum courtesy to the contractor and ... an important part of sound contractor relations."²⁷

During an exit conference the auditors should:

- Summarize the audit results;
- Confirm or follow up on requests for the contractor's reaction to any audit exceptions for inclusion in the audit report; and
- If applicable, note that the audit findings, conclusions and recommendations are subject to normal DCAA review by the auditor's office before the report is issued and that the contractor will be advised if any significant changes are made.²⁸

Contractors should use the exit conference to ensure that they understand the results of the audit and express to the auditors any disagreements with those results. The auditors are then required to include such disagreements in the audit report.²⁹ Contractors should also request a copy of the audit in draft form and an opportunity to respond to any concerns raised in the draft.

Challenging Audit Findings

Contractors should always take the opportunity to provide a written response to any concerns raised by the draft audit report. The auditors are required to include the contractor's written response as part of any final report. The audit report will reference the contractor's response and will also attach the full text of the response as an appendix.³⁰

The challenges to the audit findings are particularly important if the auditor has referred or will refer any allegations for investigation. The written response will be the contractor's first opportunity to respond to such allegations. Perhaps more importantly, the government and judge or jury will view any subsequent response or defense of the fraud allegations in comparison to this written response.

Needless to say, this response must be carefully considered and as accurate and complete as possible. A contractor should use the same diligence and resources in providing

this response as it would for a response to an inquiry from an investigator or prosecutor if an allegation of fraud is or could be implicated.

Recognizing When an Audit Has Become An Investigation

It is often difficult to recognize when an audit has shifted from a routine focus to supporting an investigation. An auditor does not have an obligation to inform a contractor of a referral for investigation or the initiation of an investigation.³¹ Defense Contract Audit Agency policy prohibits any reference to the investigation or referral even in the written audit report.³² Thus, an auditor could shift focus from a normal auditing function to supporting an investigation of fraud without any notice to the contractor.

A contractor should be alert for certain "red flags," however. A shift or expansion in the scope of the audit from that originally described in the entrance conference is likely a sign that the audit has transformed to supporting an investigation.³³ Such shifts often result in comprehensive or repetitive requests for information on a particular cost, policy or action.

In addition, on occasion an investigator will instruct an auditor to exclude the action under investigation from audit. Thus, a limitation or removal of particular areas from audit is another sign of a referral or investigation. Careful attention to the auditors' discussion of the scope and purpose of the audit during the entrance conference is essential to identifying changes to scope or focus after the audit begins.

Auditors may decline a request for an exit conference where the audit is performed in support of litigation, investigations or voluntary disclosure verifications.³⁴ Thus, a declination of an exit conference in the absence of litigation or a voluntary disclosure has likely resulted because the auditor has referred or will refer certain fraud allegations for investigation.

Similarly, a refusal to discuss certain findings or areas of the audit may indicate that the auditor has referred these findings or areas for investigation. DCAA policy prohibits an auditor from discussing with the contractor any information referred for investigation.³⁵

Finally, auditors will likely exclude any reference to information referred for investigation in a draft or final audit report. Thus, auditors have likely referred allegations for investigation if the audit report does not discuss an area where the auditors made significant inquiry, or no audit report is issued. Maintaining careful records of the auditors' requests and inquiries is essential in determining whether any particular audit area has been excluded from discussion in the audit reports.

Upon discovering a red flag indicating a possible investigation or referral, a contractor should conduct its own internal investigation of possible fraud. An internal investigation is important for several reasons.

It allows the contractor to evaluate its exposure and act accordingly. Further, it allows the contractor to gather the facts and present its case in the most favorable light to the investigators or prosecutor. Finally, a failure to conduct an internal investigation could cause the contractor to lose credibility with the investigators.

A careful record of the materials provided to the auditors will be of great benefit in conducting the internal investigation. The contractor and counsel will have the very documents that formed the basis for the auditors' referral and the government investigation.

Conclusion

Government auditors are trained to look for fraud during all routine audits and *always* view the discovery of fraud as an unstated objective. Contractors should implement and routinely follow procedures, such as those described above, that recognize this objective and the possibility of a fraud referral.

Such procedures permit the contractor to identify a fraud referral as soon as possible and provide a solid foundation for the investigation, development and presentation of an early and complete defense. In addition, these procedures are equally useful for fully and timely responding to any routine audit findings.

Notes

¹ Defense Contract Audit Agency Contract Audit Manual at § 4-702.2b (citations omitted).

² *Id.* §§ 4-702.1, 4-703, 4-704, 4-705, 4-706 (citations omitted).

³ *Id.* § 4-702.1.

⁴ Department of Defense Inspector General's Handbook on Fraud Indicators for Contract Auditors (IGDH 7600.3 Mar. 31, 1993).

⁵ *Id.* § 4-702.5.

⁶ *Id.* § 4-702.1.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* § 4-702.3.

¹² *Id.*

¹³ *Id.* § 4-702.5.

¹⁴ *Id.* § 4-702.6.

¹⁵ *Id.* § 4-702.5.

¹⁶ DCAA Information for Contractors at § 1-501.

¹⁷ *Id.*

¹⁸ DCAA Contract Audit Manual at § 1-504.1 (emphasis added).

¹⁹ GSAR § 552.215-71.

²⁰ Acquisition Programs Audit Office, General Services Administration, Audit of FSS's Contractor Assessment Initiative (CAI) Report No. A040252/F/A/V05002, at i (Sept. 29, 2005) (*available at* http://www.gsa.gov/gsa/cm_attachments/GSA_DOCUMENT/A040252_R2-z-d3-c_0Z5RDZ-i34K-pR.pdf).

²¹ Office of the Chief Acquisition Officer, General Services Administration, GSA Acquisition Workforce Forum, Southeast Sunbelt Region 'Gets It Right' (Spring 2005) (*available at* http://www.gsa.gov/gsa/cm_attachments/GSA_DOCUMENT/AWF-7_R22P1-o_0Z5RDZ-i34K-pR.htm#12).

²² Federal Acquisition Regulation § 52.215-20 (Alt. IV) (Var. I).

²³ GSAR § 552.215-71.

²⁴ DCAA Audit Manual § 4-302.1.

²⁵ *Id.*

²⁶ *Id.* § 1-504.4.

²⁷ *Id.* § 4-304.1.

²⁸ *Id.* § 4.304.1.

²⁹ *Id.* § 10-210.5.e(1)(b).

³⁰ *Id.* § 10-210.5.e(1)(d).

³¹ *Id.* § 4-702.6.

³² *Id.* § 4-702.5.

³³ *Id.*

³⁴ *Id.* §§ 4-304.1, 4-304.7, 4-702.5, 4-707.3.

³⁵ *Id.* § 4-702.5

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