

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Subcommittee on Contracting and Workforce
From: Committee Staff
Date: February 23, 2016
Re: Hearing: "Hotline Truths: Issues Raised by Recent Audits of Defense Contracting"

The Committee on Small Business Subcommittee on Contracting and the Workforce will meet for a hearing titled, "Hotline Truths: Issues Raised by Recent Audits of Defense Contracting" The hearing is scheduled to begin at 10:00 A.M. on Thursday, February 25, 2016 in Room 2360 of the Rayburn House Office Building.

As part of the Subcommittee's ongoing efforts to identify waste, fraud and abuse in federal contracting and to ensure that small contractors have the opportunity to compete, the Subcommittee will hear from the Department of Defense Inspector General (DODIG) concerning the results of two recent audits it recently conducted.¹ As a result of hotline complaints, the DODIG has begun reviewing contracting activities for compliance with the Small Business Act (the Act). The hearing will allow the Subcommittee to receive testimony on the findings of the first two audits, and put those findings in context. Specifically, the audits address compliance with the prime contracting and subcontracting requirements of the Act.

I. Prime Contracting and Subcontracting: Requirements of the Act

In order to explain the findings of the DODIG, a brief summary of the statutory requirements for federal prime contracting and subcontracting is necessary. According to the Act, prime contracts may be set aside for contracts can be set aside for small businesses in two ways. First, all contracts below \$150,000 are reserved for small businesses unless the contracting officer determines there is not a reasonable expectation of obtaining offers from two or more firms.² Second, any contract over \$150,000 should be set aside for small business if the contracting officer determines that at least two small businesses will make offers, and the award can be made a fair price.³ The business certifies that it is small at the time of offer⁴ through the System for Award Management (SAM).⁵ If an offeror or the contracting officer believes that the successful

¹ DODIG, SMALL BUSINESS CONTRACTING AT REGIONAL CONTRACTING OFFICE-NATIONAL CAPITAL REGION NEEDS IMPROVEMENT (DODIG-2015-095), available at <http://www.dodig.mil/pubs/documents/DODIG-2015-095.pdf> [hereinafter "NCR Report"]; DODIG, SMALL BUSINESS CONTRACTING AT MARINE CORPS SYSTEMS COMMAND NEEDS IMPROVEMENT (DODIG 2016-019), available at <http://www.dodig.mil/pubs/documents/DODIG-2016-019.pdf> [hereinafter "MCSC Report"].

² 48 C.F.R. § 19.502-2(a).

³ *Id.* at (b).

⁴ 13 C.F.R. § 121.404.

⁵ Available at www.sam.gov.

bidder is not actually a small business, the Small Business Administration (SBA) will adjudicate the firm's size.⁶ There is a statutory goal of awarding at least 23 percent of all federal prime contract dollars to small businesses.⁷

For subcontracts, any other-than-small business receiving a prime contract worth more than \$700,000 (or \$1.5 million in the case of contracts for construction) must negotiate subcontracting plan with the contracting agency as a material condition of the contract.⁸ Likewise, if the prime contractor is an other-than-small business that in turn subcontracts to an other-than-small business for an amount above the aforementioned dollar thresholds, the subcontractor must negotiate a subcontracting plan with the prime contractor. These subcontracting plans delineate subcontracting opportunities for each of the five categories of small businesses, usually as a percentage of the work that will be subcontracted.⁹ Some plans state the goals as a percentage of contract value.¹⁰ Failure to meet the subcontracting goals is reflected in past performance ratings on prime contractors, and if the failure is due to a lack of good faith it can be treated as a material breach of the contract.¹¹

II. The DODIG Reports

In 2012, the DODIG received anonymous complaints on its Fraud, Waste and Abuse Hotline alleging that the Regional Contracting Office – National Capital region (NCR) and the Marine Corps System Command (MCSC) were not complying with the prime contracting and subcontracting requirements of the Act.¹² In response, DODIG undertook audits of both contracting activities, and issued reports detailing their findings.

The positive news for small business is that the DODIG found no evidence that NCR or MCSC were denying prime contract opportunities to small businesses.¹³ The NCR Report found that small businesses were given an opportunity to compete for prime contracts valued at over \$344M.¹⁴ Likewise, the MCSC Report documented that small businesses were given an opportunity to compete for 40 prime contracts, valued at \$1.3B.¹⁵ While the MCSC report did find that two contracts could have been voluntarily set aside for small business and that one \$23,977 contract should have been set aside for small business, it did not believe there were systemic issues.¹⁶

⁶ 13 C.F.R. § 121.1001.

⁷ 15 U.S.C. 644(g).

⁸ 15 U.S.C. § 637(d)(4); 48 C.F.R. § 19.702. A subcontractor is defined as “any supplier, distributor, vendor, or firm that furnishes supplies or services to or for a prime contractor or another subcontractor.” 48 C.F.R. § 44.101

⁹ 48 C.F.R. § 19.704.

¹⁰ *See, e.g., FirstLine Transp. Sec., Inc. v. United States*, 12-601C, 2012 WL 5939228 (Fed. Cl. Nov. 19, 2012) (Court of Federal Claims denied a pre-award protest challenging a solicitation's small business subcontracting goal of 40% of the total contract value, holding that this goal was within the high level of discretion afforded to the agency).

¹¹ 48 C.F.R. § 19.705-4.

¹² NCR Report at 1; MCSC Report at 1.

¹³ NCR Report at 3; MCSC Report at 4.

¹⁴ NCR Report at 3.

¹⁵ MCSC Report at 4.

¹⁶ MCSC Report at 6-7.

Unfortunately, both reports confirmed that NCR and MCSC did not enforce mandatory subcontracting requirements for contract awards.¹⁷ Specifically, neither NCR and MCSC ensured that all contracts awarded to other-than-small businesses had the required approved subcontracting plans prior to award.¹⁸

a. NCR Findings

At NCR, the DODIG reviewed seven contracts that under the Act needed to have a subcontracting plan.¹⁹ Of these, only one contract met the statutory and regulatory requirements.²⁰ NCR awarded two contracts without any subcontracting plan, and two contracts that had a subcontracting plan that failed to include any small business subcontracting goals.²¹ These four contracts were valued at \$58.2 million.²² Additionally, the NCR review found that there were two contracts valued at \$790 million where the contracting officers had met the requirements to incorporate a subcontracting plan and goals only to fail to track whether the prime contractors met the subcontracting requirements.²³ The DODIG concluded that “small businesses may not have received subcontract work that large businesses were required to provide, and RCO-NCR officials may have missed an opportunity to recoup potential liquidated damages of up to \$153.5 million which they may have been entitled to.”²⁴

b. MCSC Findings

In its review of MCSC, the DODIG’s results were similar. Of the 19 contracts worth \$1.3 billion reviewed, six were awarded without subcontracting plans and two were awarded without verifying that there was an approved subcontracting plan.²⁵ On four contracts, MCSC failed to track compliance with the subcontracting plan, and on two contracts knew the prime contractor was not meeting its small business goals but failed to inquire into why the promised subcontracting opportunities had not materialized.²⁶ In one of these cases, the prime contractor had committed to \$19 million in subcontracts with small businesses, but delivered only \$1.3 million – less than 10 percent of the contractually agreed to amount.²⁷ On the other contract, only 25 percent of the promised small business subcontracting dollars materialized.²⁸

III. Issues Before the Subcommittee

a. DODIG Recommendations

Based on its findings, the DODIG provided the contracting offices with a series of recommendations. NCR agreed to have the DODIG recommendations implemented by May 31,

¹⁷ NCR Report at 10; MCSC Report at 11.

¹⁸ NCR Report at 10-11; MCSC Report at 11.

¹⁹ NCR Report at 10.

²⁰ *Id.*

²¹ NCR Report at 10-11. One of the contracts without a subcontracting plan was a follow on to a contract that also lacked a subcontracting plan. *Id.*

²² *Id.*

²³ *Id.*

²⁴ *Id.* at 10.

²⁵ MCSC Report at 11.

²⁶ *Id.*

²⁷ *Id.* at 15.

²⁸ *Id.* at 16.

2015.²⁹ MCSC committed to implementing the recommendations between November of 2015 and September of 2016.³⁰ The Subcommittee wishes to learn whether the DODIG tracks that the promised actions are indeed taken, and if so, what progress each buying activity has taken.

First, at both NCR and MCSC, the DODIG recommended that corrective action be taken in the cases of the prime contracts where subcontracting goals were not met.³¹ The DODIG also recommended that the contracting activities consider pursuing liquidated damages from the prime contractors, which could total over \$153 million at NCR and in excess of \$17.7 million at MCSC.³² The Subcommittee wishes to learn if either facility is pursuing liquidated damages.

At NCR, the DODIG advised the buying activity to “[e]stablish policy requiring contracting officials to obtain adequate subcontracting plans from contractors when the Federal Acquisition Regulation requires subcontracting plans.”³³ They agreed to “[i]mplement training to ensure that contracting officials understand their [regulatory] responsibilities for evaluating and administering subcontracting plans.”³⁴ Likewise, MCSC was told it should “[e]stablish guidance for contracting officers for reviewing, approving, and administering subcontracting plans.”³⁵ More explicitly, MCSC agreed to “[m]odify the Contract File Checklist to include steps to verify that contracts . . . without subcontracting plans are approved at a level above the contracting officer” and “[o]btain copies of approved commercial subcontracting plans before considering those plans when awarding contracts which require subcontracting plans.”³⁶ MCSC also agreed to train contracting personnel on statutory and regulatory responsibilities inherent in evaluating and administering subcontracting plans.³⁷ The Subcommittee wishes to ascertain if these actions have been taken.

Finally, both NCR and MCSC agreed to recommendations on improving the subcontracting reporting process. NCR agreed to “[e]stablish policy requiring contracting officials to verify that contractors submit the required subcontracting reports to the Electronic Subcontracting Reporting System.”³⁸ MCSC concurred in a recommendation that they “[e]stablish guidance for contracting officers . . . to verify contractors submit the required subcontracting reports to the Electronic Subcontracting Reporting System.”³⁹

b. Other Issues Regarding Prime Contracting

While neither the NCR Report nor the MCSC Report found issues with prime contracting, the Subcommittee still has some concerns. First, the Subcommittee questions the reliance on bridge contracts. Bridge contracts are short term contracts awarded to cover a period of performance between the time when a longer-term contract expires and a replacement contract is in place.

²⁹ NCR Report at 17-18.

³⁰ NCR Report at 17-18; MCSC Report at 21-23.

³¹ NCR Report at 15; MCSC Report at 21.

³² NCR Report at 16; MCSC Report at 15-16.

³³ NCR Report at 17.

³⁴ *Id.*

³⁵ MCSC Report at 22.

³⁶ *Id.* at 22.

³⁷ *Id.* at 23.

³⁸ NCR Report at 17.

³⁹ MCSC Report at 22.

NCR awarded seven such contracts valued at \$91.1 million.⁴⁰ While one bridge contract lasted only two months, the rest lasted from six months to a year, and three of the year-long bridge contracts were succeeded by yet another bridge contract.⁴¹ While small businesses may have ultimately had the opportunity to compete for the successor contract, this represents a significant amount of time when taxpayers lost the opportunity to benefit from competition which concerns the Subcommittee.

Further, both NCR and MCSC relied upon sole source contracting, which is contrary to the spirit of federal procurement policy, if not the statutory requirement that agencies “obtain full and open competition through the use of competitive procedures” in all procurements not involving the use of procedures expressly authorized.⁴² However, the NCR Report indicates that 20 contracts, valued at \$14.3 million, were awarded on a sole source basis.⁴³ While some of these contracts clearly had only one source, such maintenance of proprietary software, others seem more suitable for potential competition, such as developing training materials.⁴⁴ Similarly, at MCSC 16 contracts worth \$79.4 million were awarded as sole-source contracts to other-than-small businesses.⁴⁵ The fact that there is only one source for so many contracts may raise concerns about the industrial base.

Finally, contracting officials are required to report timely and accurate contracting information into the Federal Procurement Data System (FPDS-NG). The federal government, including SBA, uses FPDS-NG as the official system for collecting, developing and disseminating procurement data. Among other elements, the system track how a contract is competed, and the size of the business to which it is awarded. However, the DODIG found that NCR contracting officials miscoded the size of a contractor on nine contracts valued at \$2M, and again on two task order contracts with a possible value of up to \$15.9M.⁴⁶ MCSC contracting official’s miscoded businesses sized on 43 contracts, valued at \$182.9M, as awarded to other-than-small businesses, but upon review identified these contracts were actually awarded to small business.⁴⁷ The SBA relies on accurate reporting of contract award information to present to Congress and establish future year small business contracting goals, so these data issues merit examination.

c. Systemic Issues

While the litany of issues found in the NCR Report and MCSC Report are clearly problematic, the Subcommittee questions whether they are unique. Previous hearings before the Subcommittee suggest that these may be systemic issues in federal contracting. Therefore, the Subcommittee wishes to learn if the DODIG expect to review additional contracting activities.

d. Legislative Issues

The Committee on Small Business reported favorably on H.R. 4341, the Defending America’s Small Contractors Act of 2016. Section 301 of H.R. 4341 would require that the failure of a

⁴⁰ NCR Report at 6-7.

⁴¹ *Id.* at 7.

⁴² 41 U.S.C. § 253(a)(1)(A).

⁴³ NCR Report at 5.

⁴⁴ *Id.* at 5-6.

⁴⁵ MCSC Report at 6.

⁴⁶ NCR Report at 8-9.

⁴⁷ MCSC Report at 26.

prime contractor to submit required subcontracting reports would itself be considered a failure to act in good faith, and potentially trigger liquidated damages. Likewise, § 301 would allow SBA to review subcontracting plans prior to award. The Subcommittee wishes to learn whether these provisions may help ameliorate the problems documented in the NCR Report and MCSC Report.

IV. Conclusion

Providing small businesses with the ability to compete for prime contracts and subcontracts remains a key concern of the Subcommittee. The testimony from the DODIG and other witnesses should help the Subcommittee conduct better oversight and take necessary legislative action to reduce waste, fraud and abuse in federal contracting.