

**AUDIT REPORT OF SMALL BUSINESS
SET-ASIDE CONTRACT TO
MEASUREMENT INSTRUMENTS, INC.**

AUDIT REPORT NUMBER 04-20

May 18, 2004

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**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416**

AUDIT REPORT
Issue Date: May 18, 2004
Report Number: 04-20

TO: Allegra McCullough
Associate Deputy Administrator for Government Contracting
and Business Development

FROM: Robert G. Seabrooks (FOIA Ex. 6)
Assistant Inspector General for Auditing

SUBJECT: Small Business Set-Aside Contract to Measurement Instruments, Inc.

The Office of Inspector General audited a small business set-aside contract awarded by the United States Air Force, Metrology and Calibration Detachment (AFMETCAL) to Measurement Instruments, Inc. (Measurement) to determine whether the contract award complied with SBA size standards and related procurement requirements. This report presents the results of our review.

Background

On February 6, 2003, AFMETCAL issued a solicitation (No. F33660-03-R-0005) for a Triple Point of Water Maintenance System (TPWMS), a specialized measurement and calibration instrument, as a 100 percent small business set-aside contract. AFMETCAL selected Measurement to receive the \$83,300 contract for 20 TPWMS units. The contract contained an option to purchase an additional 50 units, which would increase the contract value to \$374,850, if the option was fully exercised. Measurement, a non-manufacturing reseller small business, provided a TPWMS developed by a large business, Hart Scientific (Hart), and assembled by a small business, ThermoWorks. Hart sold a complete kit of parts and provided its instructions to ThermoWorks to assemble its TPWMS. Hart also checked ThermoWorks' assembly of the TPWMS and calibrated it before final delivery.

The award to Measurement was challenged by one of the unsuccessful offerors because it believed that Measurement was not going to provide a product manufactured by a small business concern. In order for Measurement to qualify under the size standard requirement as a non-

manufacturing reseller, it needed to provide a product manufactured by another small business. The Small Business Administration's (SBA), Office of Government Contracting (GC), reviewed the protest, and issued a size determination stating that Measurement was a small business concern for the subject procurement and that Measurement was providing a product of a small business. The firm that protested the award filed an appeal with SBA's Office of Hearings and Appeals (OHA), but AFMETCAL awarded the contract to Measurement before the appeal could be heard.

Audit Objective and Scope

The audit objective was to determine whether Measurement qualified for the small business set-aside contract. This entailed determining whether Measurement qualified as a small business non-manufacturing reseller that normally sold the TPWMS to the general public, and whether ThermoWorks was the small business manufacturer of the TPWMS specified in AFMETCAL's contract.

We reviewed AFMETCAL's solicitation and contract as well as other pertinent documents received from Measurement and ThermoWorks as it related to the contract. In order to assess ThermoWorks' qualification as the manufacturer, we reviewed photos of ThermoWorks' work-site as well as interviewed its employees to assess their knowledge and expertise assembling the TPWMS. We also reviewed the protest of the award, OHA's ruling and SBA's regulations related to small business set-aside contracts and size standards regulation, 13 Code of Federal Regulations (CFR) §121.103 and 121.406. We interviewed officials from Measurement, ThermoWorks and Hart Scientific, as well as government officials from SBA's Office of Size Standards, AFMETCAL's contracting office and the Department of Defense Office of Inspector General. We conducted fieldwork from October to December 2003, in Washington, DC. The audit was conducted in accordance with Government Auditing Standards.

Results of Audit

Measurement was ineligible to receive the small business set-aside contract as a small business non-manufacturing reseller since it supplied a product considered to be from a large business. Although ThermoWorks was the manufacturer of the TPWMS, ThermoWorks was affiliated with Hart through a joint venture arrangement. Since Hart is a large business, ThermoWorks' affiliation with Hart made ThermoWorks large for size standard purposes.

In order for Measurement to qualify for the small business set-aside award as a non-manufacturing reseller, it needed to meet three criteria listed in 13 CFR §121.406(b)(1)(ii). Specifically, it must (1) not exceed 500 employees; (2) be primarily engaged in the wholesale or retail trade, and normally sell the items being supplied to the general public; and (3) supply the end items of a small business manufacturer or processor made in the United States, or obtain a waiver of such requirement. Although Measurement met the first two requirements, it failed to meet the third.

ThermoWorks assembled the TPWMS at its facility, and therefore, qualified as the manufacturer of the TPWMS as defined in 13 CFR §121.406(b)(2). According to this regulation, there can be only one manufacturer of the end item being acquired and the manufacturer is the concern, which with its own facilities, performs the primary activities in transforming inorganic or organic substances, including the assembly of parts and components, into the end item being acquired.

Although ThermoWorks was the manufacturer of the TPWMS, and ThermoWorks is a small business, ThermoWorks is considered large for this procurement because of its joint venture arrangement with Hart. Under 13 CFR §121.103(a)(4), a concern's size is determined by counting the receipts or employees of the concern whose size is at issue and those of all its affiliates. According to 13 CFR §121.103(f)(4), affiliation based on joint venture arrangements exists if the ostensible subcontractor performs primary and vital requirements of a contract or if the prime contractor is unusually reliant upon the ostensible subcontractor. Hart performed primary and vital requirements of the contract since it provided its design and the rights to assemble the TPWMS to ThermoWorks under a limited licensing agreement. Without Hart's involvement, ThermoWorks could not perform on this contract.

While ThermoWorks assembled the TPWMS for the AFMETCAL contract, the TPWMS was a Hart product. An AFMETCAL employee acknowledged that they were contracting for a Hart product, which would be assembled by a small business. Hart developed and marketed the TPWMS, obtained all the parts required for its assembly and sold it to ThermoWorks with detailed instructions on how to assemble these parts, calibrated the TPWMS after it was assembled by ThermoWorks, and provided its manual and warranty. ThermoWorks did not have its own TPWMS, and did not normally assemble the TPWMS in its normal line of business. This was the first time that ThermoWorks assembled such a device.

The parties involved in the contract attempted to develop an arrangement whereby a small business met the definition of manufacturer while the product delivered to the Government was actually a product of a large business. Although Hart, ThermoWorks and Measurement made a good faith effort to comply with SBA regulations by crafting this complex arrangement, they failed to adequately address the affiliation issue.

When SBA issued its size determination for Measurement, it too failed to address the affiliation issue, which should have disqualified Measurement from receiving the AFMETCAL's contract as a small business set-aside award. Since the complaint to SBA focused exclusively on whether ThermoWorks was the manufacturer, SBA looked specifically at this issue and applied the guidance in 13 CFR §121.406(b)(1) and (2) in its size determination. The affiliation issue was not raised, and therefore, SBA erred by failing to apply the guidance in 13 CFR §121.103(f)(4). By classifying an ineligible small business set-aside procurement as a small business contract, AFMETCAL improperly increased the amount of contracting funds the government reported as being awarded to a small business.

Recommendations

We recommend that the Associate Deputy Administrator for Government Contracting and Business Development:

- 1A: Advise AFMETCAL that this contract should not be counted as a small business award since ThermoWorks was large for this procurement purpose due to its affiliation with Hart.
- 1B: Provide guidance to SBA Size Determination officials to increase awareness of the need to include consideration of affiliation issues.

SBA Management Comments

SBA's Deputy Associate Deputy Administrator for Government Contracting and Business Development agreed with the finding and recommendations. His response is included as Attachment 1.

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The findings in this report are the conclusions of the Office of Inspector General's Auditing Division. **The recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.**

Please provide us your management decision for each recommendation addressed to you within 80 days. Your management decisions should be recorded on the attached SBA Forms 1824, "Recommendation Action Sheet," and show either your proposed corrective action and target date for completion, or explanation of your disagreement with our recommendation.

Any questions or discussion of the issues contained in the report should be directed to Robert Hultberg, Director, Business Development Programs Group, at (202) 205- (FOIA Ex. 6)



Memorandum

Date: **MAY 12 2004**

To: Robert G. Seabrooks
Assistant Inspector General for Auditing

From: Frank J. Lalumiere (FOIA Ex. 6)
Deputy Associate Deputy Administrator for Government Contracting
and Business Development

Subj: Comments on Audit of Small Business Set-aside Contract to
Measurement Instruments, Inc.

The Office of Government Contracting and Business Development (GCDB) agrees with the findings of the audit and the two recommendations. This memorandum supercedes my April 26, 2004 memorandum to you.

Recommendation 1A advised GCDB to request that the United States Air Force's Metrology and Calibration Detachment (AFMCD) not count its contract award to Measurement Instruments, Inc., as a small business award. Although no regulations require the contracting agency to change the reporting of the award, we agree that based on a subsequent review of the unique issues of the Measurement Instruments size determination, this request is appropriate and we will forward this request to the AFMCD.

Recommendation 1B advises GCDB to provide additional guidance to size determination officials to ensure that affiliation issues are part of the assessment of a size determinations case. In the Measurement Instruments size determination, further investigation of the case in terms of affiliation was warranted.

Please contact me or Gary Jackson, Assistant Administrator for Size Standards, if you have any questions concerning these comments.

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