9 Steps: for Avoiding an Ethical Disaster During Sequestration

Follow these nine recommendations in order to avoid ethical violations due to contract reductions brought about by the sequester.

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Sequestration is the name given to the mandatory, across-the-board spending cuts (totaling about $1.2 trillion) that occurred automatically earlier this year due to the failure of Congress to agree on a budget compromise.

A “Super-Committee” of the Congress invented this “doomsday” budget scenario late in 2012 with the belief that the threat of such a draconian budget exercise would incentivize cooler heads to prevail in order to avoid what everyone agreed would amount to budget armageddon. As we know now, politics prevailed over cooler heads, and the federal government is in the process of furloughing personnel, cutting programs, and reducing or cancelling contracts to meet these unprecedented budget reductions.
The Impact of Sequestration on Government Contracting

Typically, agencies attempt to reduce personnel through attrition to meet planned budget reductions, but these are not normal federal budget cuts, and they certainly aren’t planned. Agencies will need to scale back the number and size of new contracts for programs deemed “noncritical.” Even critical programs will likely be affected as agencies look for the most efficient ways to utilize reduced funding.

As a consequence, government contractors are facing a series of possible actions on existing contracts, all of which create challenges for managing their budgets, workforce, and financial future.

Existing Contracts
Funding limitations could cause agencies to reduce the scope and quantity of products or services purchased on existing contracts. Agencies may choose to “de-scope” the quantity, capability, or breadth of contract performance through change orders, as well as partial, or even complete, contract terminations for convenience. However, outright terminations for convenience require the government to pay recoveries to terminated contractors, so this approach will likely be used sparingly. Contractors should expect agencies to propose restructuring existing contracts to defer costs to the future. Such restructurings may result in more term contracts, extensions of contract schedules to match funding, and requests for waivers of existing contractor claims. Contractors may see their option periods waived, forcing them to negotiate new contracts at lower prices, and face increasingly price-sensitive competition.

New Contracts
The most likely scenario is that government contractors will see a decrease in the number of new contracts awarded, as agencies eliminate programs not absolutely essential to their missions. There is also likely to be a change in the types of contracts awarded, with agencies moving away from contract vehicles that place cost and performance risk on the government. For example, agencies are less likely to use cost-reimbursement and labor-hour contracts (previously favorites in the government services arena), instead favoring fixed-price contracts for a greater degree of cost certainty and lower risk. Indefinite delivery/indefinite quantity contracts will also become more attractive for the government because they allow agencies to negotiate at the task order level. In addition, government contractors are already seeing a trend away from “best value” procurements toward favoring lowest-price technically acceptable proposals.

Bid Protests
Stiffer competition for contracts is expected to bring an increase in bid protest litigation, particularly from incumbents seeking to extend their performance on contracts and offerors who need the awards to remain viable players in the government contracting space.

State and Municipal Contracting
Although federal budget reductions will directly impact federal contractors, the potential impact on companies that contract at the state and municipal levels should not be ignored. States and municipalities are already reeling from the loss of tax revenue due to the recession. It is reasonable to assume that follow-on cuts in federal spending in education, healthcare, transportation, and housing, for example, will result in additional reductions in the number and value of contracts administered at state and local levels.

Contract Reductions Can Lead to Ethical Violations
Nearly every company that derives a significant amount of its revenue from government business is enduring a period of intense anxiety and uncertainty about the future of its contracts and the impact of sequestration on its 2013 revenue and profit. Many companies have already restructured or laid off staff, reduced benefits, or engaged in other cost-cutting exercises to better position themselves for anticipated reductions. In many instances, this uncertainty and anxiety permeates a workforce that feels increasingly under pressure to show profits on current business, win new business, and cut costs to compete in a declining budget environment.

This intensified competition for fewer contracting opportunities can create a high-risk environment within companies, making them susceptible to employee misconduct, particularly with regard to following the rules of the competitive contracting process. In an effort to win contracts, curb layoffs, and minimize staff reductions, employees—particularly those in the contract “capture” or business development process—may feel motivated to ignore or marginalize their company ethics and compliance programs in an effort to bring in new work. This can include using whatever information is at their disposal—even prohibited government or competitor acquisition data—to give them an edge in the bidding process. Other employees may feel compelled to inappropriately shift contract and overhead costs from affected contracts that have been reduced or de-scoped to other government contracts that have not been impacted by cuts. Still other employees might be tempted to bid contracts at prices that will necessitate shortcuts on performance in terms of quality or timeliness. Such ill-advised actions can ultimately lead to government investigations, prosecutions, suspensions, and debarments at a time when contractors can least afford the damage to their reputation and subsequent loss of business.

But what can company executives do to minimize the ethics risk, particularly when they could be entirely unaware that their employees may feel pressured to engage in such behaviors?

Proactive Steps to Reduce the Ethics Risk
There are nine common-sense steps that government contractors can take to reduce the ethics risk, demonstrate their due diligence, and avoid ethical disaster.
Companies need to review their code of ethics and business conduct to make sure it is current and relevant to the ethical challenges they are now facing in the government contracting environment. If employee misconduct does occur, this is one of the first actions that government agencies will review.

With pressures coming from every direction, now is a good time to reemphasize the company’s commitment to ethics and integrity in business practices. Employees need to hear directly from their immediate supervisors, as well as company leadership, that in spite of the challenges they face in winning and retaining government business, ethical shortcuts, no matter how seemingly small or insignificant, will not be tolerated.

Most companies rely heavily on financially based performance metrics to drive employee pay, bonuses, and promotions. Consider including ethics objectives into the mix to achieve a more balanced approach to incentivizing employee behavior.

Regardless of whether government contracting processes and controls have worked well in the past, fundamental changes in the environment now require a reassessment of the adequacy of internal controls over government contracting. For example, are approvals for cross-charging contracts at a high enough level to prevent fraudulent charges? Must senior company officials certify as to the source of data used to prepare proposals?

Many companies create effective ethics and compliance programs and a strong ethical culture, only to ignore whether the same conditions exist in their joint venture partners, subcontractors, or suppliers. Government agencies regularly take action against prime contractors for failing to flow down contracting requirements, including the ethics and business conduct provisions contained in the \textit{Federal Acquisition Regulation}. Now would be a good time to reexamine the company’s due diligence with those third-party relationships.

With declining government budgets, many contractors are setting their sights overseas. While foreign governments and international markets present opportunities, contractors should be aware of potential pitfalls associated with international business, including the complexities of complying with export control laws and the \textit{Foreign Corrupt Practices Act}, which both the Department of Justice and the Securities and Exchange Commission are vigorously enforcing.

Suspensions and debarments of contractors by government agencies reached an all-time high in 2012. It is likely that decreasing budgets and the increasing importance of contract integrity and performance will drive even more aggressive enforcement of the \textit{Federal Acquisition Regulation} in 2013. For its part, the Defense Contract Audit Agency has more tools than ever to collect monies from contractors, including the ability to withhold payments if the agency finds a significant deficiency in the contractor’s business systems. Contractors will need to guard against unsupportable payment withhold by the Defense Contract Audit Agency. Finally, the political discourse indicates that declining taxpayer tolerance for waste, fraud, and abuse of public funds will continue to drive prosecutorial priorities in 2013 and beyond.

\begin{itemize}
\item \textbf{1. Brush up on the Code of Conduct}
\item \textbf{2. Get out the Ethics Message}
\item \textbf{3. Adjust Performance Expectations and Metrics}
\item \textbf{4. Reexamine Contracting and Financial Controls}
\item \textbf{5. Pay Attention to Subcontractors and Suppliers}
\item \textbf{6. Assess the Opportunities and Risks of International Markets}
\item \textbf{7. Expect a Smaller, Less-Experienced Government Workforce}
\item \textbf{8. Be Ready for Increased Government Oversight}
\end{itemize}
It is important for government contractors to consider new ways to make themselves attractive and to differentiate from their competitors. Strong ethics and compliance programs, for example, have become a competitive differentiator on government contracts as agencies can ill afford to deal with ethics and integrity problems in either the bidding or execution phases of mission-critical projects. Regular independent assessments of a contractor’s ethical culture and ethics and compliance programs can help make the case that a company deserves the public trust. In addition, proposals that incorporate ethics assessments, training, and education at the project level provide evidence of commitment to controls and accountability important to government agencies in this new environment.

While the immediate future for government contractors might appear gloomy, a renewed and demonstrable commitment to ethics and compliance activities can protect companies and better position them to maneuver today’s contracting uncertainties without exposing themselves to even greater problems. CM

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