

Aerospace & Defense

Technical alert

As early as January 23, 2008, federal government contractors were required to ensure their codes of ethics and conduct meet newly mandated standards. The only contractors excluded from the new rules are small businesses and organizations whose contracts are limited to (i) FAR Part 12 commercial items, (ii) \$5 million or less, and/or (iii) areas of performance entirely outside the U.S. Starting with contracts awarded on December 24, 2007, covered contractors have 30 days to meet the new ethics rules and 90 days (March 23, 2008 at the earliest) to meet the new awareness program and internal control system requirements. Additional standards for compliance and integrity reporting are on the horizon.

This alert provides a summary of the final and proposed changes to the federal government's new policy and standards for business ethics and conduct.

New standards of conduct: Contractor Code of Business Ethics and Conduct

Summary

The new standards of conduct are contained in two Federal Acquisition Regulation (FAR) clauses; one requiring standards for business ethics, FAR 52.203-13, Contractor Code of Business Ethics and Conduct, and another requiring the display of hotline posters encouraging the reporting of violations, FAR 52.203-14, Display of Hotline Poster(s).

Requirements

Generally, the new rules:

- are triggered by a federal prime contract expected to exceed \$5 million, awarded on or after December 24, 2007 with a performance period of 120 days or more, except those contracts for commercial items procured under FAR Part 12 contracts or performed entirely outside the U.S.;
- apply to subcontracts, under covered prime contracts, that are expected to exceed \$5 million with a performance period of 120 days or more, except those contracts for commercial items procured under FAR Part 12 contracts or performed entirely outside the U.S.;
- require, within 30 days of award, contractors to have a written code of business ethics and conduct and to provide a copy of the code to all employees who are performing on a covered contract;
- require, within 90 days of award, an ongoing awareness program promoting business ethics and proper conduct and an internal control system to facilitate timely identification and notification of improper conduct in connection with Government contracts. The clause suggests periodic reviews, an internal reporting mechanism such as a hotline, audits, and disciplinary action for violators; and
- require contractors to display in common work areas within business segments performing covered contracts hotline posters, or other reporting mechanisms, as specified in covered contracts.

The new requirements may be deferred, upon request of the contractor, by the contracting officer who can extend the 30 day time period for preparation of a code of business ethics and conduct or the 90 day time period for establishment of an ethics awareness and compliance program and internal control system.

Proposed rules: contractor compliance program and integrity reporting

In addition to the finalized rules, another proposed rule, initiated at the request of the Department of Justice (DOJ), would impose further requirements on compliance and reporting by:

- adding a satisfactory record of integrity and business ethics as a contractor qualification standard;
- creating a cause for debarment or suspension for a knowing failure to disclose overpayments or violations of federal criminal law in connection with the award or performance of any contract or subcontract;
- requiring mandatory disclosure to the government of suspected violations of criminal laws committed in connection with the award or performance of a contract or subcontract; and
- setting minimum standards for an internal control system relating to the internal audit organization, resources, procedures to ensure independence and cooperation with government agencies responsible for audit investigation or corrective actions.

Comments on this proposed rule were due January 14th, 2008.

More recently, Congress has included in Section 848 of the National Defense Authorization Act for 2008, H.R. 1585, December 6, 2007 Conference Report, a provision requiring the Comptroller of the United States to submit a report to Congress within one year on the internal ethics programs of major defense contractors (defined as any company that was awarded contracts by the Department of Defense (DoD) during fiscal year 2006 in amounts totaling more than \$500 million). The report would address the extent to which major contractors have adopted much of the new and proposed changes to ethics program requirements. Also, the report would address whether ethics programs include a notification to contractor employees of their right to be free from reprisal for disclosing a substantial violation of law related to a contract.

Marketplace impact

The standards of conduct for defense contractors already provide, as guidance, many of the requirements under the new FAR rule. For DoD contractors, the new FAR rule makes mandatory much of the pre-existing discretionary rules, which have been adopted by at least the major DoD contractors. Therefore, the medium and smaller DoD contractors as well as the non-DoD contractors will be most affected by the new rule.

The proposed rules initiated by DOJ are clearly incremental. They stem from DOJ's concerns that wrongdoing activities are either not surfaced because of insufficient internal control systems or suppressed because of management overrides of internal controls.

The Sarbanes-Oxley Act (SOX) imposed the requirement for public companies to implement, assess and certify as to the effectiveness of their internal control systems over financial reporting. Because internal control structures consider the regulatory environment, the changing rules may prompt an assessment of the exposure to risk and any potential financial impact. Contractors who must comply with the new ethics rules, but were not previously subject to SOX, will need to formally adopt SOX-like requirements for regulatory components of internal control systems.

Under the new rules, contractors will have an obligation to demonstrate that they have processes in place to proactively detect and report improper conduct. As a result, contractors may need to expand the focus of their internal audit and compliance activities, to include the following areas:

- Risk assessment—the new rules underscore the importance of performing a detailed, enterprise-wide risk assessment and aligning a multi-year internal audit plan with the identified risks. In addition, contractors should consider including a fraud risk assessment as a key element of the contractor's overall enterprise risk management model.
- Testing of controls—contractors should evaluate risks in key areas that are prone to misconduct including pricing, billing and labor charging.
- Subcontractor compliance—contractors should consider utilizing internal audit to oversee and monitor subcontractor's compliance with contract terms and conditions, as well as federal regulations.
- Overall risk management strategy—contractors should consider expanding the role of internal audit beyond financial and operational risk to provide monitoring of other aspects of their risk and compliance programs.

Action plan

PricewaterhouseCoopers governance, risk and compliance (GRC) and government contracts specialists are available to discuss these important developments, their effects, including possible implications on government contracting and SOX requirements, and how we can assist Aerospace & Defense companies. If you would like any further information or assistance regarding these important changes, please feel free to contact a member of your engagement team or any of the following specialists:

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