



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL**

**ADVISORY MEMORANDUM
REPORT NUMBER 12-19**

DATE: September 4, 2012

TO: John Shoraka
Associate Administrator, Government Contracting and Business Development

Calvin Jenkins
Deputy Associate Administrator, Government Contracting and Business Development

Robert Hill
Associate Administrator, Office of Field Operations

SUBJECT: A Non-Manufacturer Rule Waiver Allowed an 8(a) Recovery Act Contract to Bypass
Established Small Business Requirements

This advisory memorandum is the first in a series of ongoing limited scope audits. These audits will review the extent to which selected 8(a) firms participating in the 8(a) Business Development Program (8(a) program) are complying with prime contractor performance requirements for set-aside contracts. In this audit, we determined that one of the selected contracts complied with the performance of work requirements, and the other was exempt due to a waiver issued by the Small Business Administration (SBA). However, one contract was a pass through contract that resulted in large businesses receiving funds specifically designated for the 8(a) program.

The objective of this series of audits is to determine whether selected 8(a) firms are performing the required percentage of work. For this audit, we judgmentally selected these two firms¹ from a universe of contracts where the contract was: (1) awarded in fiscal year 2009 or 2010 as a set-aside or sole-source contract; and (2) performed by a contractor located in the Washington, D.C. metropolitan area.² To conduct our audit, we examined contract documentation as well as company financial documents and contract performance tracking mechanisms for each selected contract. We also interviewed company officials and the SBA Business Opportunity Specialists who have purview over the selected 8(a) contractors. Additionally, during the course of this limited scope audit, we did not identify any material internal control weaknesses at the two selected prime contractors pertaining to our audit objective. We conducted this audit in accordance with generally accepted government auditing standards from January to July 2012. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis on our audit objectives.

¹ One of the selected contracts was awarded and funded as a contract under the American Recovery and Reinvestment Act of 2009.

² As of December 31, 2011, the Washington, DC SBA District Office managed approximately 19 percent of the entire 8(a) program participant portfolio.

We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Background

The SBA has a number of programs that provide benefits and assistance to help small and disadvantaged businesses grow and develop. These benefits include program participants receiving sole source and set-aside federal contracts so that small businesses do not need to compete with large businesses that may have an industry advantage. Two of these SBA programs are the 8(a) Business Development Program and the Historically Underutilized Business Zone (HUBZone) Program. There have been longstanding concerns about fraud in these SBA preferential contracting programs, and we have identified problems with SBA's management of these programs in prior audits.

8(a) Program

The 8(a) program was created to assist small disadvantaged businesses compete in the American economy through business development. As of December 31, 2011, the program included 6,863 participants. To qualify for this program, the 8(a) contractor must be at least 51 percent owned and controlled by an individual or individuals who meet SBA's criteria of socially and economically disadvantaged, United States citizens, and of good character. The participant must also be a small business as defined by the SBA, and show a reasonable potential for success. Additionally, the primary industry classification code identified by the 8(a) participant determines its size and eligibility as a small business. However, some restrictions apply to the 8(a) program, specifically, an 8(a) participant cannot receive a sole-source contract exceeding \$4 million for services and \$6.5 million for manufacturing.³ According to the fiscal year (FY) 2011 Small Business Goaling Report, the number of contract actions for 8(a) Small Businesses⁴ totaled 117,907, which represented around \$16.7 billion in federal contract funding.⁵

HUBZone Program

The HUBZone program was designed to help small businesses—located in economically challenged communities (or HUBZones)—increase employment opportunities, investment, and economic development in such areas. As of January 31, 2012, the HUBZone Program included 5,914 participants. Program participants must maintain their primary office in a HUBZone and must attempt to maintain a workforce composed of 35 percent of their employees who reside within a HUBZone. In FY 2011, there were 91,864 contract actions for Certified HUBZone Small Businesses,⁶ or approximately \$9.9 billion in federal contract dollars, according to the FY 2011 Small Business Goaling Report.

³ The Code of Federal Regulations (CFR), Title 13, Section 124.506(a) outlines the specific thresholds for set-aside contracts. When the contracts were awarded, the value of set-aside contracts could not exceed \$3 million for services and \$5 million for manufacturing. However, 13 CFR § 124.506 (b) states that 8(a) Alaska Native Corporations (ANC) are eligible to receive sole-source 8(a) contracts regardless of the amount of the contract, unlike non-ANC 8(a) contractors.

⁴ A contract action includes any new contract awarded, any modification to an existing contract, or any new task order awarded against an existing contract. Additionally, an 8(a) small business contract action includes any action for which the type of set-aside is 8(a) competed, 8(a) sole-source, or 8(a) HUBZone and the Contracting Officer's Selection of Business Size is "small."

⁵ The Small Business Goaling Report is generated using the Federal Procurement Data System-Next Generation on an annual basis and displays the dollars, actions, and percentages for small business contracts. The goaling exclusions apply to this report, and this small business goaling report is run by the "funding agency" designated for the contract.

⁶ A Certified HUBZone Small Business Contract Action includes any contract action where the Contracting Officer's Selection of Business Size equals "small" and the vendor's business type is HUBZone Certified.

Prime Contractor Performance Requirements for 8(a) and HUBZone Participants

As a participant in either the 8(a) or the HUBZone program, a small business must agree to specific performance requirements when receiving set-aside contracts. The performance requirements state that the prime contractor must generally perform at least 50 percent of the work on the contract for all service or supplies contracts, as outlined in federal regulations.⁷ See Table 1 for a breakdown of the specific prime contractor performance requirements for 8(a) and HUBZone participants.

Table 1 Prime Contractor Performance Requirements for 8(a) and HUBZone Participants

	8(a) Program	HUBZone Program
Service Contracts (Except Construction)	The 8(a) participant must incur at least 50 percent of the costs of personnel performing the contract.	The HUBZone prime contractor must incur at least 50 percent of the costs of personnel performing the contract, or may include employee costs of another qualified HUBZone participant to meet the required 50 percent performance minimum.
Products or Supplies Contracts (Except Regular Dealers)	The 8(a) participants must incur at least 50 percent of the cost of manufacturing the supplies, not including the cost of materials. These requirements apply to all contracts for supplies or products, other than procurements from a non-manufacturer in such supplies or products	The HUBZone prime contractor must incur a minimum of 50 percent of the cost of manufacturing the supplies, or can include the manufacturing costs of another HUBZone participant to calculate the percentage of work performed. In either scenario, manufacturing costs do not include the cost of materials.

Results

Contractors Complied with, or Were Exempt from, Performance of Work Requirements

For our audit, we selected two contracts performed by 8(a) program participants: one 8(a) contract and one HUBZone contract. We found that one contractor complied with the performance of work requirements, and the other was exempt because of a waiver from the SBA. The HUBZone set-aside contract⁸ performed by Aspen of D.C., Inc. for \$5.4 million was awarded to provide recruiting services for the Census Bureau; however, the contractor had not used any subcontractors to date. The 8(a) set-aside contract⁹ performed by TKC Global Solutions, LLC—an Alaska Native Corporation—for \$7.78 million utilized a subcontractor to provide imaged personal computers and monitors for the Department of Labor (DOL).¹⁰ However, the 8(a) set-aside contract was performed as a pass through

⁷ 13 CFR § 125.6 - Prime contractor performance requirement (limitations on subcontracting) and FAR Subpart 52.219-14 - Limitations on Subcontracting. These prime contractor performance requirements contain exclusions for construction services and purchasing supplies from a regular dealer.

⁸ Contract Number YA132309CN0017 was awarded on February 1, 2009 to Aspen of D.C., Inc. for \$5,416,552 to provide recruiting services at 12 regional offices.

⁹ Contract Number DOLJ099628917 was awarded on August 21, 2009 to TKC Global Solutions, LLC for \$7,783,648 to provide 11,028 imaged personal computers and monitors.

¹⁰ Documentation obtained from TKC Global Solutions, LLC shows that the company would use a large business subcontractor to fulfill the contract requirements. Because the SBA granted TKC Global Solutions, LLC a waiver to the non-manufacturer rule it enabled them to subcontract the performance of the contract requirements to World Wide Technologies, Inc., a large business. An approved non-manufacturer waiver provides a small business with an exemption to the subcontracting limitations outlined in 13 CFR § 125.6. This exemption allowed the small business to pass through almost all of the performance of the contract to a large business rather than requiring the small business to perform at least 50 percent of the awarded contract.

contract where large businesses received most of the procurement dollars, and TKC Global Solutions, LLC received \$153,000.

8(a) Contractor Received a Pass through Contract to Benefit Large Business

The DOL awarded a \$7.78 million, sole source, 8(a) contract to TKC Global Solutions, LLC (TKC) to purchase Dell© personal computers and monitors. Subsequently, TKC placed an order with a large business to purchase and deliver Dell© personal computers and monitors. The true beneficiary of 8(a) funds in this scenario was a large business, World Wide Technologies, Inc. Therefore, TKC received \$153,000 of the total contract for only performing minimal oversight support of the contract and not adding value to the personal computers or monitors.

Federal regulations allow small businesses to supply manufactured products of large businesses in accordance with an approved waiver to the non-manufacturer rule. According to the Code of Federal Regulations (CFR), Title 13, Part 121, Subsection 406, *Size Eligibility Requirements for Government Procurement*,¹¹

To qualify as a small business concern for an 8(a) contract..., a small business must either be: (1) the manufacturer of the item being purchased, to include modification of an item which the small business increased the value of the end item by 50 percent or more; or (2) a non-manufacturer, which normally sells the type of item being supplied, and the end item must be the product of a small business, or the contracting officer must obtain a waiver from the SBA Administrator.

In this case, the DOL's waiver request to the SBA stated that it needed the waiver so that TKC could purchase Dell© products because no small business manufactured the desired Dell© products. The SBA approved the non-manufacturer waiver allowing the DOL to purchase Dell© personal computers and monitors through an 8(a) sole source contract. The contract awarded undermined the intent of the 8(a) program due to the reasons outlined below.

(1) TKC did not obtain business development experience through the awarded contract as intended by its participation in the 8(a) program.

According to SBA regulations, the purpose of the 8(a) program is to assist eligible small disadvantaged business concerns compete in the American economy through business development.¹² Additionally, the regulations provide that to assist the business development of participants in the 8(a) program, an 8(a) contractor must perform certain percentages of work with its own employees.¹³ Pass through contracts do not provide business development experience, as the 8(a) small business performs very little of the contract. For example, federal regulations dictate that value added services to a contract can include configuration consulting and design, installation of multi-vendor computer equipment, customization or hardware or software, or end user support.¹⁴ Our review found that TKC performed very little work on the contract, and the contract was performed as a pass through to a large company, World Wide Technologies, Inc. Therefore, this pass through contract did not fulfill the purpose of the

¹¹ 13 CFR § 121.406 - Size Eligibility Requirements for Government Procurement

¹² 13 CFR § 121.1204(b)(3)

¹³ 13 CFR § 124.1

¹⁴ 13 CFR § 121.201

8(a) program. The waiver approved by the SBA allowed the DOL to use TKC to procure the computers from Dell©, as indicated in the waiver request. However, TKC used World Wide Technologies, Inc. to procure the products from Dell© and only monitored the product delivery. In addition, as part of federal regulations, the SBA must determine that the small business normally sells the type of item being supplied prior to approving the waiver.¹⁵ However, the waiver approval records do not provide documentation that the SBA approving official determined that TKC normally sold the Dell© products.

(2) The waiver allowed the DOL to count \$7.63 million of large business revenue as part of its annual small business goal.

Each agency negotiates, with the SBA, annual percentages of total procurement dollars for contracts to small businesses and small, disadvantaged businesses in addition to other SBA program participants.¹⁶ Counting the \$7.78 million pass through contract as both a small business contract and a small, disadvantaged business contract—when \$7.63 million went to large business—can make the Federal government small business contracting statistics misleading.

Conclusion

The use of the non-manufacturer waiver enabled a firm to bypass small business subcontracting requirements resulting in a pass through contract to large businesses. Although authorized under statute, these types of procurements may not provide the development opportunities to small businesses intended through participation in the 8(a) program. Moreover, these types of procurements also funnel taxpayer funds to large businesses instead of developing small businesses to compete in the American economy. As a result, a large business received 8(a) set-aside funds through a pass through without competing in the open market. We are not making recommendations at this time, as we will continue additional limited scope audits on the extent that other 8(a) firms are complying with prime contractor performance requirements for set-aside contracts.

Agency Comments

On July 20, 2012, we provided a draft of this memorandum to the SBA's Office of Government Contracts and Business Development and to the Office of Field Operations. On August 8, 2012, the Associate Administrator for Government Contracts and Business Development submitted formal comments, which are included in their entirety in Appendix I. A summary of management's comments and our response follows.

Management Comments

Management disagreed with the findings in our Advisory Memorandum. Management believes that non-manufacturers gain business development experience when performing supply contracts through the 8(a) Business Development Program. Additionally, management stated that the Small Business Act allows the SBA to grant non-manufacturer rule waivers and that companies can use subcontractors to

¹⁵ 13 CFR § 121.406(b)(1)(ii)

¹⁶ The SBA negotiates with Federal departments concerning their prime contracting goals and achievement with small businesses to ensure that small businesses have the maximum practicable opportunity to provide goods and services to the Federal government. The negotiation ensures that the Federal government will achieve not less than 23 percent to small businesses; not less than 5 percent to woman-owned small businesses and small disadvantaged businesses; and not less than 3 percent to service disabled veteran-owned small businesses and certified HUBZone small businesses.

acquire the goods when a waiver has been granted. Therefore, management believes that contracts performed through a non-manufacturer waiver are not considered pass through contracts. Further, management stated that all contracts, regardless of the type, are counted towards an agency's small business goals. For example, large business contracts that subcontract to small businesses count towards an agency's small business goals. It is management's opinion that it would take an act of Congress and extensive record keeping and system changes to track, accurately, all of the annual small business contract dollars.

OIG Response

As noted in the agency comments, the SBA believes that small businesses can obtain business development experience if a non-manufacturer waiver has been issued. However, we do not believe that the 8(a) small business gained business development experience on this contract since it passed through almost all of its work to a large business. Additionally, the SBA did not provide us with examples of how the selected contractor obtained business development experience through the 8(a) sole source contract. In response to agency comments, we have made technical changes and expanded the discussion of business development experience for 8(a) BD program participants to the draft advisory memorandum. The OIG also acknowledges that the SBA has the authority to grant a non-manufacturer waiver when it determines that no small business manufacturer can offer a product meeting the required specifications. However, the DOL waiver request states that the agency wanted to purchase Dell® personal computers and monitors—a trademarked product—which no small business can provide unless they do so as a dealer. Further, the small business only monitored the delivery of the personal computers and monitors that the large business delivered directly to the DOL. Moreover, the large business that performed this 8(a) sole source contract received \$7.63 million of the \$7.78 million total contract value. However, the entire \$7.78 million counted toward the DOL's annual small business goaling results, even though the small business only received \$153,000 of the contract.

Actions Required

No further actions are required at this time. We appreciate the courtesies and cooperation of the Small Business Administration during this audit. If you have any questions concerning this report, please call me at (202) 205-7390 or Riccardo R. Buglisi, Director, Business Development Programs Group at (202) 205-7489.

/s/

John K. Needham
Assistant Inspector General for Auditing

Appendix I SBA Management Comments



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: August 6, 2012
TO: John K. Needham
Assistant Inspector General for Auditing
FROM: John Shoraka /s/
Associate Administrator
Office of Government Contracting &
Business Development
SUBJECT: OIG Advisory Memorandum – Project Number 12501

This is in response to your Advisory Memorandum dated July 20, 2012 entitled, *A Non-Manufacturer Rule Waiver Allowed 8(a), Recovery Act Contract to Bypass Established Small Business Requirement.*

The Office of Government Contracting and Business Development disagrees with your statement that non-manufacturers do not gain business development experience performing supply contracts through the 8(a) BD program. Information technology (IT) product dealers are allowed to enter the 8(a) program and there is an extensive Federal IT market for such firms to pursue. Further, many IT service providers also provide products as part of a total solution package. See for example the definition of a Value Added Technology Reseller. 13 CFR 121.201, footnote 18. The statutory non-manufacturer rule does not prohibit firms from using subcontractors to acquire the goods where a waiver has been granted. In addition, the purpose of the requirement that the firm normally sell the item is to prevent brokers from qualifying as non-manufacturers. Brokers are ineligible to participate in the 8(a) BD program. 13 CFR 124.108(d). The fact that the subject firm is in the 8(a) program and approved under the appropriate NAICS means that the firm is an IT service/product provider. Any other conclusion would be a rebuttal of the Associate administrator for Business Development's determination that the firm is eligible for the 8(a) program.

Further, your conclusion that: *"The use of the non-manufacturer waiver enabled a firm to bypass established requirements resulting in what we consider a pass through contract to large businesses"* is in direct conflict with the Small Business Act. Section 8(a)17(B) of the Small Business Act provides authority for a waiver where a determination has been made by the contracting officer that no small business manufacturer can offer a product meeting the required specifications.

We also disagree with your conclusion concerning counting awards to non-manufacturers towards the statutory prime contracting goals. All contracts, including those awarded in full and open competition

(where no limitations on subcontracting apply), are counted. Likewise, an award to a large business is counted in total, even where a large percentage is subcontracted to small business concerns. It would take an act of Congress and extensive record-keeping and system changes to track the ultimate destination of each dollar of the approximately \$500 billion awarded every year.

In view of our response above, we ask that you reconsider your following statements:

- (1) Company B did not obtain business development experience through the awarded contract as intended by its participation in the 8(a) program.*
- (2) The waiver allowed the DOL to count \$7.63 million of large business revenue as part of its annual small business percentage.*

Thank you for the opportunity to provide comments and we look forward to further discuss this matter.