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Rocco J. Maffei

Jr. Counsel Control Data Corporation 8100 34th Avenue South Minneapolis, MN 55440

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Rocco J. Maffei, Jr.
Counsel
Control Data Corporation
8100 34th Avenue South
Minneapolis, MN 55440

William E. Porter
Assistant General Counsel
Control Data Corporation
8100 34th Avenue South
Minneapolis, MN 55440

On August 14, 1985, the U.S. District Court for the Western District of Pennsylvania in United States v. Westinghouse Electric Corporation, NCWPA No. 11710, held that the Department of Defense Inspector General (DOD IG) could subpoena internal audit reports from Westinghouse Electric Corporation and could authorize the Defense Contract Audit Agency (DCAA) to review those reports as part of the DOD IG's investigation. Although Westinghouse subsequently obtained a stay of the district court order, pending appeal to the Third Circuit Court of Appeals, the case will certainly encourage DCAA to increase its demands for contractors' management data, pursuant to its new found independent subpoena authority.

DCAA, as the largest auditing agency in the Department of Defense, under pressure from Congress and the DOD IG, has recently expanded its efforts to obtain contractor records. This is due to certain perceived weaknesses in the access by DCAA to records, DCAA's handling of suspected fraud and the adequacy of the internal audit controls of corporations subject to audit.

In a January 31, 1985, memo to DCAA Director Charles O'Starrett, Jr., DOD Comptroller Robert W. Helm outlined the seven elements of a proposal being considered to improve the effectiveness of DCAA. These elements include:

1. Identification of needed regulatory and statutory changes regarding records retention and access to records that would improve accomplishment of the contract audit mission. This would broaden the current definition of records to include computerized and other types of data and revising DOD record retention rules.

2. Obtaining subpoena authority for DCAA. DCAA at that time relied upon the DOD IG subpoena authority to obtain records otherwise unobtainable from contractors. Now, DCAA has independent subpoena authority.[1]

3. Clarification and strengthening of the role of DCAA as primary advisor to the contracting officer on accounting and financial matters. This would include increasing the auditor's participation in negotiations.

4. Increasing the frequency and breadth of DCAA's audits of defective pricing.

5. Assessing audit coverage of labor and fringe benefits of major contractors.

6. Strengthening management by headquarters DCAA and regional headquarters of field activities and operations. This would include analyzing reporting needs of management levels within DCAA and evaluating the effectiveness of existing peer review programs.

7. Improving reporting by DCAA to the comptroller.

A further indication of an expansionist DCAA role is seen in Deputy Defense Secretary William H. Taft's granting the audit agency responsibility for determining final overhead rates at all defense contractor locations. In an August 5, 1985, memo to Assistant Secretary of Defense Acquisition and Logistics James Wade and Comptroller Robert Helm, Taft extended the procedures used by DCAA to determine final overhead rates at smaller contractors to the larger contractor

locations where final overhead rates had traditionally been established through procurement negotiation by administrative contracting officers (ACO).

Since the spring of 1984, DCAA has pushed for access to additional contractor records including profit plans, management studies, accounts unrelated to expenditures on government contracts, and other data previously considered off-limits. The current objective, however, is internal audit reports.

DCAA asserts it has a right to these internal cost records based on statute, contract clauses and accounting standards. If the contractor refuses to produce the desired internal cost records, DCAA has threatened to suspend all costs of the corporation's Internal Audit Department, to recommend to the ACO suspension of the corporation's Internal Audit Department costs which are included in any progress payment requests, to report the lack of cooperation to the Procurement Contracting Officer (PCO) for use in negotiating the contractor's future profit or fee, and, to question the allowability of other costs based on the alleged impact of the acceptability of the company's accounting system.[2]

In connection with these efforts, DCAA sought independent subpoena power for those cases where a contractor denied it access to records. Previously, DCAA, as it did in the Westinghouse case, had to go to the DOD IG in order to obtain a subpoena.

The Westinghouse Case Background

The litigation resulting in Westinghouse arose as a result of DCAA's demands to perform an operational audit of Westinghouse's internal audit department and to obtain access to the company's internal audit reports. Westinghouse declined to provide access to the information DCAA sought because, it contended, the internal audit reports did not reflect the incurrence and allocation of cost. Westinghouse also argued that such an audit was not authorized by the audit clauses of the contract.

In two memoranda dated August 14 and August 16, 1984, DCAA requested that the DOD IG issue a subpoena for all documents generated by the Westinghouse internal audit department relating to any of the organizational elements which allocate costs to DOD contracts. The August 16 memo stated that the Westinghouse internal audit reports were needed in order to allow DCAA to reach an opinion on the reasonableness and allocability of the internal audit costs incurred and allocated to government contracts by Westinghouse. The two memoranda stated further that the internal audit reports, "are needed for audit reviews which include in their objectives and the promotion of economy and efficiency in the prevention of fraud and abuse . . ." (SIC).[3]

On September 27, 1984, the DOD IG issued a subpoena to Westinghouse for records pertaining to internal audits for the period of January 1, 1982, through October 1, 1984, for which costs had been incurred by Westinghouse and had been allocated to defense contracts and subcontracts. The subpoena limited the demand for production of documents to those records ". . . which are necessary in the performance of the responsibility of the Inspector General under the Inspector General Act to conduct and supervise audits and investigations relating to, and to promote economy, efficiency, and effectiveness in the administration of, and to prevent and detect fraud and abuse in, the programs and operations of the Department of Defense."[4] Westinghouse refused to comply with the subpoena.

On December 27, 1984, the DOD IG filed a Petition for Enforcement of Administrative Subpoena by the Government[5] which was granted by the District Court on August 4, 1985. In addition to briefs filed by the government and Westinghouse, the Chamber of Commerce and the Institute of Internal Auditors filed amicus curiae briefs in support of Westinghouse's position.

The Contractor's Position and The Court's Response

Westinghouse raised a number of arguments directed at the propriety of the subpoena. First, Westinghouse argued that since DCAA did not have subpoena power, the DOD IG was illegally acting on its behalf. The court rejected this argument, finding that the DOD IG was acting on its own behalf and was merely using the DCAA as its delivery agent.

The court also rejected Westinghouse's argument that the DOD IG's authority to access data was limited by the standards set for the GAO. The court noted that the subpoena power granted to the DOD IG by congress was greater in scope than the examination of records authority granted to the General Accounting Office.[6]

Westinghouse contended next that the subpoena was too broad, and that disclosure of audit reports would compromise confidential

data unrelated to its defense business. The court found that since: (i) Westinghouse released its internal audit reports to its independent certified public accountants, (ii) these CPA's discharge a "public responsibility", and (iii) similarly the DOD IG also performed a public responsibility, the DOD IG should be given the same access to the reports. The national policy of preventing waste, fraud and abuse in government contracts, the court noted, outweighed any "chilling effect" on the ability of the contractors' internal auditors to perform their official duties.[7]

Since Westinghouse, for the purposes of performing its internal audits, combined funds attributable to government contracts with those of its commercial contracts, the court further held the contractor could not effectively use this situation to deny the DOD IG access to these reports. If Westinghouse had kept separate records of its government contract business and its related internal audit operations, it might have persuaded the court that the DOD IG could not intrude upon its corporate reports. Moreover, the court noted Westinghouse was paid in excess of $500,000 in 1983 for audit costs, and thus "sold its right to secrecy and opened the door to the government and its right to inspect the internal audit . . . reports."[8]

Finally, the court rejected the notion that compliance with the subpoena would be unduly burdensome. Noting that in U.S. v. Firestone Tire and Rubber Company,[9] the U.S. District Court for the District of Columbia upheld a government subpoena, despite a claim that it would require 100,000 hours or more than $2 million to comply, the court observed that the subpoena in the instant case had not been shown to be unreasonble or unduly burdensome.[10]

Impact of Decision

Unless the District Court decision in the Westinghouse case is reversed or modified through judicial appeal, executive regulation, or congressional enactment, it would appear that there will be nothing to prevent either DCAA or the DOD IG access to contractor records, where only "indirect" cost allocation--costs which are not the subject matter of the internal audit report (or other management document)--is the sole existing factor. If DCAA is granted the right of access to any one type of internal management record (i.e. internal audit department reports)--to determine the reasonableness and allocability of the costs incurred by the organizational unit generating the particular type of record--DCAA would have, by simple analogy and logic, the right to demand access to all other internal management records where any portion of the costs for generating such records is allocated to government contracts. Keep in mind only a small fraction of their costs might be allocated to government contracts since the costs of generating internal management records for either commercial or government contracts find their way into an indirect cost pool, which is then allocated to individual contracts. Thus, DCAA could claim a right to obtain virtually every report, planning and decision document and working paper a company generates.[11] This, however, should not be the case.

First, it is well established in the "Rights in Data" area that indirect costs, such as independent research and development (IR&D) expenditures, although indirectly reimbursed by the government through overhead rates, are nevertheless considered private expenditures.[12] Accordingly, the government acquires no rights in any invention, process, etc. resulting from IR&D effort even though it is indirectly and partially reimbursed by the government through the contractor's indirect costs. By analogy, therefore, the government should have no right to internal audits, even though indirectly reimbursed by the government, since they should also be considered private expenditures.

Second, is audit access, through reimbursement of indirect costs, absolute or a matter of degree based on a quantum theory and analysis? In Westinghouse, the court found that since the government had paid in excess of $500,000 for internal audits done by Westinghouse, the government in effect "owned" those internal audit reports. If the amount allocated to internal audits was, however, only a de minimus amount, would the government still have unlimited access? If the government is entitled to access through the mere indirect payment of $1.00, it may be necessary for contractors--as a defense against internal audit report access--to (i) allocate internal audit costs to the indirect pools (per the established accounting system) and then (ii) remove the allocable amount from the pool when seeking cost reimbursement. The same principle would have to be applied to forward pricing rate agreements to ensure that firm fixed contracts are purged of such costs. Only procurements based on price analysis (not cost analysis) would conceivably escape such treatment. In this way, contractors could then argue that the government has not acquired any right in

those internal audit reports since the contractor has specifically excluded payment for those costs.

A third question that arises is whether any comming'ing of commercial and government accounts justifies government access to all commercial as well as government data. If there are any internal audit reports which include information from government contracts which are subsequently made part of the total corporate audit, does that constitute sufficient "commingling" to allow the government complete access to all corporate records? If it does, contractors must clearly segregate all government accounts and take other steps necessary to protect commercial data.[13]

Finally, the Westinghouse court's determination that the subpoena was issued for a legitimate purpose within the scope of the DOD IG's authority, makes it questionable whether DCAA now needs its own subpoena power. The court found that at the time of the issuance of the subpoena, the DOD IG had personal interest, official curiosity, and suspicion that Westinghouse's refusal to produce the internal audits, plus other surrounding circumstances required an investigation to discharge the IG's responsibilities to the DOD and the public. The court also recognized that the IG had independently determined that there was a need for the subpoena and was issuing the subpoena for its own purposes and not purely for the DCAA. Even though the recently enacted DCAA subpoena authority is less extensive than the DOD IG's, this review level, however limited it may be, is eliminated.[14] DCAA has carte blanche authority to inspect a contractor's records.

Conclusion

The Westinghouse decision is no doubt the first chapter of what will be a long-running "access to records" drama. There will be greater insight when the appellate process has been exhausted by the litigants. Since DCAA has received its own statutory subpoena power, and therefore the "procedural" questions springing out of the DOD IG/DCAA relationship in Westinghouse may be of little future significance, the extent of that subpoena authority is of great importance.

It is the "substantive" questions raised by Westinghouse and noted above that have an ominous portent. Most notably, either appellate court review, executive branch regulation, and/or congressional oversight must ultimately address the fundamental proposition posed by Westinghouse: Is government reimbursement of an indirect cost in and of itself a sufficient basis to give it a right to access documents, records, etc. associated with that indirect cost-generating function? In addressing this question in whatever forum (legislative, judicial or executive), the ultimate answer--if it sustains the district court's premise--could have a very significant adverse impact on the private sector/government relationship. Those companies infused with a dynamic, entrepreneurial management with an election to focus on the commercial marketplace may conclude that government business is not worth the price of such government access and intrusion into affairs of little, if any, direct bearing on government contracted work. As a policy, the "best and the brightest" should be attracted, not repelled, to solving the government's procurement needs.[15]

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[1]The Department of Defense Fiscal Year 1986 Authorization Act (P.L. 99-145) Subpoena of Defense Contractor Records amended Section 2313 of Title 10, United States Code by adding

"(d)(1) the Director of the Defense Contract Audit Agency (or any successor agency) may require by subpoena the production of books, documents, papers, or records of a contractor, access to which is provided to the Secretary of Defense by subsection (a) or by section 2306(f) of this title."

[2]See, "Has DCAA overstepped its authority under the audit clause?" by W. Adams and J. Gallagher, Contract Management, November, 1984, at 17.

[3]U.S. v. Westinghouse Electric Corporation, Misc. No. 11710, slip op. at 11 (W.D. PA, Aug. 14, 1985).

[4]Id, at 2.

[5]Id, at 2.

[6]In Rowsher v. Merck & Company, Inc., 460 U.S. 824 (1983), a divided Supreme Court ruled that the federal access to records statutes generally don't authorize the General Accounting Office to examine contractor's indirect cost records. The court allowed that contractors could withhold records concerning research and development and other indirect costs, except to the extent that these costs are identified with a particular government contract.

[7]Westinghouse at 55.

[8]Id, at 56.

[9]455 F. Supp. 1072 (D.C.D.C. 1978).

[10]Westinghouse at 48-49. "The respondent states that compliance with the subpoena would require approximately 3700 hours of effort and $55,000 in direct reproduction costs (although the government has not required that the documents be copied, only made available for inspection), in order to produce the 920 internal audit reports that relate to DOD contracts . . . I find that the subpoena in the instant case has not been shown to be unreasonable or unduly burdensome."

[11] See, Machinery and Allied Products Institute Bulletin No. 6598, August 21, 1985, where the same conclusion is advanced.

[12]Defense Procurement Circular No. 22 (29 Jan. 1965).

[13]See, "Confronting the DOD "Access to Records" Offensive" by C. Kipps, J. Carlson and A. Brown, 43 Federal Contracts Report, June 3, 1985, at 1032, for an analysis on how contractors should protect records.

[14]DCAA's subpoena authority amended 10 U.S.C. 2313 to grant DCAA the right to require production of those books, documents, papers or records of a contractor which DCAA has a right to review pursuant to 2313(a) and 10 U.S.C. 2306(f). Section 2313(b) provides that the examination of records would involve records that directly pertain to and involve transactions relating to the contract. This is much more limited than the DOD IG's subpoena power set forth in the Inspector General Act of 1978, as amended. 5 U.S.C. Appendix §6(a)(4) and 28 U.S.C. 1345.

[15]On December 11, 1985, DCAA issued a new regulation governing the process of subpoenaing defense contractor records, implementing the provisions of Pub. L. 99-145. The regulation outlines that the DCAA director is responsible for issuing subpoenas and for providing the Secretary of Defense an annual report on the use of the subpoena authority. Pursuant to the regulation, the DCAA general counsel is tasked with reviewing subpoena requests to make sure they are legal and with notifying the Justice Department if the subpoena needs to be enforced.

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