



# FEDERAL CONTRACTS



## REPORT

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### DCAA

## **Collateral Damage: The Impact on Contractors of GAO's DCAA Reports**

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### **I. Introduction**

In the summer of 2008, the Government Accountability Office (GAO) issued a report (2008 Report) that addressed allegations that certain audits done by the Defense Contract Audit Agency (DCAA) did not comport with generally accepted government auditing standards.<sup>1</sup> This Report was presented to the Senate Committee on Homeland Security and Governmental Affairs in September 2008. The Committee subsequently requested GAO to expand its review to determine to what extent the audit quality problems identified in the instances examined in the 2008 Report existed in the rest of the agency. In September 2009, GAO issued two reports on its review of 37 diverse DCAA audits. In brief, all 37 were found to be defective. As others have already noted, these reports essentially meant that "DCAA is currently a spectacular failure."<sup>2</sup>

<sup>1</sup> - See GAO Report 08-857, "Allegations that Certain Audits at Three Locations Did Not Meet Professional Standards Were Substantiated," July 22, 2008.

<sup>2</sup> - "Reforms to the DCAA: The Potential Effect on Contract Management," by Jack Horan, *NCMA Contract Management Journal*, p. 92, December 2009.

This article briefly discusses these two follow-up GAO Reports and applicable case law, and then points out the impact these reports may have on DCAA's relationships with government contractors.

### **II. GAO's Findings**

The introductory paragraph in a DCAA audit report typically contains the following standard language:

We conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the data and records examined are free from material misstatement.

The statement that the audit "was conducted in accordance with generally accepted government auditing standards" (GAGAS) accords the report the imprimatur of quality. Because of that assertion, users of the report may rely on the validity of its findings since they are consistent with applicable professional standards. Adherence to professional standards is what provides an authoritative foundation to any audit report. Conversely, departing from applicable professional standards impairs audit quality, and calls a report's findings into question. For this reason, maintaining audit quality is a significant responsibility for any auditor. This fundamental principle is just as applicable to DCAA auditors as to auditors in the private sector.<sup>3</sup> As discussed in

<sup>3</sup> - See Defense Contract Audit Agency, *Contract Audit Manual*, Section 10-103: "The DCAA audit report must satisfy

greater detail below, the lack of audit quality in DCAA audits was found by GAO to be a significant problem throughout DCAA.

A. GAO Report 09-468, “*Widespread Problems with Audit Quality Require Significant Reform*,” September 23, 2009 (‘Long Report’)

GAO found quality deficiencies in virtually every DCAA audit it examined, and the failure to comply with GAGAS was so pervasive it concluded that the quality problems were “rooted in DCAA’s poor management environment.”<sup>4</sup> Stated bluntly, management is responsible when things are this bad. The GAO Report put it this way:

DCAA’s production-oriented culture is deeply imbedded and likely will take several years to change. Under the decentralized management environment, there has been little headquarters oversight of DCAA regions, as demonstrated by nationwide audit quality problems. Further, DCAA’s culture has focused on hiring and promoting from within the agency and most training has been conducted by agency staff. This has led to a very insular culture where there are limited perspectives on how to make effective organizational changes.<sup>5</sup>

Unfortunately, DCAA’s management was too insular to realize it even *had* audit quality problems. Speaking of DCAA’s mismanagement, GAO’s review also stated that they “found no evidence that supervisors and auditors who did not follow GAGAS and DCAA policy were disciplined, counseled, or required to take additional training.”<sup>6</sup>

Other audit problems identified by GAO stemmed from auditors’ routine use of boilerplate language in their audit reports.<sup>7</sup> This practice masked the fact that DCAA auditors almost invariably did not perform enough audit testing to substantiate their conclusions. This is a very serious shortcoming, and one that goes to the core of any audit report’s credibility, yet this problem existed in almost every audit GAO reviewed:

The most pervasive audit deficiency we identified was insufficient testing to support DCAA’s reported conclusions and opinions.<sup>8</sup>

This was not the only significant problem. Section 3.55 of GAGAS requires an organization performing audits to have its work periodically evaluated by an external organization. The process of evaluating an organization’s compliance with GAGAS is called a peer review. GAGAS state the peer review requirement as follows:

3.55 Audit organizations performing audits and attestation engagements in accordance with GAGAS must have an external peer review performed by reviewers independent of the audit or-

ganization being reviewed at least once every 3 years.

3.56 The audit organization should obtain an external peer review sufficient in scope to provide a reasonable basis for determining whether, for the period under review, the reviewed audit organization’s system of quality control was suitably designed and whether the audit organization is complying with its quality control system in order to provide the audit organization with reasonable assurance of conforming with applicable professional standards.<sup>9</sup>

Regarding its peer review process, the Defense Contract Audit Agency’s Contract Audit Manual (CAM) states:

Organizations conducting audits in accordance with government auditing standards should have an external quality control review at least once every three years by an organization not affiliated with the organization being reviewed. The external quality control review program should determine whether the organization’s internal quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed. For DCAA this function is performed primarily by the Department of Defense, Office of the Inspector General.<sup>10</sup>

Accordingly, DCAA’s peer reviews are conducted by the Department of Defense Inspector General (DoD IG). In its most recent “peer review,” the DoD IG looked at the same DCAA internal audit quality assurance reviews that GAO reviewed. In May 2007, the DoD IG issued a “peer review” report that concluded as follows:

Accordingly, we have determined that the DCAA system of quality control used on audits and attestation engagements for the review period ended September 30, 2006 is adequate.<sup>11</sup>

The DoD IG came to this surprising conclusion despite the fact that its review also found numerous audits with “serious deficiencies in audit quality.”<sup>12</sup> After reviewing the same DCAA internal audit quality assurance reviews that the DoD IG reviewed, GAO concluded that the DoD IG had clearly arrived at an erroneous conclusion. Recognizing this, GAO recommended that the DoD IG reconsider its “clean opinion.” In response, the DoD IG stated in a letter dated August 24, 2009 that it was “not prudent to allow the adequate opinion from our May 2007 report to carry forward.”<sup>13</sup> This was a bewildering statement because, as any C.P.A. knows, peer review reports do not “carry forward” anyway. It was

<sup>9</sup> - *Government Auditing Standards*, Sections 3.55 and 3.56, Government Accountability Office, 2003.

<sup>10</sup> 10 - Defense Contract Audit Agency, *Contract Audit Manual*, Section 2-205(b).

<sup>11</sup> - DoD Inspector General, *Oversight Review: Review of the Defense Contract Audit Agency Quality Control System*, Report No. D-2007-6-006 (Arlington, VA: May 1, 2007).

<sup>12</sup> - GAO Report 09-468, “*Widespread Problems with Audit Quality Require Significant Reform*,” September 23, 2009 (‘Long Report’), p. 35.

<sup>13</sup> - *Ibid.*, p. 81.

generally accepted government auditing standards (GAGAS) as outlined in 2-400 and 2-600.”

<sup>4</sup> - GAO Report 09-468, “*Widespread Problems with Audit Quality Require Significant Reform*,” September 23, 2009 (‘Long Report’), p. 14.

<sup>5</sup> - *Ibid.*, p. 42.

<sup>6</sup> - *Ibid.*, p. 41.

<sup>7</sup> - *Ibid.*, p. 16-17.

<sup>8</sup> - *Ibid.*, p. 37.

obvious that this letter evidenced the DoD IG's complete lack of understanding of the issues involved. In short, DCAA's problems were made worse by the fact that the DoD peer review process had failed.

Because DCAA does not currently meet the peer review requirement, its audit reports now use revised boilerplate language that states:

We conducted our examination in accordance with generally accepted government auditing standards, except DCAA does not currently have an external opinion on its quality control system as required by GAGAS 3.55.

This innocuous sounding language is much more significant than it looks, because it essentially means that DCAA does not have a quality control system that meets professional standards. Stated differently, the inability of DCAA to meet the quality criteria of applicable professional standards indicates that the findings in the audit report may or may not be reliable.

In order for DCAA to be able to issue reliable audit reports, GAO concluded that "significant changes will be needed in [DCAA] policy guidance and training on audit standards, appropriate procedures, and audit documentation in order to comply with GAGAS."<sup>14</sup> In this regard, GAO estimated that "it will take considerable time to develop a revised training program to address the range of changes in audit policies, processes, and procedures for performing quality audits in accordance with GAGAS."<sup>15</sup>

B. GAO Report 09-1009T, "Widespread Problems with Audit Quality Require Significant Reform," September 23, 2009 ('Short Report')

The so-called 'short report' was issued simultaneously with the 'long report,' but was more in the nature of an executive summary. This Short Report discussed in general terms (1) DCAA's management and quality controls; (2) DCAA's responses to GAO's 2008 Report, as well as two non-peer Department of Defense (DoD) reviews<sup>16</sup>; and (3) GAO's recommendations for improvement.

Regarding DCAA's management and agency-wide quality control problems, GAO summarily stated that many audit reports had been issued where the auditors lacked independence (a prerequisite for any audit).<sup>17</sup> In addition, as detailed in the Long Report, almost all audit reports reviewed had insufficient testing, which in turn meant the audit opinions were unsupported. Nonetheless, DCAA audit reports were routinely accepted despite "significant deficiencies and noncompliance with GAGAS and DCAA policy."<sup>18</sup>

It is beyond the scope of this article to address either the two DoD non-peer reviews or GAO's recommendations for improvement.

<sup>14</sup> - *Ibid.*, p. 46.

<sup>15</sup> - *Ibid.*, p. 58.

<sup>16</sup> - Of these two nonpeer reviews, one was a "tiger team" review performed by the Under Secretary of Defense (Comptroller/Chief Financial Officer), while the other was a study conducted by the Defense Business Board.

<sup>17</sup> - DCAA auditors had apparently provided material non-audit services to the same contractors they later audited.

<sup>18</sup> - GAO Report 09-1009T, "Widespread Problems with Audit Quality Require Significant Reform," September 23, 2009 ('Short Report'), p. 10.

### III. Impact on Contractors

As the GAO Reports now make clear, it is unlikely that DCAA auditors have been or even now are complying with GAGAS. This systemic failure undercuts the authoritative basis for their audit findings. Historically, contractors always assumed that the standard GAGAS language was correct, and rarely challenged the underlying validity of DCAA audits. As a result of these GAO Reports, however, it is now apparent that the assumed veracity of DCAA audits may frequently be absent.

GAGAS do not pertain to everything DCAA does. For example, prior to the award of a cost-reimbursement contract, DCAA auditors review the contractor's accounting system to determine its adequacy for performing such a government contract.<sup>19</sup> In like manner, DCAA auditors also review the adequacy of a contractor's estimating system, and for contracts covered by the Cost Accounting Standards (CAS) DCAA auditors review CAS Disclosure Statements (CASB Form DS-1 and -2). These matters are in the nature of compliance reviews, not audits, and for that reason GAGAS are inapplicable.

On the other hand, GAGAS do apply to DCAA audits of numerous widely divergent contractor activities, such as an incurred cost submission,<sup>20</sup> healthcare claims processing, Davis-Bacon price adjustments,<sup>21</sup> approval of invoice payments,<sup>22</sup> defective pricing audits,<sup>23</sup> executive compensation reviews,<sup>24</sup> requests for equitable adjustments and/or claims,<sup>25</sup> termination settlement proposals,<sup>26</sup> and contract close-outs.<sup>27</sup> Given the breadth of DCAA audit activity governmentwide, the inability of DCAA auditors to comport with professional audit standards adversely affects the entire contract administration process.

Speaking of contract administration, the usual procedure for resolving audit issues is an iterative one with the contracting officer serving as the intermediary. Specifically, the draft audit report goes through the contracting officer to the contractor for comment. In turn, the contractor's responses to the draft audit report also go through the contracting officer to the auditor. During this process, some or possibly all of the audit findings may be accepted by the contractor. However, audit findings not accepted by the contractor would usually be the subject of a contracting officer's final decision, which the contractor may either accept or appeal.<sup>28</sup>

<sup>19</sup> - DCAA used to participate in source selection evaluation boards, but ceased to do as of September 12, 2008 in response to independence concerns expressed in a review by the Defense Business Board. See GAO Report 09-468, "Widespread Problems with Audit Quality Require Significant Reform," September 23, 2009 ('Long Report'), p. 54.

<sup>20</sup> - FAR 52.216-7. Non-profits would follow the cost principles in OMB Circular A-122.

<sup>21</sup> - FAR 52.222-32.

<sup>22</sup> - FAR 32.111.

<sup>23</sup> - 10 U.S.C. § 2306a; 41 U.S.C. § 254b.

<sup>24</sup> - DCAA's many shortcomings in performing executive compensation reviews have already been noted. See "Compensation Is Not a Four-Letter Word: Coping With a DCAA Executive Compensation Review," by Richard B. O'Keefe, Jr., American Bar Association's *The Procurement Lawyer*, Vol. 45, No. 1, Fall 2009.

<sup>25</sup> - 41 U.S.C. §§ 601 *et seq.*

<sup>26</sup> - FAR 52.249-2.

<sup>27</sup> - FAR 42.708.

<sup>28</sup> - FAR 233-1.



This is because only contracting officers are authorized to render final decisions – auditors, like other members of the government’s procurement team (quality assurance inspectors, contract specialists, property administrators, attorneys, and so on), are only advisors. Where contracting officers do not concur with an auditor’s recommendations (i.e., where audit findings are not accepted by a contracting officer), that is simply the decision of the government’s contracting officer.

Unfortunately, this process has been seriously undermined by a recent DCAA policy change that essentially encourages an auditor to complain to the DoD Inspector General when the auditor disagrees with a contracting officer’s decision not to uphold DCAA’s audit findings. This new DCAA *Action Guidance Memo* states in pertinent part:

Certain unsatisfactory conditions related to actions of Government officials will be reported to the Department of Defense Inspector General (DoDIG) in lieu of reporting the conditions to a higher level of management. The unsatisfactory conditions reported to the DoDIG will be those cases where DCAA determines an independent assessment and related actions are necessary due to the significance and/or sensitivity of the matter.

*Unsatisfactory conditions include actions by Government officials that appear to reflect mismanagement, a failure to comply with specific regulatory requirements or gross negligence in fulfilling his or her responsibility that result in substantial harm to the Government or taxpayers, or that frustrate public policy.*<sup>29</sup> [Emphasis added.]

Recently, DCAA announced that this policy memo only relates to actions of government officials that rise “well above simple disagreements between the audit position and the contracting officer decision.”<sup>30</sup> Inasmuch as no guidance has been issued for auditors to be able to distinguish a “simple disagreement” from an “unsatisfactory condition,” this clarification is a distinction without a difference. The fact remains that contracting officers who disagree with audit findings still run the risk of being caught up in an IG investigation, while merely rubber-stamping audit findings, no matter how egregious, entails no such risk.

As a result, the role of the contracting officer as a decisionmaker has been effectively emasculated by this new DCAA policy, notwithstanding a recent memorandum by the Director of Defense Procurement and Acquisition Policy.<sup>31</sup> Because contracting officers are now reluctant to disapprove audit findings, DCAA audit findings generally cannot be resolved at the contracting of-

ficer level. Accordingly, the only alternative available to contractors unwilling to accept DCAA audit findings is to seek relief through the appeals process. In the opinion of many knowledgeable observers, this will likely increase the number of contract disputes.<sup>32</sup> That’s the bad news.

The good news for contractors is that it will be difficult for DCAA audits to withstand judicial scrutiny. As a rule, courts and boards are unlikely to rely on DCAA audit reports that fail to meet applicable audit standards. Understandably, government attorneys will be very hesitant to use such evidence at trial. As the recent GAO Reports have conclusively shown, there is a general lack of adherence to professional standards in DCAA audit reports, and the collateral damage to the Government is that contractor attorneys can now prove it. That being so, it is worthwhile to consider whether there is any instructive current case law.

#### IV. The General Dynamics Case: Attacking DCAA Malpractice

Defective DCAA audits are, of course, nothing new in the world of government contracts. One of the most egregiously defective DCAA audits led to an accounting malpractice suit against the agency by the General Dynamics Corporation (“General Dynamics”) under the Federal Tort Claims Act (“FTCA”). In the 1996 *General Dynamics* case, the United States District Court for the Central District of California awarded almost \$26 million to General Dynamics. While the United States Court of Appeals for the Ninth Circuit reversed the district court two years later, the appeals court may have left the door open for contractors to use the FTCA to attack defective DCAA audits, at least where prosecutorial discretion is not involved. As such, the *General Dynamics* case deserves extended discussion.

In 1978, the Department of the Army awarded a contract to General Dynamics to develop two prototypes for the Divisional Air Defense (“DIVAD”) System, a computer-operated antiaircraft weapon mounted on a tank chassis. Following an audit, DCAA issued a report in 1984 which concluded that General Dynamics had mischarged approximately \$8.4 million to the contract. On the basis of the DCAA audit report, the Department of Justice (“DOJ”) indicted General Dynamics and four of its executives. In addition, the DOJ sued General Dynamics under the civil False Claims Act with respect to the alleged mischarges. During its subsequent pretrial work, the DOJ determined that DCAA had erroneously interpreted the DIVAD contract and related acquisition regulations – by failing, in particular, to understand that the contract was a firm-fixed-price (best efforts) contract rather than a firm-fixed-price contract – and that no mischarging had in fact occurred. Thereafter, the DOJ dismissed the indictment and related civil action, and the Attorney General sent letters of apology to the four General Dynamics executives.

In 1989, General Dynamics sued the Government under the FTCA to recover its costs of defending the civil and criminal actions, alleging that DCAA had negligently prepared the audit report. The Government initially moved to dismiss the case, arguing that the FT-

<sup>29</sup> - DCAA *Action Guidance Memo* PAS 730.4.A.4, dated March 13, 2009.

<sup>30</sup> - Statement by DCAA Spokesperson Tara Rigler, BNA *Federal Contracts Report*, Vol. 92, No. 384, November 24, 2009.

<sup>31</sup> - The “Assad Memo” essentially establishes little more than high level, intra-agency ADR procedures for disagreements related to contract proposals over \$10 million, and where the contracting officer does not agree with 75% of the questioned costs. These procedures are of very limited applicability. See Memorandum, “*Resolving Contract Audit Recommendations*,” Director, Defense Procurement and Policy (DPAP), December 4, 2009; available at [http://www.acqosd.mil/dpap/ops/policy\\_vault.html](http://www.acqosd.mil/dpap/ops/policy_vault.html).

<sup>32</sup> - “*Reforms to the DCAA: The Potential Effect on Contract Management*,” by Jack Horan, *NCMA Contract Management Journal*, p. 95, December 2009.

CA's discretionary-function exception applied. The Government asserted that its decision to investigate, prosecute, and civilly charge General Dynamics constituted a permissible exercise of a policy judgment and that DCAA's actions were "so intertwined with this prosecutorial function as to be themselves discretionary." The district court rejected the argument, noting that General Dynamics had not alleged that DCAA was acting in any discretionary capacity, but rather had alleged that the agency had failed to follow its prescribed procedures in the DCAA *Contract Audit Manual* ("CAM").<sup>33</sup> Significantly, the court further observed that DCAA's auditing function could be distinguished from the Government's prosecutorial function. Finally, the court found that General Dynamics had pled a *prima facie* case of professional malpractice under California law - the applicable state law under the FTCA. Accordingly, the court denied the Government's motion to dismiss and permitted the case to go to trial.

Following trial, the district court issued an exhaustive opinion.<sup>34</sup> In analyzing whether DCAA had committed malpractice in erroneously concluding that General Dynamics was guilty of mischarging, the district court first noted that DCAA auditors must adhere to the standards of the auditing profession when performing their audit work. Here, the court found that the DCAA auditors had failed to meet even minimal professional standards. As a result, the findings, conclusions, and recommendations in the audit report were not supported by the evidence in the workpapers.

In excoriating the DCAA auditors, the district court pointed to a lengthy list of misdeeds: (1) negligence in not understanding the purpose of the audit; (2) negligence in reviewing and briefing the DIVAD contract; (3) negligence in preparing the audit program; (4) negligence in not conducting an entrance conference; (5) negligence in preparing workpapers; (6) negligence in not obtaining technical assistance; (7) negligence in failing to resolve conflicts in the evidence; (8) negligence in failing to draft the audit report based on the workpapers; and (9) negligence in failing to discuss the audit conclusions at an exit conference and in failing to include General Dynamics' response in the audit report. After again finding that the FTCA's discretionary-function exception was inapplicable, the court awarded almost \$26 million in damages to General Dynamics.

In 1998, the Ninth Circuit reversed the district court, holding that the discretionary-function exception precluded suit.<sup>35</sup> In a divided opinion, the Ninth Circuit held that "the buck stopped at the prosecutors" and that "the decision to prosecute was all their own." Accordingly, the court held that the United States was immune from suit under the FTCA.

Notwithstanding the Ninth Circuit's reversal on other grounds, the *General Dynamics* district court decision

<sup>33</sup> - *General Dynamics Corp. v. United States*, No. CV 89-6762JGD, 1990 WL 267366 (C.D. Cal., Nov. 7, 1990) (not reported in F. Supp.).

<sup>34</sup> - *General Dynamics Corp. v. United States*, No. CV 89-6762JGD, 1996 WL 200255 (C.D. Cal., Mar. 25, 1996) (not reported in F. Supp.).

<sup>35</sup> - *General Dynamics Corp. v. United States*, 139 F.3d 1280 (9th Cir. 1998).

stands for the proposition that DCAA audits are subject to applicable professional standards. What is less clear, however, is whether - given the appeals court's ruling on the discretionary function exception - the DCAA may be held accountable in a given case when those standards are not met. On the basis of the Ninth Circuit's opinion, the answer appears to be "no," at least where a defective DCAA audit report results in a DOJ decision to charge the contractor and/or sue it under the civil False Claims Act. Assume, however, that a contracting officer simply relies on a defective DCAA audit report to deny a contractor's claim or assert a claim against the contractor. Simply put, the discretionary-function exception may not apply.<sup>36</sup>

## V. Conclusion

The GAO Reports suggest that DCAA's quality problems are so severe that the agency is currently unable to issue an audit report in accordance with professional standards. This is a very disturbing development for everyone in the government contracts community, because the use of DCAA audits is interwoven with the entire contracting process from preaward through contract administration to contract close-out. Indeed, the government audit function is integral to the integrity of the entire procurement system.

While acknowledging DCAA's crucial procurement role, the GAO Reports document DCAA auditors' pervasive and systemic lack of adherence to GAGAS. The failure of DCAA auditors to meet minimal professional standards calls the credibility of their audit reports into question, because audit reports that do not comport with professional standards have skewed or unreliable results. Under these circumstances, contractors now have every incentive to attack adverse DCAA audit reports. Should a DCAA audit report not state - without qualification - that it was performed in accordance with GAGAS, there is no presumption of the report meeting minimal professional standards.

Finally, with its recent policy encouraging complaints to the DoD IG, DCAA has impaired contract administration by essentially usurping the role of the contracting officer. For this reason, government contractors desiring to challenge DCAA audit findings have little to lose by resorting to litigation. In litigation, the most fertile ground for contractors would be a thorough examination of the auditor's documented compliance with professional standards. Between the pervasive audit quality problems documented by the recent GAO Reports, as well as the holding in *General Dynamics*, contractors have ample basis to challenge DCAA audit reports.

<sup>36</sup> - In addition, a defective audit report may result in a finding that the Government's litigation position was not "substantially justified" - the predicate for awarding attorneys' fees under the Equal Access to Justice Act. See *Application under Equal Access to Justice Act - Shirley Contracting Corp.*, AS-BCA No. 29,848, 87-2 BCA (CCH) ¶ 19,759 (1987) (noting the DCAA's "obviously inadequate and superficial analysis"); see also Vernon J. Edwards, "Reliving History: The New DoD Policy on Resolution of Contract Audit Recommendations," 24 *Nash & Cibinic Report* ¶ 3, Jan. 2010, at 12 (discussing the *Shirley* case).