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

AUDIT REPORT
Issue Date: June 18, 1998
Number: 8-7-H-002-017

To: Richard L. Hayes, Associate Deputy Administrator for Government Contracting and Minority Enterprise Development

From: Peter L. McClintock, Assistant Inspector General for Auditing

Subject: Memorandum Audit Report - National Oceanic and Atmospheric Administration (NOAA) Computer Workstation Contracts

The Office of Inspector General (OIG) completed an audit of four NOAA 8(a) contracts classified as manufacturing contracts under Standard Industrial Classification code 3571 (Electronic Computers). The contracts were awarded to Sylvest Management Systems Corporation (Sylvest); Data Procurement Corporation (DPC); McBride and Associates, Inc. (McBride); and Pulsar Data Systems, Inc. (Pulsar) to manufacture computer workstations and related equipment.

The 3-year contracts were awarded on April 19, 1996, with the exception of the Pulsar contract, which was awarded on September 17, 1996. The contracts were indefinite delivery, indefinite quantity contracts with a minimum value of $100,000 each and an aggregate value of $20 million. The table below shows the number and total dollar amount of orders received by the four contractors as of April 30, 1997.

Contractor	***No. of Orders***	***Total Amount (in millions)***
(FOIA deletion)	108	$5.0
(FOIA deletion)	53	$3.7
(FOIA deletion)	35	$3.5
(FOIA deletion)	1	$0.1

OBJECTIVE AND SCOPE

The audit objective was to determine if SBA applied the criteria at Title 13, Code of Federal Regulations (CFR) Part 121, Section 406, in determining that the four NOAA contractors qualified to provide the computer workstations and related equipment as the manufacturers. OIG auditors reviewed program regulations, contractual documents, agreements with suppliers, *(FOIA deletion)* order, and one order from the other contractors that the contractors determined required the most manufacturing effort on their part. The auditors also interviewed officials from SBA, *(FOIA deletion.)*

Field work was performed from December 1996 to April 1998 and covered contracting activity from June 1995 through April 1997. The audit was performed in accordance with Government Auditing Standards.

PRIOR AUDIT RESOLUTION

This was the OIG's first audit of the four NOAA 8(a) contracts. The OIG reported in a previous audit of Pulsar on August 15, 1994, (report number 4-2-E-403-019) that Pulsar did not perform sufficient assembly to be the manufacturer on one contract and possibly numerous others. The OIG recommended that Pulsar be advised of the applicable requirements regarding manufacturing, Pulsar's contracts be evaluated for compliance with those requirements, and appropriate actions be taken to protect the Government's interests. A second report (report number 4-4-E-005-024) on brokering of computer equipment was issued on September 30, 1994, as a result of the Pulsar audit. It recommended that the Philadelphia District Office (PDO) take appropriate action to prevent the brokering of 8(a) contracts and to counsel Pulsar and procuring agencies regarding the prohibition against brokering. In response to the two reports, the PDO revamped its contract review procedures to preclude reoccurrence of the reported problems and counseled Pulsar on SBA's manufacturing requirements.

RESULTS OF AUDIT

SBA did not apply the manufacturing criteria at 13 CFR 121.406 in determining whether the four contractors would be the manufacturers of the computer workstations and related equipment. Even if they had applied the criteria, the regulations allow for subjective judgments when assessing whether a contractor is a manufacturer. SBA has not issued any interpretative guidance on applying the regulatory guidance. Furthermore, 13 CFR 124.308 states that SBA will accept SIC codes assigned by procuring agencies if they are reasonable, not necessarily the most appropriate. As a result, contractors who perform minimal assembly are allowed to receive 8(a) contracts as manufacturers. Also, SBA manufacturing regulations may be applied inconsistently or not at all, and there is no assurance that SBA is developing and assisting small business manufacturers as intended by the 8(a) program. Further, large businesses that supplied the basic system received the majority of the contract funds.

Application and Evaluation of SBA Manufacturing Criteria Requires Strengthening

Three of the four NOAA contracts were accepted by SBA without any evaluation as required by 13 CFR 121.406, and one of the contracts was awarded even though the district office determined the contractor did not qualify as a manufacturer. The Washington District Office (WDO) and Albuquerque District Office (ADO) accepted three of the contract offerings based on NOAA's representations that the contractors would manufacture the end item, without applying the manufacturing criteria at 13 CFR 121.406. The criteria state that

- there can be only one manufacturer of an end item;
- the manufacturer performs the primary activities in transforming organic or inorganic substances, including the assembly of parts and components, into the end item being acquired;
- firms that perform only minimal operations do not qualify as manufacturers; and
- in evaluating whether a concern is a manufacturer of an end item, SBA is required to evaluate the total value added and the importance of elements added by the concern to the function of the end item, regardless of their relative value.

The criteria are intended to provide assurance that contract funds are provided for the purpose of assisting and developing small business manufacturers as intended by the 8(a) program. SBA, upon receipt of the offerings for the four NOAA contracts, was required to determine whether the contractors qualified to provide the end items as manufacturers based on application of these criteria. The WDO and ADO did not make this evaluation and accepted the contracts based on a determination that the SIC code assigned by the procuring agency was reasonable, as required by 13 CFR 124.308. The district offices indicated that although existing regulations require evaluations of value added and importance of elements added, the regulations do not provide guidance for them to make the evaluations, nor have they developed any internal guidance. In addition, no supplemental guidance or definitions have been provided by SBA program officials.

The Associate Administrator for SBA's Office of Government Contracting verified that no guidance has been provided to the district offices to evaluate the criteria and was unable to provide clarification on how to evaluate the criteria. We concluded, therefore, that additional guidance is needed to enable field personnel to comply with

SBA’s regulations and to ensure the regulations are consistently applied.

For the Pulsar contract, the PDO initially declined to accept the NOAA offering based on its analysis that the contractor would not be manufacturing the end items. The former Associate Administrator for Minority Enterprise Development (AA/MED) subsequently determined that the contractor would manufacture the end items and he also concluded that there was no legal reason not to accept the offering. The AA/MED then requested NOAA to resubmit the offering to the PDO and notified the PDO of his decision. Consequently, the PDO approved the Pulsar contract.

The PDO’s initial determination that Pulsar was not qualified for the procurement as a manufacturer was based on an evaluation of the technical proposal and subsequent clarification which they believed indicated the contractor’s assembly efforts were not substantial. In making its determination, the PDO did not evaluate total value added and importance of the elements added. The PDO’s methodology in making this determination was similar to that reported by the OIG in the prior Pulsar audit. The PDO believed that Pulsar was obtaining an operational unit and making some changes in the hardware/software to meet the needs of the procuring agency. Based on a request from the PDO, an official from SBA’s Office of Government Contracting performed an informal evaluation which substantiated the PDO’s assessment. The Government Contracting official found that Pulsar would not be performing substantial and significant assembly operations. The official stated that there would be no hard-wiring involved for electronic components, merely plug-in connections.

Despite the positions of the PDO and the Government Contracting official, the former AA/MED found no legal impediments to executing the contract. He told the OIG that he did not dispute the facts the PDO and the Government Contracting official presented regarding the activities performed by the contractor. He stated, however, that it was not unreasonable to conclude that Pulsar was the manufacturer. Furthermore, he stated that there is only one manufacturer of an end item, and if a contractor adds a $1 part to a $10,000 end item, it could be considered the manufacturer. His rationale was that the contractor has added value to the end item and the item would be unusable to the end user without the part required by the specifications. He also stated that the review completed by the Government Contracting official was not a formal size determination. A formal size determination is a binding decision based on a review of whether a business entity is small and thus eligible for a government program.

The former AA/MED agreed with the OIG that current regulations leave room for differing opinions as to whether a contractor is the manufacturer of a particular end item. In addition, he stated that current regulations did not take into consideration the computer manufacturing industry and the regulations need to be reviewed and revised to consider this industry. As a result, we concluded that there is no assurance small business manufacturers are the recipients of 8(a) contracts as intended by the program regulations. In addition, the majority of 8(a) manufacturing contract funds may benefit large businesses, and procuring agencies can meet 8(a) program contracting goals when purchasing the products of large businesses.

Contractors Performed Minimal Assembly

The contractors' efforts were minimal for the four orders examined. Specifically, the contractors performed the following activities in completing these orders:

- For three of the orders, minimal assembly was performed. The contractors obtained a basic operating system from a supplier and added components to customize the system. The customizing consisted of (1) installing internal items such as ethernet cards and modems by removing the computer cover and inserting the items into a slot, (2) plugging in external items such as monitors and keyboards, (3) installing software, and (4) testing the assembled end item to ensure it operated correctly (See Appendix 1 for detailed explanation of the work performed by the contractors on these orders).

- For one order reviewed, no manufacturing effort was performed on a portion of the order. Invoices showed that part of the order was drop shipped directly from the large business supplier and the system and related equipment contained the name of the large businesses (See Appendix 1 for details).

- For three of the orders, the time spent by the contractors on non-assembly activities, such as customer service and testing, exceeded the efforts of assembling the end item. Specifically, of the hours spent on the orders by *(FOIA deletion)*, 73 percent, 56 percent, and 55 percent, respectively, were for non-assembly activities.

The agreements *(FOIA deletion)* had with their main suppliers (large businesses) for orders relating to the NOAA contracts stated they were value added resellers or systems integrators and that they would enhance the products provided. Some agreements prohibited the removal of logos, trademarks, or labels.

Contract Funds Benefit Big Business

The purpose of the 8(a) program is to develop small businesses. This goal is not achieved when 8(a) manufacturers perform minimal assembly and essentially re-sell the product of a large business. Thus, most of the contract money is used to purchase component parts from large businesses. The tables below show that 87 percent of *(FOIA deletion)* direct cost and 91 percent of *(FOIA deletion)* total costs went to large businesses for two of the orders reviewed. Specific data on *(FOIA deletion)* was not available, as it did not record cost on a per order basis. *(FOIA deletion)* invoices, however, showed that 76 percent of the sales price ($1.3 million) went to a large business.

(FOIA deletion) Order

Description of Costs	Dollars	Percentage of Direct Costs
Direct costs:		
Materials Purchased From Large Businesses	$67,096	87%
Materials Purchased From Small Businesses	$7,914	10%
Direct Labor	$2,004	3%
Total Direct Costs:	$77,014	100%
Indirect Costs:	$15,013	
Total Costs	$92,027	
Total Sales Price	$103,128	
Net Profit To 8(a) Contractor	$11,101	

(FOIA deletion) Order

Description of Costs	Dollars	Percentage of Total Costs
Materials Purchased From A Large Business	$25,630	91%
Materials Handling (Includes Portion For Direct Labor)	$1,768	6%
General and Administrative Costs	$685	3%
Total Costs	$28,083	100%
Total Sales Price	$29,956	
Net Profit to 8(a) contractor	$ 1,873	

Procuring Agencies Obtain Name Brand Products While Meeting 8(a) Goals

The 8(a) program is a way for procuring agencies to obtain name brand equipment from large businesses while ostensibly meeting their 8(a) contracting goals. An end user on another order completed by *(FOIA deletion)* stated that he attempted to obtain the equipment he needed directly from IBM, but when he contacted his contracting office, they told him he could use the NOAA contracts to obtain the same name brand products while avoiding normal procurement channels. As a result, contract funds are not being used as intended by the program.

RECOMMENDATION

We recommend that the Associate Deputy Administrator for Government Contracting and Minority Enterprise Development (ADA/GC&MED) provide definitive guidance and definitions to evaluate the manufacturing criteria at 13 CFR 121.406.

SBA MANAGEMENT'S RESPONSE

The ADA/GC&MED agreed with our finding and recommendation and stated that he planned to solicit comments from the business community and have specific discussions with businesses in the computer related industry. The ADA/GC&MED's planned actions are responsive to our recommendation.

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The findings included in this report are the conclusions of the Office of Inspector General's Auditing Division. **The findings and recommendation 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 proposed management decision for the recommendation within 80 days on the SBA Form 1824, Recommendation Action Sheet. If you disagree with the recommendation, please provide your reasons in writing.

This report may contain proprietary information subject to the provisions of 18 USC 1905. Do not release to the public or another agency without permission of the Office of Inspector General.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations at (202) 205-7204.

Attachments

Details of Work Performed By Contractors on the Order They Felt Represented Their Best Example of Manufacturing and *(FOIA deletion)* **One Order.**

(FOIA deletion)

This order was for four computer servers. *(FOIA deletion)* obtained basic systems and customized them to the order specifications. For the server that required the most effort, *(FOIA deletion)*, at its facility, removed the computer cover and inserted into the proper slots the following: (1) ethernet card, (2) additional RAM memory, (3) floppy drive, and (4) modem. The contractor then connected the following external items (1) tape drive, (2) disk drive, (3) uninterruptable power source, (4) monitor, and (5) keyboard. *(FOIA deletion)* then installed operating and file system software, made adjustments commonly referred to as configuration, and performed testing to ensure proper operation of the systems. The component parts, except for the disk and tape drives, modem, and uninterruptable power source, were obtained from Sun Microsystems, Inc., a large business manufacturer.

(FOIA deletion)

(FOIA deletion) order was for six computer workstations. The contractor obtained basic computer systems and customized them by removing the computer cover and inserting a hard drive, video card, network card, and additional RAM memory into the proper slots. *(FOIA deletion)* then (1) externally connected the keyboard and monitor, (2) made configuration adjustments, (3) installed the applications and operating system software, and (4) tested the system. The parts were purchased from Digital Equipment, a large business, and carried Digital's labels and trademarks. Also, *(FOIA deletion)* technical proposal for the contract indicated that 30 percent of the orders would require no assembly effort and the end items would only be checked for completeness and shipped.

(FOIA deletion)

(FOIA deletion) order was to upgrade existing computer systems and to acquire new computer systems. For the new systems, *(FOIA deletion)* performed the following: (1) installed software, (2) verified system installation, and (3) adjusted and tested the system. *(FOIA deletion)* also indicated it installed drives on storage media which were mounted to the new systems by IBM. *(FOIA deletion)* stated IBM's customer engineer participated in the installation of hardware and that *(FOIA deletion)* acted as a systems integrator/reseller in filling the order.

(FOIA deletion)

(FOIA deletion) order was for three servers. The end-user on the order informed us that he had requested *(FOIA deletion)* to ship the servers directly from Hewlett Packard (HP) because no assembly was required by *(FOIA deletion)*. The end-user later informed us that only one server was shipped from HP and the other two were shipped from *(FOIA deletion)*. When the components were received, all of which had the HP name, only minor adjustments were performed to set up the systems. The direct shipment of one of the servers suggests that the contractor was merely passing through the products of a large business without adding value to the product.

Attachment 2

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