Avoiding Litigation When Auditing Government Contractors

By Claude M. Millman

Government contracting is big business. More than 4 million contractors serve the U.S. government, and they collectively receive more than $500 billion per year. While many people think of those federal contracts when they refer to "government contracts," states and municipalities also have substantial contracting budgets. For example, New York City (where the author used to serve as chief procurement officer) spends close to $20 billion per year through roughly 40,000 procurement actions.

Of course, government contractors need tax preparation and auditing services. While CPAs can be of great service to such clients, government contracting involves special risks that can affect contractors and the accountants they retain. Before agreeing to audit a government contractor, it is useful to consider these issues, recognize how they may lead to controversies and litigation, and take steps to mitigate the chances that small problems will become big ones.

Risks of Doing Business

It is not always obvious that a client is a government contractor. Where government contracting is the focus of a business (e.g., a defense contractor), the unusual exposure faced will be readily apparent; however, many companies that primarily service the private sector also contract with federal, state, or local governments. A wide variety of enterprises may engage in such government contracting, from for-profit firms in the construction, information technology, or manufacturing sectors to nonprofit providers of human services. Since a company that dabbles in government contracting may have inadequate internal controls to handle the peculiar challenges of selling to the government, it is particularly valuable for CPAs to be alert to whether clients have business with the government.

When auditing a government contractor, it is important to understand the unique pressures faced by such a client. While government contracting can be profitable, government vendors often navigate mind-numbing bureaucracies, unintelligible contracts and regulations from multiple sources, unrealistic obligations (often flowing from legislation despised by government contracting officers), counterintuitive ethical standards and lobbying restrictions, and payment delays. On top of that, although government agencies rarely terminate contracts early—and usually renew them—most government contracts afford agencies unilateral rights to terminate, for cause or "convenience," and to cancel if funds are not appropriated. Most significantly, when an interaction with the government fails, consequences for the business can be catastrophic. Regardless of whether a company is a novice seeking government business for the first time or has served a particular agency for decades, a public procurement problem can lead to investigations, criminal charges, and reputational injuries that are rarely attendant to private business conflicts.

A company seeking government business faces danger even before it becomes a contractor because, in the course of the bidding process, the government might brand it "non-responsible" (i.e., lacking in ability or integrity) and thus cripple the company's reputation. The risks intensify after the contract is signed. A government declaration of a default on a single contract can be a fatal blow. Moreover, a contractor that commits a seemingly minor breach might be sued by a whistleblower (or, worse yet, the government) under a federal, state, or local False Claims Act, and can be sued for retaliation if it takes action against the whistleblower.

An accounting firm auditing a government contractor has good reason to be concerned that some of these dangers may spill over to the auditor. Whistleblower lawyers have named major accounting firms as defendants in False Claims Act cases. Seizing on the

fact that the law imposes liability on a defendant that—with no intent to defraud—acts recklessly or with deliberate ignorance, aggressive plaintiffs' attorneys have argued that accountants charged with auditing contractors bear responsibility for false claims. While such lawsuits are often dismissed prior to trial, they have also been settled for millions of dollars, and even a successful defense can be costly.

When a government contractor is in trouble, its auditor may share the burden, even if it is not named in a whistleblower suit. It might be compelled, in civil or criminal litigation, to produce documents from the audit or provide witnesses and records in connection with an investigation. Responding to these demands can be costly and risky, as lawyers and investigators may focus on the auditing firm after reviewing its documents or testimony.

Overreactions to the risks faced by government contractors and their auditors can also undermine the auditor-client relationship and make matters worse. On the one hand, CPAs should not allow a concern for client relations to undermine an audit. A weakened audit is, among other things, not in the long-term interest of the client. On the other hand, if the government contractor misperceives the auditor as its "enemy," problems that might otherwise be avoided or minimized for the contractor, the auditor, and the public may become the subject of heated controversy and litigation.

Steering around Trouble

There are several steps that auditors and their government contracting clients can take to strike the right balance and avoid unwarranted litigation. First, an auditor should work with management to develop an understanding of the business and its government obligations. While this is obviously always important, it becomes critical when an auditor is engaged by a government contractor to conduct an audit under the federal Single Audit Act, as implemented by the Office of Management and Budget's Uniform Administrative Requirements, Cost Principles, and Audit Requirements. Since such an audit must, among other things, address whether the contractor is in compliance with the laws and regulations that apply to the federal funding, an auditor engaged for that purpose must have a keen understanding of the legal framework within which the contractor operates.

Second, the auditor should promote a relationship that helps management recognize that transparency and communication are in the contractor's best interest. Major problems are less likely to arise when management creates a culture that does not merely prohibit retaliation against whistleblowers, but actually encourages employees who suspect fraud to come forward. An effective corporate environment is most likely to emerge when employees are frequently reminded of their obligation to report suspicious activity, when employees who fail to do so are disciplined, and when management follows a policy of swiftly disclosing reports of suspected fraud to the board's audit committee and the company's outside auditor.

Relatively few management teams seek to defraud government agencies, and most are interested in contract compliance. Many government contracting disputes, and even False Claims Act allegations, arise from misunderstandings by clerical staff or midlevel managers, intracorporate miscommunications, or confusing instructions from government agencies. Such matters can often be handled with minor consequence if they are promptly identified (as may arise when government contracting employees are encouraged to report problems), thoroughly reviewed by the contractor's outside counsel (generally under the shield of attorney-client privilege), remedied (through a refund, if warranted, and with strengthened internal controls), and reported to the audit committee, auditors, and the relevant government agency. Instances of contractual noncompliance can easily turn into corporate crises when whistleblowers are ignored, allegations are cursorily dismissed by biased internal reviewers, or problems are concealed.

Third, auditors should seek to ensure that their own communications with management are clear and that management truly comprehends the significance of its representations to the auditors. Management representations can become routine, and their gravity can be lost. A government contractor will likely benefit if it errs on the side of disclosure. When the management representation letter is viewed as just another form to be hurriedly signed and returned, remediable problems may be missed, with adverse consequences for the government contractor, and sometimes the auditor.

Fourth, while auditors must be skeptical, it does not follow that every allegation of misconduct will be substantiated. Although auditors must obviously issue negative opinions when they are warranted, the consequences for government contractors are particularly grave. Thus, if a government contractor perceives that it will be presumed guilty, there will be little transparency. The client's relationship with the government makes it particularly important for the auditor to convey neutrality, demonstrate that it keeps an open mind, and maintain that perspective.

Fifth, when the relationship is shattered, the auditor, government contractor, and public will likely benefit if it does not linger. As a crisis emerges, a government contractor's knee-jerk reaction will likely be to restore relationships of trust with government agencies, investors or funders, banks, and auditors. It is often better for the auditing relationship to end quickly, as a long, dramatic breakup is more likely to generate disputes, fuel investigations, and undermine credibility on all sides.

Exercise Caution

However well intentioned and skilled a government contractor and its auditor may be, controversies and litigation may arise. CPA firms should prepare for that eventuality by documenting concerns, preserving evidence, and ensuring that problems are elevated to the appropriate levels and raised with legal counsel promptly. ❑

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