



## AUDIT ALERT: DCAA TO INCREASE “GESTAPO” AUDIT TACTICS

Recently, **GATE 6 Solutions, Inc.** (“**GATE 6**”) became aware that the United States Government Accountability Office (“**GAO**”) has released an internal draft report on the Defense Contract Audit Agency (“**DCAA**”) audits of government contractors. This report is purported to be highly critical of **DCAA**’s auditing methods and its auditor’s lack of compliance with its own Audit Guidance. The report contends that based on an examination of 37 **DCAA** audits carried out between 2004 and 2006 in which **DCAA** found contractor systems to be adequate, the **GAO** reportedly found deficiencies in all 37 audits, including the failure of auditors to fully and adequately review contractor data prior to finding contractor systems sufficient.

Similar to this recent **GAO** report of auditor deficiencies, **GATE 6** has been monitoring **DCAA** auditor methods and tactics since we first saw a disturbing trend developing back in 2005. Over the past several years, **GATE 6** has been examining the revisions and changes that **DCAA** has been making to its Audit Guidance through various means and methods. We have noted a lack of supported basis of entitlement for the direction **DCAA** has been giving its auditors.

**DCAA** provides auditing, accounting, and financial advisory services in connection with the negotiation, administration and settlement of contracts and subcontracts to government agency procurement and contract administration activities. **DCAA** contract audits are intended to be a key control to help assure that prices paid by the government for needed goods and services are fair and reasonable and that contractors are properly charging the government in accordance with applicable laws, regulations (e.g., Federal Acquisition Regulations (“**FAR**”), and Defense Federal Acquisition Regulation supplements (“**DFARS**”), standards (e.g., Cost Accounting Standards (“**CAS**”)), and contract terms. In performing its audits, **DCAA** provides Audit Guidance through the **DCAA** Contract Audit Manual (“**CAM**”). The **CAM** prescribes auditing policies and procedures for personnel engaged in

the performance of the **DCAA** mission. According to **DCAA**’s own statements, Audit Guidance is to be in compliance with **GAAP** (Generally Accepted Accounting Principles), **FAR** (Federal Acquisition Regulations), and **GAGAS** (Generally Accepted Government Audit Standards). Supplemental Audit Guidance is provided with the periodic issuance of Audit Guidance Memorandums for Regional Directors (“**MRD**”), Inter-office Memorandums (“**IOM**”) and Other Audit Guidance (“**OAG**”) documents. Currently, there are eighty three (83) **MRDs** open dating back to April 2004 which have not been incorporated into the **CAM**.

**GATE 6** is observing a **DCAA** trend of continuing to change/modify the Audit Guidance set forth in the **CAM** in order to provide its auditors with “apparent” authority, irrespective of contract, **FAR**, statutory, or other regulatory entitlement, which gives the appearance that **DCAA** is arming its auditors with a “license to hunt”.

The motivation for “empowering” its auditors without adherence to, or concern for, regulatory or contract authority appears to be focused to find fraud (i.e. Fraud Indicators) at every possible audit or examination opportunity. The auditor, “armed” with its Audit Guidance (i.e. “license to hunt”) feels empowered to demand more and more information without the supported basis of entitlement, until the auditor finds what he is looking for. We call this unwarranted practice the “bring me a rock” game. The auditor keeps asking for another “rock” and the contractor keeps bringing “rocks” until either nothing is found or the “Fraud Indicator” is identified. If the contractor pushes back on the auditor’s demands, the auditor declares the contractor to be “non-responsive” and takes punitive actions for denial of access to records.

This aggressive predatory auditor behavior was not the predominant mind-set of **DCAA** auditors prior to these Audit Guidance changes. However, the trend for this type of audit behavior is



continuing to gain acceptance and prominence amongst DCAA auditors, especially as the GAO continues to be critical of DCAA's performance. Auditors now feel compelled and are emboldened both by the internal DCAA Audit Guidance and the GAO criticism to step "outside the box" in order to find contractors guilty of something, no matter how immaterial.

In an earlier July 2008 GAO report (GAO-08-857), the GAO also sharply criticized the DCAA auditors. The GAO reviewed 14 DCAA audits and identified deficiencies in the DCAA's audit processes and criticized the close relationship between DCAA auditors, contractor officials and the government contracting community (i.e. auditor impairment). Following the 2008 GAO report, the DCAA has stepped up the pace to issue revised Audit Guidance that expanded the circumstances in which contractor systems should be determined to be "inadequate" and directed DCAA auditors to aggressively seek to compel production by contractors of information that the auditor deems relevant ("bring me a rock"). Almost half of the 83 open MRDs have been issued since January 2008. These and other actions demonstrate that the DCAA is becoming significantly more aggressive, demanding an unprecedented level of access to information of questionable relevance to issues for which the DCAA has responsibility, and closing traditional channels of communication between contractors and the federal agency.

Noteworthy DCAA Audit Guidance provided through the issuance of recent MRDs includes:

**Audit Alert on Current Economic Conditions and Financial Condition Risk Assessments, MRD 08-PPD-036(R), Oct. 20, 2008**

MRD 08-PPD-036(R) places auditors on alert to conditions that may indicate unfavorable or adverse financial conditions that could impede a contractor's ability to perform on Government contracts. Auditors should be alert for situations where the contractor may try to inappropriately accelerate billing costs to the Government in order to improve its cash flow. If auditors become aware of these unfavorable financial conditions, auditors should immediately commence a financial capability risk assessment/audit.

Examples of indicators of possible unfavorable financial conditions may include, but are not limited to, any of the following:

- Increase in the aging and amounts of accounts payables
- Defaults on loan/line-of-credit agreements
- Denial of usual trade credit from suppliers
- Restructuring of debt with higher interest rates
- Noncompliance with loan/line-of-credit covenants
- Loss of principal customers/suppliers
- Unpaid or late payment of state, local, and federal tax liabilities
- Deteriorating bond ratings
- Failure to fund pension plans
- Loans from employees or issuing stock to employees in lieu of salary
- Significant unpaid debts and/or liabilities
- Unusual progress payments or other billing concerns
- Poor physical condition of the work facilities

**Audit Guidance on Denial of Access to Records, MRD 08-PAS-042(R), December 19, 2008**

MRD 08-PAS-042(R) advocates auditor actions in the event that the contractor does not provide documentation in support of an audit in a timely manner. The auditor actions should include:

- Follow the procedures for denial of access to records;
- Take appropriate actions to effect a suspension or
- Withhold of any unsupported costs billed to the Government until the data is received and a determination is made regarding the allowability of the costs; and
- Question the unsupported costs in the audit report if the supporting documentation is not received prior to completion of fieldwork.

These procedures should be followed even if the contractor concurs to the questioned costs based on the lack of support. In cases where the records are alleged to have been destroyed, lost, or stolen, auditors should obtain a written statement from appropriate high-level contractor management to that effect with a detailed explanation of the circumstances. This guidance has been communicated to DCMA Headquarters.



**Audit Guidance on Significant Deficiencies/Material Weaknesses and Audit Opinions on Internal Control Systems, MRD 08-PAS-043(R), December 19, 2008**

MRD 08-PAS-043(R) clarifies that a significant deficiency/material weakness occurs when the contractor's failure to accomplish any control objective tested for in DCAA's internal control audits will or could ultimately result in unallowable costs charged to Government contracts, even when the control objective does not have a direct relationship to charging costs to Government contracts. The contractor's failure to accomplish the control objective creates an environment that could ultimately result in mischarging to Government contracts. It is not necessary to demonstrate actual questioned cost to report a significant deficiency/material weakness.

Audit reports on contractors' internal controls that include any significant deficiencies/material weaknesses will result in an opinion that the system is inadequate. The audit report will identify the portions of the system affected by the deficiencies and recommend that the contracting officer disapprove the system (if applicable) and pursue suspension of a percentage of progress payments or reimbursement of costs. Contractors receiving cost-reimbursement or incentive type contracts, or contracts which provide for progress payments based on costs or on a percentage or stage of completion, shall maintain an accounting system and related internal controls throughout contract performance which provide reasonable assurance that-

- (a) Applicable laws and regulations are complied with;
- (b) The accounting system and cost data are reliable;
- (c) Risk of misallocations and mischarges are minimized; and
- (d) Contract allocations and charges are consistent with invoice procedures. DFARS 242.7501

Upon receipt of an audit report identifying significant accounting system or related internal control deficiencies, the ACO will consider whether it is appropriate to suspend a percentage of progress payments or reimbursement of costs proportionate to the estimated cost risk to the

Government, considering audit reports or other relevant input, until the contractor submits a corrective action plan acceptable to the ACO and corrects the deficiencies. DFARS 242.7502

**Audit Management Guidance – Reporting Suspected Contractor Fraud and Other Contractor Irregularities, MRD 09-OO-010(R), March 3, 2009**

MRD 09-OO-010(R) requires auditors to use DCAA Form 2000 when reporting suspected contractor fraud and other contractor irregularities. There is no requirement for management approval of the auditor-prepared DCAA Form 2000 prior to its submission to DCAA Headquarters. Management reviews of DCAA Form 2000s prior to submission to Headquarters should be limited to that necessary to ensure clarity.

Information which suggests a reasonable basis for suspicion of fraud, corruption, or unlawful activity affecting Government contracts must be reported **promptly**. For reporting purposes, **fraud** is defined as: a **material statement** of fact which is **false**, and **known** to be false. Other reportable irregularities include Kickbacks, Gratuities, Illegal Political Contributions, Foreign Corrupt Practices Act violations, and Agreements in Restraint of Trade. Activities **not** reportable on the Form 2000 include matters such as (1) those already known by the Government, (2) Contractor Disclosures, and (3) unsatisfactory conditions (CAM 4-800).

To assist the investigator in evaluation of the material presented, indicate in item 4 which of the following classifications best fits the matter being referred (more than 1 classification may apply):

1. Defective Pricing
2. Billing Irregularities
3. Labor Charging Irregularities
4. Accounting Mischarging
  - a. FAR 31/CAS 405 Violations (see CAM 4-708)
5. False Claims/Certifications
  - a. Equitable Adjust. Claims a. Kickbacks
  - b. Termination Settlements
  - c. Indirect Cost Certification
  - d. Other (explain)
6. Consultants/Subcontractors Practices Act



7. Materials
  - a. Product Substitution
  - b. MMAS
  - c. Other (explain)
8. Ethical Violations
9. Other Irregular Activity
  - a. Conspiracy
  - b. Obstruction of Audit
  - c. Other (explain)

The full text of these and all of the other open MRDs may be viewed on DCAA's website at [www.dcaa.mil](http://www.dcaa.mil) by clicking on "Open Audit Guidance".

## CONCLUSION

**Whether the trend of auditors to be more assertive and aggressive is driven by the critical GAO reports or DCAA's revising of its internal Audit Guidance, absent any basis in regulatory or contractual entitlement, Government contractors can fully expect DCAA will likely accelerate this "trend" of increased DCAA assertiveness and aggression (i.e. "Gestapo Tactics").**

Whichever the catalyst may be for the change in auditor behavior, DCAA has already begun:

- Issuing Form 1s denying direct billing and finding systems inadequate for:
  1. Denial of access to records to which it is not entitled (including internal audit reports, lists of violations of contractors' ethics codes, "turnover" data relating to employees of competitors and Sarbanes Oxley information);
  2. Failing to;
    - Provide information within an unreasonable timeframe;
    - Provide unfettered access to employees; and
    - Create information to provide to DCAA.
- Finding accounting systems to be inadequate for immaterial system issues or just simply not having the time or resources to evaluate a system;
- Challenging or disregarding PCO determinations of cost reasonableness; and
- Overturning prior purchase and billing system approvals despite the absence of any change in findings.

If you find yourself confronted with what appears to be auditor "Gestapo Tactics", here are some things to consider:

- DCAA's basis of entitlement is limited to the access provided by your contract with the government, FAR, or GAGAS (reference FAR 52.215-2, Audit and Records);
- Acknowledge and respond appropriately to access requests, where deemed correct;
- Ask for the support for the basis of entitlement for access to requests for information;
- Be in a position to identify, resist, and document inappropriate DCAA demands for information;
- The FAR does not provide DCAA with the right to interrogate your employees;
- Enlist the support and action of your Administrative Contracting Officer ("ACO") and document the ACO's failure to act if appropriate;
- Ensure that your processes, procedures, and systems are compliant and well documented;
- If there is a legitimate DCAA finding, take prompt steps to implement and document necessary corrective actions.

**Contact the GATE 6 Government Contractor Services Division for SME assistance with dealing with these new "Gestapo Tactics" by calling 865-919-4507 or via e-mail to: [Bruce.Bowland@gate6solutions.com](mailto:Bruce.Bowland@gate6solutions.com).**

**GATE 6's Government Contractor Services Division** will continue to monitor this disturbing situation and others pertaining to DCAA audits and contract compliance. We will provide alerts and guidance as the situation warrants. The professional resources of the **GATE 6 Government Contractor Services Division** have decades of combined experience in dealing with Government contract compliance audits and providing liaison interface between contractors and DCAA, DCMA, GAO, etc. as well as more contentious matters dealing with the CID, DOJ, DOL, etc. **GATE 6** also provides contract/subcontract administration support, and contract change/dispute resolution services. For more information on **GATE 6** and the range of services we offer government contractors please visit our web-site at [www.gate6solutions.com](http://www.gate6solutions.com).