



## EXPANSION OF FEDERAL GOVERNMENT AUDIT POWERS AND PROGRAMS: *WHAT TO DO WHEN THE AUDITORS ARRIVE*

Our earlier Client Alerts described initiatives by the federal Government to impose strict ethics and compliance requirements on most federal contractors and subcontractors<sup>1</sup> and to broaden the application of the False Claims Act (“FCA”) to all federally funded contracts and grants while making a contractor’s retention of overpayments a new ground for violating the FCA<sup>2</sup>. These initiatives were taken to an even higher level by the enactment of the American Recovery and Reinvestment Act of 2009, P.L. 111-5, February 17, 2009 (“ARRA” or commonly called the “Stimulus Act”), with its own set of whistleblower, reporting, and Buy American requirements.<sup>3</sup>

Predictably, the Government has, in parallel with its new ethics initiatives, strengthened its right to audit contractors’ financial and other records in order to confirm that ethics and compliance requirements have actually been implemented by contractors. The Government has long had the right to audit the records of its contractors. Now, however, Government auditors will have the right to interview a contractor’s officials and employees, a new board will audit ARRA-funded contracts and grants, and a newly expanded program of “Payment Recapture Audits” may offer contingent fee payments to professional auditors who can identify misspent funds on federal contracts. Finally, in the last year, the Government’s principal agency for auditing Government contracts, the Defense Contract Audit Agency (“DCAA”), has begun requiring its auditors to examine not only the financial books and records of contractors, but also potential violations of the Government’s ethics and compliance requirements.

Contractors that have significant ARRA-funded contracts stand a substantial chance of being audited at some point. In this environment, it is critically important for contractors to know how to respond to a Government audit.

<sup>1</sup> See Peckar & Abramson Client Alert, “Federal Regulations Now Require All Government Contractors to Have a Comprehensive Compliance Program; Plus, Newly Proposed Regulations Would Further Expand Compliance Requirements,” December 2007, [http://www.pecklaw.com/PDF\\_files/Client\\_Alert-12-2007-FedReg.pdf](http://www.pecklaw.com/PDF_files/Client_Alert-12-2007-FedReg.pdf)

<sup>2</sup> See Peckar & Abramson Client Alert, “New Federal Regulations require Contractors to ‘Self Disclose’ Violations of Federal Criminal Laws, Violations of the Civil False Claims Act, and Overpayments on Contracts,” November 2008, [http://www.pecklaw.com/PDF\\_files/Client\\_Alert-New\\_Fed\\_Regs.pdf](http://www.pecklaw.com/PDF_files/Client_Alert-New_Fed_Regs.pdf)

<sup>3</sup> See Peckar & Abramson Client Alert, “The New Stimulus Act,” February 2009, [http://www.pecklaw.com/PDF\\_files/Client\\_Alert-Stimulus\\_Act.pdf](http://www.pecklaw.com/PDF_files/Client_Alert-Stimulus_Act.pdf)

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## **The Government's Right to Audit**

Federal Government contracts have for many years given the Government the right to audit its contractors and subcontractors' records. Today, most federal construction contracts are competitively negotiated procurements that contain FAR 52.215-2, Audit and Records—Negotiation. This clause gives the Government access to a contractor's records relating to any cost-based pricing action under the contract (for example, change orders over \$650,000 requiring the submission of cost or pricing data) for 3 years after final payment.

When Congress enacted ARRA, the standard FAR audit requirements were broadened for ARRA contracts to give both the contracting agency and the U.S. Comptroller General the right to: (i) examine any contractor or subcontractor records that pertain to and involve transactions relating to the ARRA contract or subcontract; and (ii) interview any contractor or subcontractor officer or employee regarding such transactions. When this change to the FAR was made, the drafters knew that the right to interview employees was unprecedented ("In the matter of interviewing contractor or subcontractor employees concerning contracting transactions, there are no current authorities under the FAR.").

ARRA contracts and grants are also subject to audit by the Recovery Accountability and Transparency ("RAAT") Board whose powers include "auditing and reviewing covered funds to determine whether wasteful spending, poor contract or grant management, or other abuses are occurring and referring matters it considers appropriate for investigation to the inspector general for the agency that disbursed the covered funds." The RAAT Board has the same power to issue subpoenas that agency Inspectors General have, as well as the right to interview a contractor's officers and employees.

The data shows that the RAAT Board and agency Inspectors General have been actively pursuing possible fraud, waste and abuse on ARRA contracts. As of the end of February 2010, almost 2,100 ethics violations have been reported at a rate of about 150 a month. Of those, about 10% have triggered active investigations and a smaller percentage has thus far resulted in criminal prosecutions.

## **Government Auditors Are Looking for Fraud**

**Fraud Indicators.** Government auditors are on the lookout for fraud. Many federal agencies specifically require their auditors to look for contractor fraud during routine audits. For example, the Inspector General of the Department of Defense ("DoD") has issued to its auditors and investigators a "Handbook on Fraud Indicators for Contract Auditors" that identifies specific practices in accounting for direct and indirect costs as well as other business practices that indicate potential fraud.



The Inspectors General are also schooling their auditors who are assigned to audit ARRA contracts and grants to look for fraud. The “Spot Checking for Fraud” guidance issued to auditors directs them to review payments for possible kickbacks, fraud or collusion. Auditors are also advised to “talk to employees” to see the ethics “tone” set by a ARRA fund recipient, what ethics training has been provided, whether employees are aware of the ARRA whistleblower program, and how ethics complaints are being handled.

**DCAA.** For its part, the DCAA has provided specific guidance to its auditors regarding the pricing of requests for an equitable adjustment of the contract price under standard federal Government contract remedy-granting clauses and claims for an equitable adjustment in the contract price resulting from Government-caused delay or disruption. In each case, DCAA auditors are required to “review the fraud indicators specific to the audit” in accordance with the DoD fraud indicators handbook.

Effective June 30, 2009, the DCAA Audit Manual (“DCAM”) now has an entire section devoted to requirements and procedures for auditors to evaluate contractor ethics and compliance programs as part of DCAA’s assessment of a contractor’s system of internal controls. This new guidance applies during even routine DCAA audits.

In assessing the “control environment” of a contractor, auditors are supposed to assess not only the contractor’s financial capability, but also its “integrity and ethical values.” Thus, DCAA auditors are directed to consider management’s commitment to ethics and compliance and whether the contractor’s compliance program has policies and procedures to facilitate the timely discovery of improper conduct and to ensure corrective measures are promptly instituted and carried out for any cases of improper conduct.

DCAA auditors are further directed to review the adequacy of the specific elements of contractor compliance programs, including the following:

- Evaluate the contractor’s ethics awareness and compliance training materials to ensure that it covers the contractor’s code of business ethics and conduct.
- Test the implementation of the compliance program by obtaining completed training documents to determine that the training was periodically provided to the appropriate individuals.
- Review the results of a contractor’s periodic audits of the effectiveness of the contractor’s business ethics and awareness compliance program and internal control system. The DCAM states that these periodic internal evaluations should be conducted “at least annually.”

Auditors are also supposed to specifically review how a contractor has dispositioned



ethics problems and, in particular, whether a contractor has taken reasonable measures to detect and punish ethics violations. To this end, DCAA has issued demands for, among other things:

- Contractor ethics training materials, agendas and attendee lists;
- Contractor's Code of Conduct, policies dealing with communications of the Code of Conduct, and lists of employees who have acknowledged receiving the Code of Conduct over the past 12 months;
- List of all violations of the Code of Conduct over the past 12 months;
- All "non-compliances" reported through the contractor's internal control system (including the contractor's hotline) within the past 12 months; and
- List of any current open investigations.

If the auditor finds that there is a report of improper conduct and the contractor has failed to take disciplinary action when it should have been taken, the auditor should cite the contractor for an internal control deficiency.

DCAA's auditors are specifically directed to assess a contractor's compliance with the FAR mandatory disclosure requirement. This means that auditors – who may or may not have any legal training - will evaluate whether "the contractor's policies and procedures include a reasonable definition of credible evidence, and a reasonable timeframe for disclosure once credible evidence is obtained." Auditors should "verify" whether a contractor has delayed disclosing a reportable violation and, if it has, then "an internal control deficiency should be reported." By the same token, if the contractor has not taken the appropriate corrective action or has not cooperated with audits or investigations, the auditor should report this as an internal control deficiency.<sup>4</sup>

**Payment Recapture Audits.** Another recent Government audit initiative was the Obama Administration's announcement on March 10, 2010 that it would encourage federal agencies to expand the use of "Payment Recapture Audits" to discover payments for work that was not performed, duplicate payments, overpayments and fictitious vendors. To implement this initiative, the Administration is considering the use of professional auditors as bounty hunters "on a contingency basis, with their compensation tied to the identification of misspent funds." The Office of Management and Budget is supposed to issue final guidelines for this program by early June 2010.

### **Responding to an Audit Request**

Audit requests are usually in writing although they can be oral. The days when Government audits were limited to verification of contractor costs are gone. Government

<sup>4</sup> In keeping with this increased scrutiny of contractor internal control systems, on January 15, 2010, the Department of Defense ("DoD") issued proposed regulations to increase the oversight of contractor business systems by the Defense Contract Management Agency ("DCMA") and DCAA, including accounting systems, estimating systems and purchasing systems. The proposed regulations would permit DoD to withhold a percentage of certain types of payments when DoD concludes that the contractor's business systems contain deficiencies.



auditors are now focused on ferreting out potential fraud, waste and abuse. Given the Government's increased scrutiny of contractor records and internal controls, it is more important than ever that contractors properly respond to any audit request. If you receive an audit request from the DCAA<sup>5</sup>, you should take the following steps:

- Consult with your legal counsel regarding the scope of your responsibility to provide information to the Government's auditors.
- Designate within your organization the person who will serve as the single point of contact with the Government's auditor for the receipt of information requests and the transmission of documents and other information to the auditor. It is a good idea to also designate an alternate representative in case your point of contact is unavailable in order to avoid unnecessarily delaying the audit.
- Assemble a contractor audit team (usually financial, contract administration and legal personnel) who will gather information internally and then channel it to the contractor point of contact.
- Request an "entrance" conference. The DCAA Audit Manual requires that auditors should normally meet with the contractor's designated representative at the beginning of the audit and describe the purpose and overall plan for the audit, estimated duration, and the types of records that the auditor will want to review.
- Attempt to reach an agreement with the auditor regarding the logistics and protocols that will be followed in transmitting information (hard copies vs. electronic copies, etc.) NOTE: Auditors may send a letter telling you what procedures they intend to follow, but they will not agree to sign a written agreement or acknowledgement of procedural arrangements that limit the Government's ability to conduct a complete audit.
- Make sure that your responses to Government auditors are accurate and complete.
- Promptly respond to requests for information. Never unnecessarily delay or impede an audit.
- If you believe the auditor's requests are overly broad, consult with your legal counsel. Also consult with counsel if the auditor raises questions about your compliance with federal ethics and disclosure requirements.
- Seek information about the status of the audit during interim conferences, when auditors are supposed to apprise you of omissions or mistakes that the auditors have uncovered.
- Request an "exit" conference at the conclusion of the audit. Auditors are supposed to advise you of the conclusions they have reached.
- The auditor should provide you with a draft copy of the audit report and permit you to submit comments. You should take this opportunity to fully explain your side of disputed issues.

<sup>5</sup> Audits by other federal agencies may not follow exactly the same procedures, although those agencies will probably use the DCAA procedures as a general guide.



## Conclusion

As the Government's audit oversight of its contractors and subcontractors becomes an increasingly important element of the Government's commitment to uncover and prosecute fraud, waste and abuse, the value of an effective ethics and compliance program becomes correspondingly important. Implementing internal controls that prevent potential ethics problems reduces the chances that an audit will lead to an investigation and prosecution.

Besides advising our clients on how to structure an effective compliance program and respond to Government audits and investigations, Peckar & Abramson has also operated as the "gatekeeper" for the information flow from and to Government auditors and investigators to ensure that our clients are operating within their legal rights and obligations.