United States Government Accountability Office

GAO

Report to the Chairwoman, Committee on Small Business, House of Representatives

March 2010

8(a) PROGRAM

Fourteen Ineligible Firms Received $325 Million in Sole-Source and Set-Aside Contracts

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GAO-10-425

March 2010

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Highlights

Highlights of GAO10-425, a report to the Chairwoman, Committee on Small Business, House of Representatives

Why GAO Did This Study

The Small Business Administration (SBA) helps socially and economically disadvantaged small businesses gain access to federal contracting opportunities through its 8(a) program. To participate, firms must be at least 51 percent owned and controlled by an individual who meets SBA's criteria of socially and economically disadvantaged. The firm must also qualify as a small business. Once certified, 8(a) firms are eligible to receive sole-source and set-aside contracts for up to 9 years.

GAO was asked to (1) determine whether ineligible firms are participating in the 8(a) program, (2) proactively test SBA's controls over the 8(a) application process, and (3) determine what vulnerabilities, if any, exist in SBA's fraud prevention system. To identify cases, GAO reviewed SBA data and complaints to GAO's fraud hotline. To perform its proactive testing, GAO created four bogus businesses and applied for 8(a) certification. GAO did not attempt to project the extent of fraud and abuse in the program.

What GAO Recommends

GAO makes six recommendations to improve SBA's ability to screen and monitor fraud and abuse within the 8(a) program. SBA agreed with five recommendations and stated that it would evaluate our recommendation related to how family members' assets are included in the assets of the 8(a) participant based upon the comments received as a result of the proposed 8(a) rule change.

View GAO-10-425 or key components.
For more information, contact Gregory Kutz at (202) 512-6722 or kutzg@gao.gov.

8(a) PROGRAM

Fourteen Ineligible Firms Received $325 Million in Sole-Source and Set-Aside Contracts

What GAO Found

GAO identified $325 million in set-aside and sole-source contracts given to firms not eligible for the 8(a) program. Most were obtained through fraudulent schemes. In the 14 cases GAO investigated, numerous instances were found where 8(a) firm presidents made false statements, such as underreporting income or assets, to either qualify for the program or retain certification. For example, one firm president who is not socially disadvantaged misrepresented her ethnicity to SBA. GAO also found cases where ineligible companies used certified firms to secure 8(a) work. For instance, a West Virginia company that graduated from the program in 2001 used a series of three certified companies as pass-throughs to continue obtaining set-aside and sole-source contracts. In some cases, SBA did not detect the false statements and misrepresentations made by certified firms. In others, SBA became aware of the firms' ineligibility but failed to take action. The table below shows details on 3 of the 14 case studies.

Selected Case Studies of Fraud and Abuse in the 8(a) Program

Industry	Ineligible 8(a) awards / awarding department	Case details
Roofing/ construction	$48.3 million—Agriculture, Commerce, Defense, Interior, EPA, GSA, SSA	• This firm is ineligible because it operated as a pass-through for a graduated company—both firms were being run by the same white, father-and-son team at the time of our investigation.
Construction	$ 11.2 million—Defense, Homeland Security	• This firm is ineligible because the president fraudulently reported his adjusted net worth to be $217,000 on his application when it was actually at least $806,000—an amount clearly exceeding the allowable $250,000 threshold. We estimate his current adjusted net worth to be at least $1.7 million dollars—nearly double the allowable $750,000.
Landscaping/ janitorial	$13.8 million—Defense	• This firm is ineligible because it operated as an extension of a graduated 8(a) firm run by the same father-and-son team that owned the previous firm—effectively giving them an extra 9 years of eligibility.

Source: GAO.

GAO's proactive testing found several strengths in SBA's 8(a) application process that helped prevent three bogus applicants from being certified for the program. Examples of the strengths included validation of data with third-party credit bureaus and the Excluded Parties List System. These controls and effective review appropriately raised questions about income and assets of GAO's bogus applicants that would have made them ineligible. However, GAO obtained 8(a) certification for one bogus firm using fabricated documentation and owner information. Certification of GAO's bogus firm shows vulnerabilities in the process such as the lack of any face to face contact that could allow ineligible individuals or pass through companies to enter the program. Although we were unable to determine whether all 14 cases were ineligible at application, these cases show substantial vulnerabilities in SBA's monitoring of eligibility for individuals and firms already in the program. The lack of a consistent enforcement strategy or any real consequences for fraud and abuse is a further weakness in SBA's fraud prevention program.

Contents

Abbreviations

AGI	Adjusted Gross Income
BDS	Business Development Specialists
CAIVRS	Credit Alert Interactive Voice Response System
DSBS	Dynamic Small Business Search
EIN	Employer Identification Numbers
FPDS-NG	Federal Procurement Database System-Next Generation
HUD	U.S. Department of Housing and Urban Development
IRA	Individual Retirement Account
IRS	Internal Revenue Service
LLC	Limited Liability Company
SBA	Small Business Administration

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Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

March 30, 2010

The Honorable Nydia M. Velázquez
Chairwoman
Committee on Small Business
House of Representatives

Dear Madam Chairwoman:

The 8(a) Business Development Program, administered by the Small Business Administration (SBA), is one of the federal government's primary vehicles for nurturing small businesses owned by socially and economically disadvantaged individuals. To participate in the program, a firm must be certified as meeting several criteria, including: be a small business as defined by SBA; be unconditionally owned and controlled by one or more socially and economically disadvantaged individuals who are of good character and citizens of the United States; and show potential for success. Upon certification, firms can obtain federal contracts without competing fully and openly for the work. For example, agencies are permitted to enter into sole-source contracts after soliciting and negotiating with only one 8(a) company. They also can participate in restricted competitions for federal contracts, known as set asides, open to only 8(a) companies. According to SBA, in fiscal year 2008, there were a total of 9,462 firms certified to participate in the program—about half of which had at least one active 8(a) sole-source or set-aside contract.[1] In fiscal year 2008, according to the Federal Procurement Database System-Next Generation (FPDS-NG), federal agencies awarded $15.2 billion in 8(a) sole-source and set-aside contracts.

SBA's Office of Business Development administers the 8(a) program. The office's Business Development Specialists (BDS) work directly with 8(a) firms and are located in 68 district offices throughout the nation. They perform a variety of functions: help firms prepare a business plan, conduct annual reviews of the firms' progress in implementing these plans, review firms' continued eligibility, and provide technical assistance. Once approved for the program, participant firms must continue to meet all eligibility criteria and submit documentation to SBA to complete

[1]Active contracts included any contract having a modification in fiscal year 2008 even if those modifications were non-monetary ones.

mandatory annual reviews. For instance, each year, as part of the annual review, participants must provide SBA with a certification that they continue to meet eligibility requirements as well as year-end financial statements, income tax returns, and a report on all non-8(a) contracts.

Given your interest in whether the 8(a) program has sufficient controls in place to detect fraud and abuse, you asked us to (1) determine whether ineligible firms are participating in the 8(a) program, (2) proactively test SBA's controls over the 8(a) application process, and (3) use case studies and proactive testing to determine what vulnerabilities, if any, exist in SBA's fraud prevention system.

To determine whether firms are participating in the 8(a) program through fraudulent misrepresentation, we used a risk-based approach to identify firms that exhibited signs that they were not qualified for the program. For example, we used data from the FPDS-NG to determine which firms in the Washington, D.C., area received the most 8(a) contracts in 2006 and 2007. Next, we used data from SBA's Dynamic Small Business Search (DSBS) Web site to identify current 8(a) firms in the Washington, D.C., area that were operating at the address of a graduated 8(a) firm. We limited our work to the Washington, D.C., area because there are significantly more firms located there than in any other area in the country. We used information about 8(a) firms provided by SBA to data mine for potentially fraudulent activity. We also reviewed allegations of fraud and abuse sent to our email address established to receive reports about small business contracting programs. We received about 30 allegations related to 8(a) fraud and abuse—more than we were able to investigate. In addition, we pursued leads found during the course of our other work on the Service Disabled Veteran Owned Small Business and HUBZone programs. From these sources, we selected 14 cases for further investigation based on a variety of factors,[2] including facts and evidence provided in allegations, and whether a firm received 8(a) contracts. For the firms we selected for further investigation, we reviewed documentation available from SBA in the firms' official 8(a) files maintained in district offices. We worked with SBA's audit liaison to request this documentation; in some instances we received information directly from officials in SBA district offices and other times information was transmitted through this liaison. We conducted both unannounced and announced site visits and interviewed

[2]We excluded Alaskan Native Corporation (ANC) 8(a) firms from our investigation due to different qualification standards.

firm employees and executives. We used a variety of investigative methods, such as analyzing firm payroll data, verifying the value of assets, and reviewing information from investigative databases to gather information about the firms and to determine whether the firms or their principals met 8(a) program criteria. In some cases, we also met with SBA staff responsible for annually recertifying these firms for the 8(a) program. Although 8(a) firms must meet several eligibility criteria to enter and remain in the program, we did not test all criteria. Generally our investigations focused on whether firms' presidents were economically disadvantaged, and whether they managed the day-to-day operations of the firm because we felt these eligibility criteria posed the highest risk of being misrepresented to the SBA.

To proactively test whether SBA's 8(a) application process and controls were sufficient to prevent ineligible firms from entering into the program, we established four bogus businesses, and submitted falsified applications and supporting documentation to SBA. For each application, we created substantial information on the business management experience and technical expertise of the firm's disadvantaged owner, the firm's ability to obtain the resources necessary to perform contracts, the firm's access to capital, and the firm's record of contract performance. To the extent possible, we developed scenarios to test various controls related to the firm's management and the owner's adjusted net worth. For one scenario, we also hired a for-profit certification firm to assist in the development of our application package. As part of SBA's application process, agency officials request copies of personal and business tax transcripts from the applicant as well as directly from the Internal Revenue Service (IRS). Therefore, in order to proactively test SBA's program application process, we used Employer Identification Numbers (EIN) and undercover Social Security numbers to file real tax returns with the IRS for our four bogus individuals. In order to minimize our costs associated with paying taxes, we created tax scenarios in which our firms reflected net business losses over multiple tax years. While these income scenarios minimized costs to GAO, they also limited our testing scenarios to firms that were not profitable, and thus decreased the likelihood that our firms would meet SBA's criteria that firms show reasonable potential for success.

To determine what vulnerabilities, if any, existed in SBA's fraud prevention system, we made observations based on our case studies and proactive testing. Furthermore, we compared current controls in the 8(a) program to a fraud-prevention model we developed and utilized in prior small business contracting investigations. Our work was not designed to identify all fraud and abuse in the 8(a) program or estimate its full extent for the entire population of 8(a) firms. In addition, our 14 case studies cannot be projected to the overall population of 8(a) firms. This investigative work complements our other work on the internal controls SBA has implemented to ensure that only eligible firms participate in the 8(a) program.[3]

We conducted our audit work and investigation from October 2008 through January 2010 in accordance with U.S. generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our objectives. We performed our investigative work in accordance with the standards prescribed by the Council of the Inspectors General on Integrity and Efficiency (CIGIE). A detailed discussion of our scope and methodology is presented in appendix 1.

Background

SBA's 8(a) program, named for a section of the Small Business Act, is a development program created to help small, disadvantaged businesses compete in the American economy and access the federal procurement market. To qualify for the 8(a) program, a firm must be at least 51 percent owned and controlled by an individual or individuals who meet SBA's definition of socially and economically disadvantaged and are of good character and citizens of the United States. The firm must also be a small business, as defined by SBA, and show a reasonable potential for success.

According to SBA regulations, at least 51 percent of the 8(a) firm must be owned and controlled by one or more disadvantaged individuals. Ownership requirements vary depending on whether the firm is a sole proprietorship, partnership, limited liability company (LLC), or a corporation. However, SBA makes a clear distinction between ownership of an 8(a) firm, and control of an 8(a) firm. To be in control of an 8(a) firm the disadvantaged individual or individuals must control both the strategic policy setting and the day-to-day management and administration of business operations. For example, SBA may find that nondisadvantaged

[3]GAO, *Small Business Administration: Steps Have Been Taken to Improve Administration of the 8(a) Program, but Key Controls for Continued Eligibility Need Strengthening*, GAO-10-353 (Washington, D.C.: Mar. 30, 2010).

individuals actually control an 8(a) firm if the firm cannot exercise independent business judgment without great economic risk.

Socially disadvantaged individuals include, but are not restricted to, members of designated groups, such as blacks or Hispanics,[4] or any individuals who have been subjugated to racial, ethnic, or cultural bias because of their identities as members of groups without regard for their individual qualities. Others, who may not be members of these groups, can be considered for the 8(a) program if they are able to provide substantial evidence and documentation that they have been subjected to chronic racial prejudice, cultural bias, or similar circumstances beyond their control. Economically disadvantaged individuals are defined by SBA regulations as those who at the time of application have a personal net worth of $250,000 or less, adjusted to exclude personal residence and business assets. Once certified to participate in the 8(a) program, the individual's adjusted net worth must not exceed $750,000 according to regulation. In addition, if an individual's income or total assets exceed certain standards, SBA may determine that the individual is not economically disadvantaged.[5] Applicants must also be of good character and citizens of the United States.

The firm must further qualify as a small business under the size standard that corresponds with its primary industry classification. SBA defines a small business concern as one that is independently owned and operated, is organized for profit, is not dominant in its field, has a place of business in the United States, and either operates primarily within the United States or makes a significant contribution to the U.S. economy. Depending on the industry, size standard eligibility is based on the average number of

[4]SBA regulations presume that the following individuals are socially disadvantaged: black Americans; Hispanic Americans; Native Americans; Asian Pacific Americans; and Subcontinent Asian Americans.

[5]Although not currently spelled out in the 8(a) regulations, SBA may, in its discretion, deny 8(a) certification or continued participation to an applicant or participant, respectively, if his or her Adjusted Gross Income (AGI) for the past 2 years falls within the top 1 to 2 percentiles of all American taxpayers. An applicant may also be disqualified because of an excessive amount of total assets. On December 9, 2009, SBA solicited comment on a proposed rule amending the 8(a) regulations to explicitly state that an applicant is presumed not to be economically disadvantaged if their AGI exceeds $200,000 (averaged over the last 2 years). For continued 8(a) participation, an 8(a) participant may not exceed an AGI of $250,000. In addition, the proposed regulations would disqualify an individual with assets in excess of $3 million at the time of application and $4 million for continued 8(a) participation.

employees for the preceding 12 months or on sales volume averaged over a 3-year period. In addition, a firm must demonstrate its potential for success by documenting revenues in its primary industry for at least 2 years; however, a waiver of this requirement may be granted if a firm meets certain criteria. SBA also considers a firm's access to credit and capital, as well as the technical and managerial experience of the firm's managers.

To help clarify eligibility criteria and address other issues, SBA recently proposed changes to its Small Business Size and 8(a) Business Development Regulations.[6] Among other things, the proposed rules would introduce more detailed guidance for specific thresholds for personal assets, compensation, and exceeding size standards. The proposed changes would also limit the participation of firms with a family member that is a previous participant of the 8(a) program. The public comment period for these proposed regulations closed in January 2010, and according to an SBA official, the comments are expected to be finalized by the end of fiscal year 2010.

Firms in the 8(a) program are eligible to receive set-aside and sole-source contracts. Set-aside contracts can be awarded to 8(a) firms if there is a reasonable expectation that at least two 8(a) firms will submit offers and the award can be made at a fair price. Sole-source contracts can be awarded when the dollar thresholds are $5.5 million or less for acquisitions involving manufacturing and $3.5 million or less for all other acquisitions.[7] In addition, once a firm receives an 8(a) contract, the firm is required to abide by certain subcontracting limitations based on the type of contract. For example, in the case of a contract for services, the 8(a) firm must perform at least 50 percent of the cost of the contract incurred for personnel with its own employees. In the case of general construction contracts, the 8(a) firm must perform at least 15 percent of the cost of the contract with its own employees (not including the costs of materials).

[6] *Small Business Size Regulations; 8(a) Business Development/Small Disadvantaged Business Status Determinations*, 74 Fed. Reg. 55694 (proposed Oct. 28, 2009) (to be codified at 13 C.F.R. pts. 121 and 124).

[7] However, SBA generally may award a sole-source 8(a) contract to an 8(a) firm owned and controlled by an Indian tribe or an Alaska Native Corporation where the value of the procurement exceeds the competitive dollar threshold. If it is a Department of Defense procurement, this exemption extends to Native Hawaiian Organizations.

Firms can remain in the program for up to 9 years provided that they maintain their eligibility. At the end of this term, SBA considers the firm to have "graduated" from the program. SBA can also remove a firm's 8(a) status by graduating it early if the agency determines that it no longer meets the criteria for assistance. Examples of such eligibility changes include the following: meeting the goals and objectives set forth in a firm's business plan; demonstrating the ability to compete in the marketplace without assistance from the 8(a) program; or the qualified owners of a firm are determined to be no longer economically disadvantaged. Firms are required to inform SBA of any changes that would adversely affect program eligibility while they are participating in the 8(a) program. SBA may also terminate a firm from the 8(a) program for good cause, such as submission of false information or failure to maintain eligibility requirements. Firms may also voluntarily remove themselves from the program. Once a firm graduates from the 8(a) program it cannot reapply, even if it changes its name or comes under new management. The disadvantaged individual upon whom eligibility was based is no longer eligible to qualify another firm. Federal law states that any person who misrepresents a firm's status as an 8(a) participant, or makes any other false statement in order to influence the certification process in any way or to obtain a contract awarded under the 8(a) program shall be: (1) subject to fines and imprisonment; (2) subject to civil and administrative remedies, including suspension and debarment; and (3) ineligible for participation in programs conducted under the authority of the Small Business Act.

Selected Case Studies of Fraud and Abuse in the 8(a) Program

We identified 14 firms that received set-aside or sole-source 8(a) contracts worth $325 million through fraud or abuse.[8] These 14 firms received another $1.2 billion in other federal obligations since entering the 8(a) program,[9] including $17 million in awards through the American Recovery and Reinvestment Act of 2009. We found evidence that shows officials at 13 of these firms misrepresented their eligibility for the program to fraudulently acquire or maintain 8(a) status and obtain federal contracts awarded with limited or no competition. Examples include underreporting adjusted net worth and serving as a "pass-through" for non-8(a)

[8]The firms are located in Georgia, Idaho, Maryland, New Jersey, Texas, Virginia, and West Virginia.

[9]This $1.2 billion includes both non-8(a) awards, as well as 8(a) awards that these firms were eligible to receive.

companies. In the case of a pass-through, an 8(a) firm receives the sole-source or set-aside contract, but contrary to program requirements, work is performed and managed by a non-8(a) company. We also determined that SBA staff responsible for annually assessing firm eligibility allowed 3 firms to remain in the 8(a) program and receive contracts despite clear evidence provided by company officials during annual reviews that showed they were no longer eligible. For example, SBA allowed a firm to remain certified even though the president reported a salary which substantially exceeded the threshold. Permitting ineligible firms to obtain 8(a) contracts undermines the intent of the program and deprives qualified firms from receiving targeted contracting opportunities.

Table 1 highlights the case studies we developed on these 14 firms. More detailed information on 5 of these cases follows the table. We will be referring all 14 cases to SBA and the agency's Office of Inspector General for further investigation.

Table 1: Selected Cases of Fraud and Abuse in the 8(a) Program

Case	Industry/ business location	8(a) obligations since firm was not eligible and awarding department[a]	Case details
1	Construction Toms River, NJ	$11.2 million—Department of Defense, Department of Homeland Security	• This firm was ineligible because the president fraudulently reported his adjusted net worth to be $217,000 on his application when it was actually at least $806,000—an amount clearly exceeding the allowable $250,000 threshold. We estimate his current adjusted net worth to be at least $1.7 million dollars—more than double the allowable $750,000. • The president underreported the value of investment properties, an Individual Retirement Account, and other assets. He also failed to report the ownership of multiple properties held in a LLC registered to his wife, but under his control. • The president made numerous false statements during the application process to hide his relationship with a previous employer that was a graduated 8(a) company. • The firm contacted us in September 2009 to state that it had decided to voluntarily withdraw from the 8(a) program as a result of our investigation. SBA agreed to remove the firm from the program.

Case	Industry/ business location	8(a) obligations since firm was not eligible and awarding department[a]	Case details
2	Landscaping, janitorial, and painting Wharton, NJ	$13.8 million—Department of Defense	• This firm is ineligible because it is operating as an extension of a graduated 8(a) firm owned by the same father-and-son team. The arrangement effectively gave the team an extra 9 years of eligibility to receive 8(a) sole-source and set-aside contracts. • Four months after the father's landscaping and janitorial firm graduated from the program, the son applied to the program under a different company name and received certification about a month later. • The current 8(a) firm and the graduated company share workers and equipment to perform contract work. • We requested a number of documents to verify the net worth of the current 8(a) president and establish whether the two firms were affiliated but were denied access by company officials—a material breach of the firm's program agreement. • The firm is slated to graduate in September 2015.
3	Roofing and construction Hyattsville, MD	$48.3 million—Department of Agriculture, Department of Commerce, Department of Defense, Department of the Interior, Environmental Protection Agency, General Services Administration, Social Security Administration	• The firm is ineligible because it operated as a pass-through for a graduated company—both of which were being run by the same white, father-and-son team at the time of our investigation. • The two businesses share top executives, staff, administrative offices, and warehouse space. As such, we determined that they were essentially operating as one company. • The father and son never applied to SBA to be considered as disadvantaged, yet they controlled and managed the daily operations of the currently certified firm. For example, the white vice-president disclosed much of the operational knowledge of the firm during the site visit, while the black president rarely spoke. The white executives both work out of large suites while the black president sits in a small room located at the back of the building. • The firm is slated to graduate in April 2011.
4	Security consulting Arlington, VA	$6.7 million—Department of Defense, Department of Homeland Security, National Aeronautics and Space Administration, Nuclear Regulatory Commission	• This firm is ineligible because the president is not socially disadvantaged and it relied, at the time of application, on a graduated company for operational resources. The firm fraudulently obtained contracts by making false statements to SBA about these matters. • The president attested to being Hispanic on her 8(a) application, but she stated on her Maryland driver's license application that she was not. In addition, her previous employer stated that the woman had misrepresented herself as socially disadvantaged. • The firm is slated to graduate in August 2013.

Case	Industry/ business location	8(a) obligations since firm was not eligible and awarding department[a]	Case details
5	Health and human services consulting Rockville, MD; Fairfax, VA; Atlanta, GA	$12.6 million—Department of Health and Human Services, Office of Personnel Management	• This firm is ineligible because the president of the firm is no longer economically disadvantaged. • The president withdrew about $600,000 from the firm for an equity loan—double what SBA regulations allow. • The president provided corporate tax returns during annual reviews which showed she drew a salary in excess of $1 million for several years—exceeding the cap for adjusted gross income (AGI) established by SBA case law and placing her in the top 1 percent of American taxpayers. • In March 2009 we pointed out these violations to SBA staff responsible for assessing firm eligibility; however, no action was taken to graduate the firm. Subsequently, the firm received a $3.3 million set-aside contract. • The firm is slated to graduate in May 2010.
6	Roofing Emmett, ID	$400,000—Department of the Interior	• This firm is ineligible because it is a shell company dependent upon the resources of a large construction firm managed by a nondisadvantaged individual.[b] • The president worked for the nondisadvantaged individual's firm—but was not compensated for this work— while in the 8(a) program. The 8(a) firm did not have any employees and used employees of the nondisadvantaged individual's firm to perform work. • The president stated that her firm was located on land owned by the same nondisadvantaged individual. • The large construction firm provided bonding for work performed by the 8(a) company and the president of this firm told the SBA that he was compensated for providing this support. • Both SBA district office staff and the State of Idaho found evidence that the firm was affiliated with a nondisadvantaged individual. • The firm is slated to graduate in October 2014.

Case	Industry/ business location	8(a) obligations since firm was not eligible and awarding department[a]	Case details
7	IT consulting Fairfax, VA	$9.9 million—Department of Defense, Department of State, Peace Corps	• The firm was ineligible because the president failed to report the ownership of significant assets to SBA, which would have disqualified it from the program. • The president failed to declare joint ownership of $4.2 million in properties located in Virginia, Maryland, and Nevada, including a $900,000 home in Las Vegas—which would have been included in SBA's calculation of adjusted net worth. • When we inquired about these purchases, the president could not provide evidence substantiating her claim that the properties were purchased with monies inherited by her husband. • We brought the unreported assets to the attention of SBA; however, once SBA learned that the firm was scheduled to graduate in 8 months, it no longer wanted to investigate the firm's actions. Eleven days later, the firm was awarded a $1.7 million dollar contract. • The firm graduated in September 2009.
8	Construction Fort Dix, NJ	$2 million—Department of Defense	• This firm is ineligible because it is a shell company that is economically dependent upon a large, privately-owned construction company in Brooklyn, NY, and subcontracts all of its work to other businesses. • The firm operates out of a regional office for the Brooklyn company. A founding owner also works for the Brooklyn company, as does its general manager. Interrelated relationships such as these have been found by SBA to disqualify a business from being considered small. • The firm also has only four employees, including the president—too few to complete contract work on its own, so it subcontracts all of its 8(a) work to other businesses. SBA regulations require 8(a) firms to perform at least 15 percent of the work on construction contracts with its own employees. • The firm is slated to graduate in May 2017.

Case	Industry/ business location	8(a) obligations since firm was not eligible and awarding department[a]	Case details
9	Human resources Alexandria, VA	$117 million—Department of Agriculture, Department of Commerce, Department of Defense, Department of Health and Human Services, Department of Homeland Security, Department of Labor, Department of Transportation	• The firm fraudulently obtained 8(a) contracts after the president failed to report a $450,000 down payment made towards the purchase of a $3.7 million dollar home which would have caused the president's adjusted net worth to exceed program limits. • SBA allowed this firm to remain 8(a) certified for 5 years even after the president of the firm reported receiving a salary which, according to SBA case law, indicated that the president was no longer economically disadvantaged. She reported a salary ranging from $525,000 to $730,000 during this time. • Moreover, the firm was determined to be ineligible by SBA because it had exceeded small-business size standards, but was allowed to "ride out the program" for 21 months. During this period, the firm received an 8(a) sole-source contract worth $554,000 for which it was no longer eligible. We asked SBA why it approved a contract to an ineligible firm, but were told by the audit liaison that SBA had no records related to this contract. • The firm graduated in November 2008.
10	IT consulting Bethesda, MD	$12.6 million—Department of Agriculture, Department of the Interior, Department of Transportation, Department of Veterans Affairs	• The firm was ineligible because the president misrepresented that he used proceeds from the sale of a $236,000 Miami condominium to purchase his home, but instead transferred the property into his wife's name. • The president also exhibited signs that he is not economically disadvantaged. For example, he owns a $2.5 million house on a private island in Miami, FL, a $450,000 yacht, and a $200,000 Lamborghini. The president's wife owns a $1 million house in Bethesda, MD, but SBA regulations do not require a spouse's assets to be included in an owner's adjusted net worth. • The firm graduated in March 2010.

Case	Industry/ business location	8(a) obligations since firm was not eligible and awarding department[a]	Case details
11	Construction Weirton, WV	$70.8 million—Department of Agriculture, Department of Defense, Department of Energy, Department of Health and Human Services, Department of Homeland Security, Department of the Interior, Department of Justice, Department of Veterans Affairs, General Services Administration	• The firm fraudulently received 8(a) contracts because it graduated from the program in 2001 and used a series of three certified companies as pass-throughs to continue obtaining 8(a) contracts. In addition, all four businesses are currently being controlled by two white men who never applied to SBA to be considered as disadvantaged. • The three pass-through companies effectively operated as extensions of the graduated firm because they all shared facilities and employees to perform contract work. • There is evidence that two white men controlled the businesses: (1) they maintained offices at headquarters where the daily operations were conducted, while the black presidents worked about a mile away in a satellite office, and (2) they also earned more money than the black executives do. • One pass-through graduated in September 2007. The other two are slated to graduate in October 2013 and May 2014 respectively.
12	Consulting Alexandria, VA	$2.5 million—Department of Defense, Environmental Protection Agency	• The firm was ineligible because the president failed to disclose over $1 million in reportable property, including an ocean-front condominium in Florida and two townhouses in Virginia. • The firm graduated in December 2009.
13	Manufacturing rubber products Mansfield, TX	$15.5 million—Department of Defense, General Services Administration	• The firm was ineligible because the president underreported his salary to SBA, stating in 2001 that he earned a salary of $100,000; tax documents showed he received an income of $1.6 million that year. • The president reported income on an annual review in excess of $1.9 million for 2003—exceeding the cap for AGI and placing him in the top 1 percent of American taxpayers, which does not demonstrate economic disadvantage. • The firm graduated in June 2006.
14	Janitorial, carpet cleaning, grounds maintenance Baltimore, MD	$600,000—Department of Defense	• This firm was not eligible to obtain 8(a) contracts after the president passed away and his wife failed to report this to SBA for 2 years. • After the president of the firm passed away, his wife continued to submit documentation to SBA falsely indicating that he was the president. • Approximately 2 years after his death, SBA staff responsible for assessing firm eligibility was able to determine that the president of this firm had died and in September of 2009 filed paperwork to terminate the firm from the program. At the time of this report, in March of 2010, the termination was still being processed.

Source: GAO Analysis.

[a]This figure represents the amount of obligations that 8(a) firms received from the date at which we determined that the firm was no longer eligible to participate in the program. We found that some firms were ineligible for participation prior to their certification, while others became ineligible at some time during the course of their participation in the 8(a) program. Obligation amounts are rounded to the nearest $100,000.

[b]A shell company is defined as a business that has no independent assets or operations of its own, but is used by its owners to conduct specific business dealings or maintain control of other companies.

The following provides a more detailed description of five of the cases in table 1.

Case Study 1

The president of this New Jersey construction firm fraudulently obtained $11.2 million in 8(a) set-aside and sole-source contracts by misrepresenting his qualifications for the program. This firm was never eligible because the president's adjusted net worth was at least $806,000—more than triple what he reported on his application in late 2007 and what SBA regulations allow. As of May 2009, after a year in the program, his adjusted net worth had grown to at least $1.7 million—more than double the $750,000 cap set by SBA regulations to retain 8(a) status. We found evidence the president hid his relationship with a graduated 8(a) company in order to obtain certification for his own firm. In addition, we also were told by Navy job-site inspectors that the firm was subcontracting most, if not all, of the work on the $2.3 million sole-source demolition contract it received from the Department of the Navy. After we began questioning the president's qualifications and the firm's contracts, the president withdrew his company from the 8(a) program. SBA agreed to remove the firm from the program in November of 2009.

The president of this firm attested to an adjusted net worth of $217,370 at the time of application, which was about $32,000 below the cap for being considered economically disadvantaged. However, using public records and documents provided by the president, our investigation found that the president's actual adjusted net worth at that time was at least $806,527, which is triple the allowable limit. The difference results in part from the president underreporting the value of his individual retirement account (IRA) and two investment properties. SBA took no steps to verify the value of these assets. The president also failed to report a third investment property entirely. Later in this report we describe the steps that SBA takes to verify information during the application and subsequent annual review processes. Table 2 summarizes the discrepancies we found between the asset values the president submitted to SBA and the ones we determined to be accurate based on public records and documentation, such as bank statements, provided by the president.

Table 2: President's Adjusted Net Worth in November 2007 at the Time of Application

	President's claimed value of assets	GAO's estimated value of assets
Cash	$7,080	$14,202
IRA or other retirement account	$40,000	$99,913
Stocks and bonds (other than ownership in 8(a) firm)	$72,000	$152,122
Real estate (excluding personal residence)		
Investment property 1 (Ulster, NY)	$10,000	$24,000
Investment property 2 (Manchester Township, NJ)	$70,000	$278,000
Investment property 3 (Seaside Heights, NJ)	Not reported	$220,000
Other assets and personal property[a]	$40,618	$40,618
Total assets	**$239,698**	**$828,855**
Debt (excluding mortgage for personal residence)[a]	$22,328	$22,328
Total net worth	**$217,370**	**$806,527**

Source: SBA documents, public records, and documents provided to GAO by the president.

[a]GAO did not attempt to verify the accuracy of these figures.

For the undervalued investment property in Manchester Township, the president submitted a market analysis produced by a real estate agent with whom he had a prior business relationship showing the vacant land to be worth less than a quarter of what public records state he actually paid for it. In addition, an LLC that lists the president's wife as its registered agent and manager—but evidence indicates is controlled by the president himself—paid $220,000 in cash for an investment property 10 days after the president applied to the 8(a) program.

A little more than a year after entering the program, the president's adjusted net worth had grown to at least about $1.7 million—more than double the cap set by SBA regulations to remain eligible. However, the president again understated his assets to SBA in May 2009, which resulted in SBA calculating his adjusted net worth as $119,434. Table 3 summarizes the discrepancies we found between the asset values the president submitted to SBA as part of his annual review and the ones we determined to be accurate based on public records and documentation provided by the president.

Table 3: President's Adjusted Net Worth in May 2009 about the Time of the Firm's First Annual Review

	President's reported value of assets	GAO's estimated value of assets
Cash	$21,555	$21,499
IRA or other retirement account	$48,164	$77,788
Stocks and bonds (other than ownership in 8(a) firm)	$15,842	$31,685
Real estate (excluding personal residence)		
Investment property 1 (Ulster, NY)	$10,000	$24,000
Investment property 2 (Manchester Township, NJ)	$70,000	$838,700
Investment property 3 (Seaside Heights, NJ)	Not reported	$336,000
Investment property 4 (Lacey Township, NJ)	Not reported	$451,500
Other assets and personal property[a]	$93,175	$93,175
Total assets	**$230,434**	**$1,930,947**
Debt (excluding mortgage for personal residence)[a]	$139,302	$139,302
Total net worth	**$119,434**	**$1,735,145**

Source: SBA documents, public records, and documents provided to GAO by the president.

[a]GAO did not attempt to verify the accuracy of these figures.

The president continued to understate the value of his Manchester Township property, despite the tripling of its assessed taxable value. He maintained in an interview that the vacant land was worthless, but public records and interviews with Township officials indicate he spent 2 years and over $30,000 to connect it to public utilities. In addition, the same LLC mentioned above purchased a nearly $500,000 waterfront home in Lacey Township, New Jersey, with cash in January 2009—4 months before the firm's first annual review.

Case Study 2

A landscaping and janitorial firm in New Jersey fraudulently obtained $13.8 million in 8(a) contracts because it was operating as an extension of a graduated 8(a) firm owned by the same family. The father's company—also a landscaping and janitorial company—entered the program in 1997, but its certification for 8(a) contracts ended after the 9-year eligibility term expired. Four months after the father's company graduated, the son applied to the program in 2006 under a different firm name and was certified about a month later.[10] Our investigation found the two businesses operated out of the same location, employed the same workers, and shared the same equipment. This effectively gave the family an extra 9 years of eligibility to receive sole-source and set-aside 8(a) contracts.

We determined that the current 8(a) firm is operating as the graduated 8(a) firm with little more than a name change.[11] First, an undercover site visit and postal records revealed that the two firms are operating out of the same unmarked administrative office. They also share an email address. Second, we found that, according to tax records, the two firms shared 16 employees in 2008. We interviewed 6 people who worked for the current 8(a) firm, each of whom indicated that the graduated company and 8(a) firm were operating as the same business, but used different names depending on where work was being performed. One employee stated that he applied for a job at the graduated company, but that he received most of his paychecks from the current 8(a) firm—despite never having filled out tax forms for the current firm. Another told us that employees often do not know which job site at which they are working until the morning when they are told where to go by a foreman who oversees employees working for both businesses. In addition, the son once worked as the vice-president for operations and marketing for his father at the graduated company. Third, several employees stated that the two companies share equipment, such as trucks. Lastly, a former consultant for the graduated company told us that the current 8(a) firm was created for the sole purpose of remaining in the program after the 9-year eligibility term expired.

[10] SBA has proposed changes to the 8(a) regulations that would prohibit firms from participating in the 8(a) program if the president has an immediate family member who is a disadvantaged principal of a former 8(a) firm. This prohibition may be waived by the Associate Business Development Administrator if there are no connections between the two firms and if the applicant can demonstrate sufficient expertise to operate the firm. There is a presumption against the waiver if the firms are in the same line of business.

[11] SBA has previously disqualified firms that are simply an extension of a former 8(a) participant, as well as firms in which there is a "confusion of identities" between the firm and a previous 8(a) participant. Matter of Infotech International, Inc., SBA No. 205 (2004).

We requested a number of documents to verify the adjusted net worth of the current 8(a) president and establish whether the two firms were affiliated but were denied access by company officials—a material breach of the firm's program agreement.[12] We asked the two firms for a list of all equipment owned or leased, including identifying information such as serial numbers or Vehicle Identification Numbers. We also requested personal financial information from the president, such as investment account statements. We notified SBA program officials about our inability to obtain these documents; however, SBA officials told us that they would not request information on our behalf. Breach of the program agreement is a basis for 8(a) termination.[13] According to the SBA, the firm is slated to graduate from the program in September 2015.

Case Study 3

We found that this Hyattsville, Maryland, construction firm fraudulently obtained $48.3 million in 8(a) set-aside and sole-source contracts by operating as a pass-through for a graduated company—both of which were being run by nondisadvantaged individuals at the time of our investigation. We determined that the two businesses were essentially operating as one because they shared the work on contracts, top executives, staff, administrative offices, and warehouse space. We also found that a father and son—two white executives from the graduated company who never applied to SBA as disadvantaged—actually control and manage the daily operations of the currently certified firm. One of the white men told us that in order to receive federal contracts, a person needed to "create" other companies because it was difficult to compete without some type of preference. He referred to this process as "succession planning." We did not determine who controlled the graduated company while it was active in the program.

The president of the currently certified firm received 8(a) status in April 2002—about a month after the graduated company left the program. The president's firm works in the same line of business as that of his

[12]All 8(a) participants sign an agreement upon entering the program which states, among other things, that the firm president agrees to fully cooperate with any and all requests from authorized government officials (including auditors and investigators from SBA or other agencies) for examination of business records and any other information deemed necessary by such officials for legitimate program purposes.

[13]13 C.F.R. § 124.303(a)(19).

former employer—roofing, sheet metal, and other commercial construction.

The firm uses about 6,000 square feet of office space and approximately 13,000 square feet of warehouse space leased by the president's former employer. In addition, about a third of the firm's 29 staff were hired from the president's former employer after the graduated company left the 8(a) program. The father initially served as the firm's senior vice-president, according to the business's Web site, but is now listed as a mentor and advisor; at the graduated company, he worked as vice-president. The son, meanwhile, acts as one of the firm's vice-presidents and was operations manager at the graduated company. The father said that he formed the currently certified firm with the president before his company left the program. His son joined the currently certified firm the same year that it received its 8(a) certification.

Evidence that the currently certified firm is being controlled by two white men includes subcontracts that the 8(a) firm awarded to both the graduated company and a woman-owned construction firm that was closely tied to these men. We concluded that this woman-owned construction firm was closely tied to these men after one of them told us they created the firm to prepare the graduated 8(a) firm for an expected increase in government contracts to woman-owned businesses. He called this "pre-positioning". The president of the woman-owned firm is a former employee of the two white men and operates from the same address as the graduated 8(a) firm. Additionally, the domain name for the woman-owned firm's website is registered to the graduated 8(a) firm. Other evidence of control over the current 8(a) firm includes the operational knowledge of the white men and the size and location of the black president's office. When we interviewed the men about the firm's business operations, the white vice-president answered most of the questions while the black president rarely spoke. SBA officials told us that they consider a key indicator of control to be who discloses much of the operational knowledge during site visits. Finally, the white vice-president worked in a large executive suite. The black president, meanwhile, sat in a small room located at the back of the building. SBA considers the relative size of offices given to disadvantaged and nondisadvantaged individuals to be a key indicator of control. We visited the currently certified firm's headquarters as part of our fraud investigation of the HUBZone program—also administered by SBA—which allows sole-source and set-aside contracts to be awarded to firms located in economically depressed areas. The firm also had been granted HUBZone certification and as a result received an additional $15.3 million in noncompetitive federal contracts.

Our investigation found, however, that the firm was not actually located in a HUBZone. SBA subsequently revoked this certification. According to SBA, the firm is slated to graduate from the 8(a) program in April 2011.

Case Study 8

A construction firm in Fort Dix, New Jersey, fraudulently obtained $2.2 million in 8(a) sole-source and set-aside contracts because it is economically dependent upon a large, privately-owned construction company in Brooklyn, New York, and subcontracts all of its work. First, the Fort Dix firm operates out of a regional office for the Brooklyn company. In addition, a founding owner of the firm works for the Brooklyn company, as does its general manager. A business's close affiliation with a large company through the sharing of facilities, employees, and economic interests has been found by SBA to disqualify a business from being considered small.[14] Second, the Fort Dix firm possesses only four employees, including the president—too few to complete the contract work on its own. It subcontracts all of its 8(a) work to other businesses. SBA regulations require 8(a) firms completing general construction contracts perform at least 15 percent of the cost of the contract with their own employees (not including the costs of materials). Third, we found evidence indicating that a previous 8(a) participant in Jersey City, New Jersey, had an interrelated relationship with the Brooklyn company while in the program. The Jersey City business also had ties to the Fort Dix firm, such as a common employee and nearly identical business plans. However, the Jersey City firm did not provide us with all of the documents we requested, so we could not determine whether it was economically independent.

Case Study 11

A graduated 8(a) firm currently controlled by two white men fraudulently obtained $70.8 million in 8(a) set-aside and sole-source contracts by using a series of three construction companies as pass-throughs to obtain the awards. The graduated firm—founded by one black man as president and two white men as fellow executives—gained certification in 1992 and completed the program in 2001 after its eligibility term expired. A succession of certified companies subsequently operated as an extension of the graduated firm because they all shared facilities and employees to perform contract work. In addition, two of the top executives of the successor companies, both disadvantaged individuals, were personally

[14]See, for example, Size Appeal of Bering Pacific Construction, SBA No. 4094 (1995).

tied to the graduated firm's president. For example, the president of the second successor company was the sister of the graduated firm's president, while the president of the third successor company was his cousin. After graduating from the program, the graduated firm's president received a salary from the first and second successor companies. We could not determine who controlled the graduated firm during its participation in the program, but we believe that the two white men—neither of whom ever applied to SBA as disadvantaged individuals—currently oversee all of the firms' daily operations. The use of the successor companies effectively gave the two men an extra 13 years of eligibility to receive sole-source and set-aside 8(a) contracts.[15]

Table 4: Chronology of Firms

	SBA 8(a) entrance date	Date of first 8(a) obligation	SBA 8(a) graduation date	8(a) obligations
Graduated firm	September 1992	April 1996	September 2001	$17,355,321
Successor 1	September 1998	November 2002	September 2007	$9,401,780
Successor 2	October 2004	June 2005	October 2013	$57,321,506
Successor 3	May 2005	September 2006	May 2014	$4,085,870

Source: SBA and FPDS-NG.

The graduated firm controls the three successor companies because it shares its facility and employees with the other businesses—a relationship that SBA regulations and case law consider indicative of which entity is actually in power. The graduated firm's headquarters, located in Weirton, West Virginia, effectively serves as the operations center for the successor companies. We conducted a surprise visit to this location and found on-site clerical staff and project managers conducting day-to-day operations for all four businesses. The payroll clerk also told us that the graduated firm pays the rent for this facility. In addition, the resumes of three job site superintendents at the first and second successor company show that they once worked for the graduated firm. The wage and tax statements from when the graduated firm was in the program were destroyed in a 2004 flood. We were able to obtain the wage and tax statements from the graduated firm and its three successor companies for 2006 and 2007. These documents show the companies paid the same employees in the same calendar year. For example, in 2006, 82 employees received a paycheck

[15]Eligibility calculated by adding the years since the graduated firm's eligibility term expired (2001) and the last successive firm's eligibility term will expire (2014).

from two or more of the businesses. In 2007, 37 employees received a paycheck from each of the four businesses. The on-site payroll clerk at headquarters told our investigators that an employee earns the same salary each year regardless of which business pays the employee. The clerk said she never had a problem issuing paychecks from multiple businesses because they all use the same bank.

Our investigation also found that the two white men who were among the founders of the graduated firm control all four businesses. First, both white men have offices at headquarters where the daily operations of the four businesses are located, while the black presidents work about a mile away in a satellite office.[16] Second, both white men also earn more money than the black executives do.[17] In 2009, the highest-paid black president received only $53,000 in compensation compared to the $125,000 the two white men told our investigators that they each earned. The two white men received this income from more than one company. Both earn a paycheck from multiple companies and both receive a portion of the money that the graduated firm charges the second successor company for equipment leases. One of the white men also received income from monthly fees as the accountant for the second successor company. In addition, the two white men told our investigators that one or more of the companies pays for their personal vehicles. Both men agreed with our investigators that they were managing all four businesses but told investigators, "We don't do [the third successor company] as a steady diet. We do [the second one]."According to SBA, the second and third successor companies—the only ones with current 8(a) certification—are slated to graduate in October, 2013 and May, 2014 respectively.

[16]SBA regulations require that the disadvantaged principal manage the day-to-day operations of the firm.

[17]SBA regulations require that employees of 8(a) firms generally may not receive greater compensation than the disadvantaged principal. 13 C.F.R. § 124.106(e)(3).

Our Proactive Testing Identified Strengths and Vulnerabilities in SBA's 8(a) Application Process

Our proactive testing found strengths in SBA's 8(a) application process that allowed the agency to correctly determine firms' lack of qualifications. We also identified vulnerabilities that demonstrate weaknesses ineligible firms could exploit to fraudulently receive program certification. We were unsuccessful in gaining certification for three bogus firms. In the first unsuccessful application, SBA stated that it denied our application because the firm lacked the financial capacity to perform 8(a) contracts. In the other two of these cases, SBA raised concerns about our eligibility based on the presidents' adjusted net worth. The agency also questioned control of one of these firms. SBA provided us with such thorough comments that we determined we could not overcome the deficiencies and eligibility issues identified in both applications, so we abandoned them. However, we obtained 8(a) certification for one bogus firm using fabricated documentation and fictitious owner information. We consider this a vulnerability because unscrupulous firms could do the same to create front companies and funnel 8(a) contracts to themselves, circumventing eligibility requirements. In contrast to our 2008 test of SBA's HUBZone program—in which we were quickly and easily able to obtain certification for four fictitious firms—the agency demanded we overcome more rigorous controls, such as verification of critical business information contained in IRS tax returns with third-party sources.

We prepared all but one of these applications to reflect scenarios in which the individual or the firm would not be eligible for the program, such as a firm president with an adjusted net worth in excess of program limits. SBA identified many of the eligibility issues that we included in our applications and requested substantial documentary evidence and clarification for claims and statements that we made. We reviewed the approved application to obtain details on why it was certified, and determined that SBA performed independent verifications of some of the information we provided. However, we do not know what verifications SBA performed on our other three firms. Communications and submissions were conducted primarily through the Internet, by mail, and by fax. For the accepted firm, we conducted limited real-time telephone conversations with SBA staff responsible for processing our application. SBA staff also left several voice messages for all but one of our firms. At no time during the application process for the four bogus firms were we required to conduct face-to-face meetings.[18] By all indications, SBA's

[18]The owners of newly certified 8(a) firms are required to attend an orientation in person. We never attended our required orientation session.

review focused on our firms' potential for success and the technical and administrative completeness of our applications. This is a necessary and reasonable focus; however, SBA did not question the legitimacy of the documents we submitted and, as a result, we were able to gain 8(a) certification for a company that only existed on paper. This successful application shows that SBA is vulnerable to certifying firms based upon fraudulent application information. We provide specific details on each of our four applications below.

Unapproved Fictitious Applications

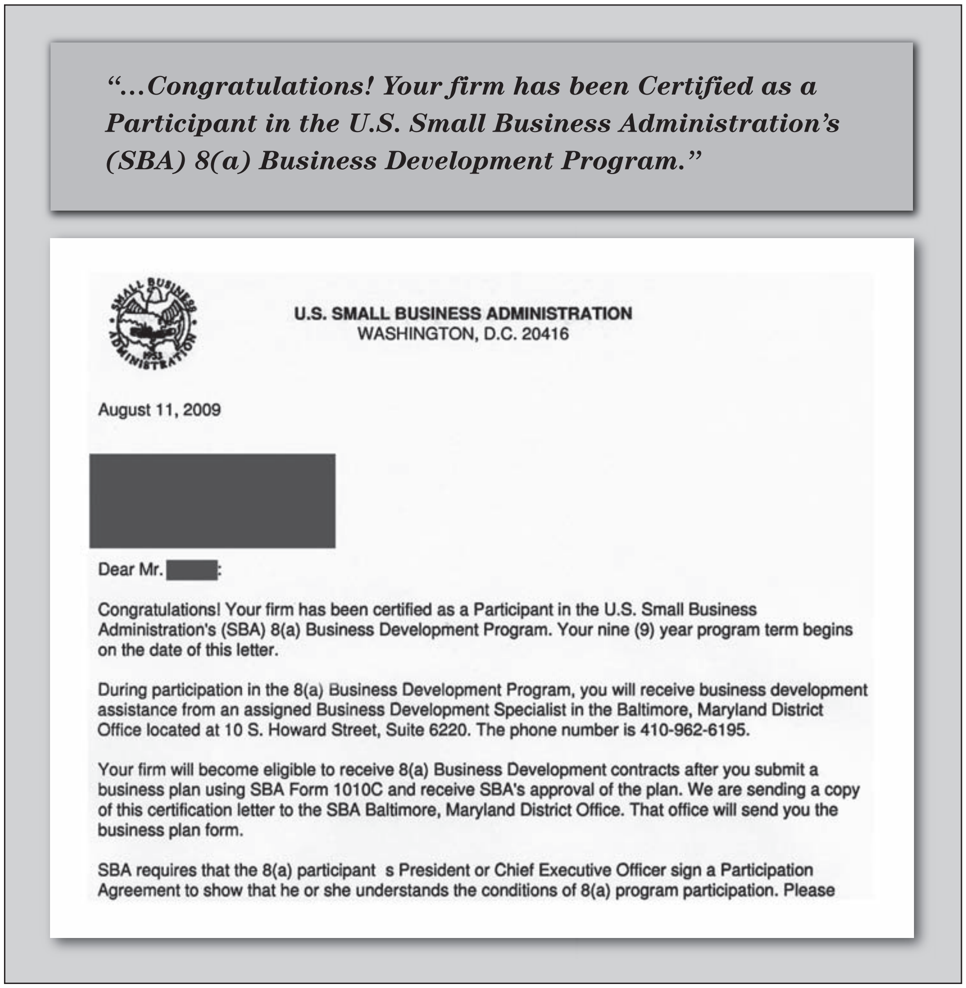
Fictitious Application 1: SBA denied this application after a 4-month review because the firm appeared to lack the financial capacity to execute contracts in the 8(a) program. We prepared this application to appear as if a nondisadvantaged individual had the potential to control the applicant. In addition, the personal financial statement of the applicant included a substantial degree of debt that was unsustainable because the owner had limited wage income and the firm had not generated any measurable profit in the past. To appear as if another individual could potentially control our disadvantaged individual, we created another fictitious identity and added his name as a signatory on a bogus bank signature card that we submitted to SBA. We also incorporated this name in various documents throughout our application, such as in bank statements, loan agreements, and leases, without including him as a partial owner of the firm, naming him as an employee, or providing any information on his identity. SBA requested that we provide evidence from our bank listing the names of all individuals with access to our business account. To meet this request, we provided a bogus story to explain why the individual was a signatory on our account and then indicated that he was removed. To back up our claim, we provided a phony bank letter indicating that our firm's owner was the sole signatory on the account.

Fictitious Application 2: SBA's requests for evidence and documents to support the claims and explanations we made about control and adjusted net worth were so extensive that we abandoned this application after 3 months, determining that we could not overcome the agency's concerns. SBA identified almost all of the "red flags" that we included in this application, except for indications that our bogus applicant could be involved in money laundering. For example, SBA identified the fact that we underreported the value of a high-end sports car and luxury motorcycle that were included in our statement of assets and subsequently determined that the adjusted net worth of our bogus applicant exceeded $250,000, because of the value of the vehicles. In contrast, SBA did not question us about the information we provided that suggested money laundering. For instance, we provided SBA with fake bank statements that included numerous banking transactions that were split into sums that fell just below the $10,000 identification and reporting threshold. The bank statements reflected substantial transfers that originated from countries identified as tax havens with no association with our business activity. They also reflected large deposits that were immediately followed by cash withdrawals of an equal sum or a wire transfer to another financial institution or individual. While SBA requested copies of contracts, invoices, and other information related to any business that our bogus firm may have conducted outside of the United States, there was no indication that its staff became suspicious of the illicit activities that are generally associated with the information we included in our bank statement.

Fictitious Application 3: SBA determined that this firm had significant eligibility issues and that it could not accept our 8(a) application for processing, after 4 months of correspondence, and despite the hiring of a private company to help us obtain certification. Specifically, SBA determined that the fictitious firm had limited potential for success because we reported that we did not receive any W-2 income or wages on both our 2007 and 2008 income taxes. Additionally, our firm's application reflected significant business debts and liabilities, ownership of real estate assets, and personal and business lines of credit that could not be reconciled or sustained with the fact that we reported no wages and or income. For this fictitious firm, we employed the services of a private company that offered "8(a) Certification Services" to determine if such businesses offer the advantage that they advertised. We selected this particular firm because it described itself as deft at helping individuals who are not generally classified as disadvantaged obtain 8(a) certification for their firms. We signed a contract and paid the private company almost $4,000. The company stated that it would advise us if we were not eligible for the program. However, it did not identify any of the eligibility issues that we planted in the application. In fact, the company told us that our firm's application was as "good as any it had ever seen" and "had as good a chance as any firm of being certified." SBA returned our application, citing a number of eligibility issues, such as our limited potential for success and our net worth exceeding the cap. The private company neither provided continuous guidance in addressing SBA's concerns throughout the process, nor did it follow up with us to determine the status of our application after resubmission. While we did not systematically test these private companies, as a result of our testing, we are concerned that they are marketing and advertising themselves as capable of improving an 8(a) applicant's chances of getting certified when they may not offer the advantages they claim.

Approved Fictitious Application

Figure 1: SBA Certification Letter for Our Bogus 8(a) Firm



"…Congratulations! Your firm has been Certified as a Participant in the U.S. Small Business Administration's (SBA) 8(a) Business Development Program."

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

August 11, 2009

[redacted]

Dear Mr. [redacted]:

Congratulations! Your firm has been certified as a Participant in the U.S. Small Business Administration's (SBA) 8(a) Business Development Program. Your nine (9) year program term begins on the date of this letter.

During participation in the 8(a) Business Development Program, you will receive business development assistance from an assigned Business Development Specialist in the Baltimore, Maryland District Office located at 10 S. Howard Street, Suite 6220. The phone number is 410-962-6195.

Your firm will become eligible to receive 8(a) Business Development contracts after you submit a business plan using SBA Form 1010C and receive SBA's approval of the plan. We are sending a copy of this certification letter to the SBA Baltimore, Maryland District Office. That office will send you the business plan form.

SBA requires that the 8(a) participant s President or Chief Executive Officer sign a Participation Agreement to show that he or she understands the conditions of 8(a) program participation. Please

Source: SBA.

Fictitious Application 4: SBA approved this fictitious application for 8(a) certification after conducting a 5-month review. We did not intentionally prepare this application with any specific eligibility issues, but SBA identified several discrepancies and missing items in our application during its review. For example, SBA found a significant eligibility issue regarding our firm's business experience since it had less than the minimum 2 years required.[19] To overcome this issue, we crafted a request for a business waiver including detailed information that demonstrated our firm's potential for success. Table 5 below provides details on the timeline and interactions that occurred with SBA during the processing of this application. It shows that SBA's certification process was lengthy—requiring our bogus firm to submit substantial documentation.

Table 5: Timeline of Approved Fictitious Application

Date	Actions of fictitious 8(a) firm	Actions of SBA
March 9, 2009		SBA confirms receipt of signed 8(a) application via email.
March 18, 2009		SBA sends a letter via email indicating application deficiencies; namely, our firm did not meet its 2 years in business requirement. To continue processing, SBA notes that our firm would have to submit documents demonstrating that we met business waiver requirements. SBA also requested the following: • copies of all contracts with corresponding customer payments, invoices, and bank statements equaling revenues reflected in financial statements; • copies of personal taxes stamped by IRS; • evidence of payment for taxes owed; and • clarification of information provided in our financial statements, among other things.
April 13, 2009	Mailed requested items to SBA.	
May 12, 2009		SBA sends an email indicating that our application required follow-up. Items requested include: • additional documentation that supports revenue and evidence of annual personal income; • a front and back photocopy of several bank-deposited checks, and evidence of available credit; • explanation of a promissory note; and • updated income statement and balance sheets.
May 27, 2009	Emailed requested items to SBA.	
June 8, 2009		SBA requests evidence of payment for 2008 taxes, and that we certify that there have been no changes with our firm since the submission of our application.
July 16, 2009	Emailed requested items to SBA.	
July 21, 2009		SBA runs a credit report on our firm.

[19]This application was submitted with less than the necessary 2 years of business experience to avoid tax implications.

Date	Actions of fictitious 8(a) firm	Actions of SBA
July 28, 2009		SBA leaves a voice mail requesting a copy of our firm's business insurance.
July 30, 2009	Emailed copy of business insurance to SBA.	
August 11, 2009		Received SBA letter stating that our firm was certified as a participant in the 8(a) Business Development Program.

Source: GAO analysis.

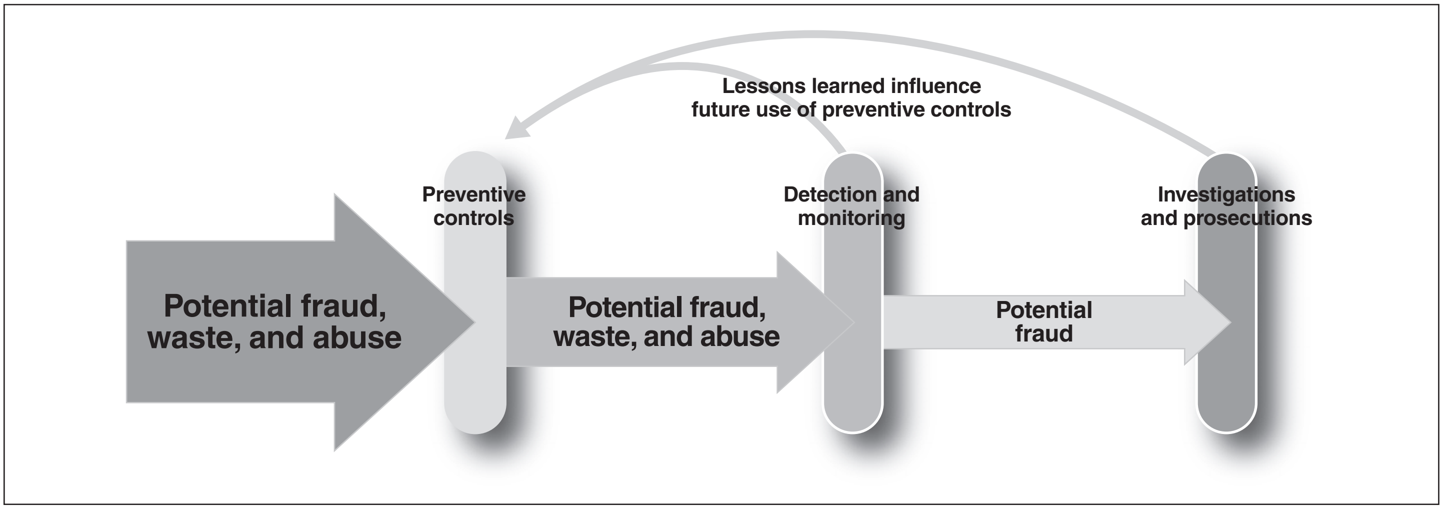
In some instances, SBA failed to adequately follow up on issues that it identified as potential concerns. For example, SBA discovered that the firm represented in this application shared the same home and business addresses as the firm represented in our third application. While SBA requested information from the owner represented in our third application to determine if the two firms operated separate concerns, no such information was requested from the owner represented in this application. Additionally, when we prepared this application, we submitted a bogus military service record and represented that the owner of our firm had over 20 years of active-duty military service. While SBA requested evidence of all compensation, including a military pension, the agency did not inquire as to why an honorably discharged veteran with over 20 years of military service did not report or receive any military pension after we failed to provide any information on this pay on our income tax returns. Moreover, because this firm had been in business for less than 2 years, SBA requested that we provide documentation to prove that the president had substantial business management experience. We were also required to document that the firm had the technical experience to carry out its business plan; adequate capital to sustain operations; a record of successful performance on contracts; and the ability to obtain personnel, facilities, and equipment to perform on contracts if admitted to the program. SBA did not independently verify any of the information that we submitted was true. SBA did not verify that we actually performed work on any of the contracts we stated we had previously obtained, nor did it confirm if we had the office space that we represented as our firm's bona fide place of business. If SBA had verified any of the information in the documents that we submitted for this waiver, it would have discovered that none of it was true.

8(a) Program Has Inadequate Controls to Prevent Fraud and Abuse

The 14 case studies of ineligible firms discussed above and the certification of a bogus firm show that weaknesses exist in SBA's controls for preventing, detecting, monitoring, and investigating fraud and abuse in the 8(a) program. We did not systematically test SBA's fraud prevention controls, but the awarding of over $325 million in sole-source and set-aside 8(a) contracts to just 14 ineligible firms illustrates the need for improving them. Fraud prevention requires a system of controls which, in their aggregate, minimize the likelihood of fraud occurring while maximizing the possibility of detecting any fraudulent activity that may transpire. Fraud prevention systems set forth what actions constitute fraudulent conduct and specifically spell out who in the organization handles fraud matters under varying circumstances. The potential of being caught can also deter likely perpetrators from committing fraud.

No system of internal control can provide absolute assurance against fraud. While the complete elimination of fraud risk is unlikely, agencies can take constructive steps to reduce their exposure. As shown in figure 4 below, a well-designed fraud prevention system (which can also be used to prevent waste and abuse) should consist of three crucial elements: (1) upfront preventive controls, (2) detection and monitoring, and (3) investigations and prosecutions. For the 8(a) program this would mean (1) front-end controls at the application stage, (2) fraud detection and monitoring of firms already in the program, and (3) the aggressive prosecution or suspension and debarment of individuals committing fraud. In addition, as shown in figure 4, the organization should use "lessons learned" from its detection and monitoring controls and investigations and prosecutions to design more effective preventive controls.

Figure 2: Fraud-Prevention Model



Source: GAO.

Preventive Controls

We found weaknesses and strengths in SBA's fraud prevention controls for the 8(a) program. Controls that keep ineligible firms and individuals from entering a federal program in the first place are the most efficient and effective means to minimize fraud, waste, and abuse. Three examples of preventive controls are validating data used in decision making against other government or third-party sources, inspecting whenever possible to confirm information, and training staff on fraud awareness.

Data Validation: SBA relied heavily on self-reported information from the firms during the initial certification and annual reviews, particularly in evaluating an individual's adjusted net worth and total assets, with limited data validation performed after firms enter the program. At the time of application, and for each year of their 9-year term, SBA requires 8(a) firm presidents to complete a "Personal Financial Statement." This statement is the primary document used to calculate the individuals' assets and liabilities. SBA uses the information disclosed in it to determine whether an applicant's adjusted net worth is under $250,000 at the time of application and under $750,000 during the 9-year program period. SBA's 8(a) standard operating procedures require agency staff to verify the completeness of all information provided to them by program participants. However, officials in the 8(a) program office told us that the only document routinely used to "cross-check" the value of assets and liabilities disclosed in the statement is the president's annual tax return. While the information found in a tax return can corroborate the income component of a president's adjusted net worth, it would not allow SBA to confirm the value of assets, such as the president's retirement account or other stocks and bonds being held. It also would not confirm how much equity a president has in an investment property, among other things. While, a president's spouse is also required by regulation to submit separate financial information to SBA, recent Office of Hearings and Appeals (OHA) decisions have interpreted the regulation to exclude consideration of a spouse's assets in the calculation.[20] Regulations do not specifically prohibit SBA from taking a spouse's assets or income into consideration. On the basis of our work, there is evidence that 8(a) firm presidents are using this loophole to "hide" assets by transferring or holding them in a spouse's name, as illustrated in Cases 1 and 10.

We found SBA applied some effective validation controls during the processing of our successful application. We requested to review this firm's file without alerting SBA to the fact that the firm was our bogus applicant. On the basis of this review, we documented that SBA verified (1) business information through Dun and Bradstreet; (2) credit and loan information through the Credit Bureaus; (3) federal loan delinquency status through the U.S. Department of Housing and Urban Development's (HUD) Credit Alert Interactive Voice Response System (CAIVRS); and (4) suspension and debarment status through the Excluded Parties List System. Nevertheless, these controls did not allow SBA to identify the bogus documents we submitted. Although SBA guidance requires the request of income tax transcripts from the IRS in order to validate tax returns submitted by applicants, in the case of our bogus firm that was certified, SBA did not request a tax transcript. SBA's data validation controls are strongest during the initial certification phase, but are less rigorous during subsequent annual reviews. For example, according to the program's standard operating procedures, SBA does not routinely request tax transcripts from the IRS once a firm has been certified to participate in the program. Instead program staff is advised by internal procedures to request the tax transcript "as needed."

[20]The Office of Hearings and Appeals (OHA) is an independent office of the SBA established in 1983 to provide an independent, quasi-judicial appeal of certain SBA program decisions.

Inspection: As we reported in 2008, SBA staff stated that emphasis on ensuring the completion of 100 percent of 8(a) firm annual reviews, an inefficient termination process, and resource constraints, limited the amount of time available for staff to conduct site visits of 8(a) firms.[21] There is neither a requirement that SBA conduct a site visit of a firm prior to certification, nor must the applicant meet anyone from SBA in person prior to entering the program. We conducted unannounced site visits and found instances of firms in violation of 8(a) program regulations. For example, when the president of the firm highlighted in Case 1 applied for initial certification, SBA raised several questions and concerns about the president's affiliation with his previous employer, a recently graduated 8(a) firm. However, officials in the New Jersey district office stated that they had not been able to conduct a site visit on any firm in their portfolio in several years. Our site visit verified that the president had made numerous misrepresentations on his application.

Staff Training: SBA staff responsible for annually recertifying firms for program participation told us that they are provided with limited fraud detection training. As a result, these staff may not be adequately trained to detect the occurrence of fraud in the 8(a) program.

Detection and Monitoring

Although preventive controls are the most effective way to minimize fraud, continual monitoring is an important component in detecting and deterring fraud. Monitoring and detection within a fraud prevention program involve actions such as data-mining for fraudulent and suspicious applicants and evaluating firms in order to provide reasonable assurance that they continue to meet program requirements. Although SBA requires that 8(a) firms are annually recertified for participation, evidence based on our investigation of 14 firms indicates that SBA needs to strengthen its controls in order to provide reasonable assurance that only eligible firms remain in the program. For example, SBA was not able to identify properties purchased by 8(a) participants that were not reported during

[21] GAO, *Small Business Administration: Agency Should Assess Resources Devoted to Contracting and Improve Several Processes in the 8(a) Program* GAO-09-16 (Washington, D.C.: Nov. 21 2008).

the annual review. Moreover as noted in our related report,[22] SBA failed to complete some required annual review procedure 55 percent of the time.[23]

While SBA is required to conduct a review of 100 percent of 8(a) firms annually, SBA does not use data-mining techniques or other means in order to identify "red flags;" such techniques could identify firms that might warrant further investigation. For example, data-mining techniques could be used to detect applicant firms that are operating at the same address as a graduated 8(a) firm. When we asked 8(a) program office officials whether the agency took this step during the initial application process, they told us that their current systems did not provide them with the capability to determine if firms in their own database share a common address. They also said that they did not feel a new 8(a) firm operating at the same address as a previous participant was a concern unless they have reason to believe a relationship exists that would cause them to question ownership and control, or the two companies exceed small-business size standards because of their affiliation. However, we found that when 8(a) firms were operating at the same address as a previous participant, the companies were affiliated or had commingled resources.

From our limited review, there is indication that SBA staff responsible for assessing firms' continued eligibility do not always follow established program criteria during the annual review process. As mentioned previously, some of the 14 firms described in table 1 were determined to be ineligible after our investigators confirmed information that was concealed from SBA by firm presidents. In other cases, our review of SBA's files clearly indicated that these firms were not eligible for the 8(a) program, yet SBA failed to terminate or graduate these firms from the program, as the following examples illustrate.

- In our review of SBA's file of Case 6, we found that SBA received strong indications that a nondisadvantaged individual influenced the management and operations of the current 8(a) firm, yet took no action to investigate further or to terminate the firm from the program. In January 2006, SBA received a decision letter from the Idaho

[22]GAO, *Small Business Administration: Steps Have Been Taken to Improve Administration of the 8(a) Program, but Key Controls for Continued Eligibility Need Strengthening*, GAO-10-353 (Washington, D.C.: Mar. 30, 2010).

[23]Because these estimates are based on a probability sample, they are subject to sampling error. The 95 percent confidence interval for this estimate is (46, 64) percent of the cases, SBA failed to comply with some annual review procedure.

Department of Transportation Certification Committee on its decision to deny the 8(a) firm's application for certification as a Disadvantaged Business Enterprise.[24] The state's denial was based on concerns it found regarding the ownership and control of the firm. SBA staff told us that such a letter should raise a red flag, but acknowledged that no action was taken to review or investigate the state's findings. Then, in March 2006, SBA denied the firm's request for a mentor/protégé relationship with the nondisadvantaged individual—deeming such a relationship as "merely a vehicle to enable a non-8(a) participant to receive contracts." One month later, SBA wrote a letter to the 8(a) firm's owner about the completion of her annual review. In that letter, SBA indicated that the firm's annual revenues increased by nearly 1,300 percent over a 1-year period. It also attributed the growth to management and technical assistance the firm had received from the nondisadvantaged individual. SBA acknowledged that for the 8(a) firm to sustain such growth, it would have to depend upon the future assistance of said individual. SBA took no action to address concerns that the firm was affiliated with a nondisadvantaged individual in either of the aforementioned instances, or under the totality of the circumstances.

- For Case 4, SBA initiated termination proceedings against the 8(a) firm after conducting a site visit and determining that a nondisadvantaged individual exercised control over the 8(a) firm. It determined that the president of the 8(a) firm operated her business from the same office as her previous employer. In an attempt to convince SBA that her former employer no longer exercised control over her firm and that its efforts to terminate her from the program should cease, the 8(a) president provided SBA with a lease showing that she had relocated to an adjacent office. SBA accepted this document as evidence and dropped its termination proceedings. The agency did not take any other steps to determine whether the former employer exercised control over the 8(a) firm from within the same building.

- In Case 9, SBA staff responsible for annual reviews allowed an ineligible firm to remain in the program for 21 months past the date at which SBA staff determined that it was no longer eligible. Notes in the firm file indicate that the president had exceeded salary limitations

[24]In general, to be eligible for the Disadvantaged Business Enterprise program, persons must own 51 percent or more of a "small business," establish that they are disadvantaged within the meaning of Idaho Department of Transportation regulations, and prove they control their business.

and that the firm had exceeded all applicable size standards and was no longer "small" by federal standards. The SBA supervisor of the agency specialist responsible for the firm noted that the firm should be graduated and profiled as a success story. During the 21-month period, the firm received a contract extension worth $554,418 that it would no longer have been eligible for. We asked SBA why it awarded this contract to an ineligible firm, but were told by the audit liaison that SBA had no records related to this contract.

In a number of instances, our staff brought eligibility violations to the attention of the relevant specialist in SBA's district office. In none of these instances did the agency take any action to remove these firms from the program, even after acknowledging to our staff that the issues we raised ought to be "red flags" or cause for termination from the program. For three of the cases we investigated, 8(a) firm presidents' earned salaries that placed them in the top 1 percent of American taxpayers—a level at which SBA OHA has determined an individual is no longer economically disadvantaged. SBA regulations do set eligibility caps for adjusted net worth, but not for income and total assets. Agency staff are expected to rely on case law when determining whether program participants are economically disadvantaged for these last two criteria. However, agency staff follow case law inconsistently. These three 8(a) firm presidents received salaries which indicated they were no longer economically disadvantaged; however, SBA officials failed to graduate these firms. As we noted in our related report,[25] a file review in five SBA district offices found that for about seven percent of the 123 firms we reviewed there was no evidence that SBA reviewed the president's net worth, or SBA retained the firms despite a net worth that exceeded program limits.[26] SBA is currently considering changing the regulations to explicitly set caps for salary and total assets.

Investigation and Prosecution

The final element of an effective fraud prevention system is the aggressive investigation and prosecution of individuals who commit fraud against the federal government. However, SBA currently does not have an effective process for investigating fraud and abuse within the 8(a) program.

[25]GAO, *Small Business Administration: Steps Have Been Taken to Improve Administration of the 8(a) Program, but Key Controls for Continued Eligibility Need Strengthening*, GAO-10-353 (Washington, D.C.: Mar. 30, 2010).

[26]Because these estimates are based on a probability sample, they are subject to sampling error. The 95 percent confidence interval for this estimate is (3, 13).

Through the course of our interviews, we found that SBA staff responsible for annually assessing the eligibility of participants were not actively looking for fraud and abuse in the program. For example, we raised questions about the eligibility of one firm, and were told by the SBA employee responsible for monitoring the firm's eligibility that the firm was one of the 8(a) program's best success stories and that we would be unlikely to find any problems with the firm's operations. In another case, we provided evidence showing a participant withheld information that should have been reported and were told that if the president failed to report the purchase of several pieces of property, it was by mistake. Another official told us that they recommended the termination of a number of firms, but were overruled by their supervisors or the OHA.

In a small number of cases, SBA's Office of Inspector General (SBA OIG) has worked in collaboration with other criminal investigative units at agencies such as the Department of Defense, IRS, and the Federal Bureau of Investigation to prosecute cases of 8(a) eligibility fraud. In the last several years, the SBA OIG has recommended that SBA debar only two firms and their presidents. In one case, the firm was recommended for debarment because the financial and managerial involvement of a nondisadvantaged individual was not disclosed.[27] SBA ultimately suspended both the individual and the company and will consider debarment upon sentencing. In the other case, SBA OIG recommended that the 8(a) firm and its president be debarred for intentionally violating subcontracting limitations. SBA did not carry out the recommendation. As noted in our related report,[28] SBA lacks a formal mechanism to collect and analyze complaint data related to 8(a) eligibility. While SBA OIG maintains general complaint information such as the name of the 8(a) firm and type of complaint, an SBA OIG official told us that 8(a) complaints involving a single company generally do not rank high in priority for a review due to resource limitations and other priorities. We asked the SBA 8(a) program office if it had ever referred any firms for debarment or suspension proceedings based on their findings from their program eligibility reviews.

[27]During the application process, firms are reminded of the program's eligibility requirements. The owners sign a document stating that they understand if they misrepresent the firm's status as an 8(a) participant, or make any other false statement in order to influence the certification process in any way, they will be subject to penalties, such and fines and imprisonment.

[28]GAO, *Small Business Administration: Steps Have Been Taken to Improve Administration of the 8(a) Program, but Key Controls for Continued Eligibility Need Strengthening*, GAO-10-353 (Washington, D.C.: Mar. 30, 2010).

As of the writing of our report, the SBA liaison had not provided us an answer to the question. Officials in SBA's program office told us that while the agency annually tracks the number of firms that are terminated from the program, its records do not allow the agency to isolate which firms were terminated for fraud or abuse. While supporting the growth of 8(a) firms is an important aspect of SBA's mission, investigating those firms that are involved in fraudulent activity is essential to the integrity of the program. By failing to hold firms accountable, SBA has sent a message to the contracting community that there is no punishment or consequences for committing fraud or abusing the intent of the 8(a) program.

Conclusions

The 8(a) program needs to strengthen its fraud prevention, detection, monitoring, and investigative controls to minimize its vulnerability to fraud and abuse. SBA's prevention controls have some strengths, such as the validation of certain information with third-party sources. However, there are substantial vulnerabilities in the detection, monitoring, and investigation components. The consequences of these control weaknesses are substantial: in just the 14 cases we investigated for this report, over $325 million in sole-source and set-aside 8(a) contracts went to ineligible firms that manipulated the current system. To a substantial degree, the steps we took to investigate these firms could be part of an effective fraud detection program. Victims of the fraud and abuse in this program are legitimate economically and socially disadvantaged small businesses. To address the vulnerabilities we identified, an improved fraud prevention program is necessary. Ineligible firms will continue to participate in the 8(a) program unless the weaknesses are addressed.

Recommendations for Executive Action

In order to minimize the potential for fraud and abuse in the 8(a) program, we recommend that the Administrator of SBA take the following six actions to improve its fraud prevention program:

- As part of implementing our previous recommendation to assess the workload of business development specialists, evaluate the feasibility of using additional third-party data sources and unannounced site visits, based on random or risk-based criteria, to allow more independent verification of firm-reported data during both initial certification and subsequent annual reviews.
- Evaluate the use of fraud detection tools, such as the use of data-mining techniques (e.g., matching addresses of applicants and previous participants), and evaluate the use of financial and analytical training for business opportunity specialists.

- Enact proposed regulation changes that would specify economic disadvantage with respect to participant's income and asset levels at the time of application and annual recertification.
- Evaluate changing program regulations to require adjusted net worth or total asset calculations to include assets held by the spouses of 8(a) participants.
- Enact proposed regulation changes that would limit new firms from participating in the 8(a) program if an immediate family member is, or has been, an 8(a) participant in the same line of work.
- Develop a more consistent enforcement strategy, to include the suspension or debarment of contractors who knowingly misrepresent themselves to qualify for the 8(a) program.

Agency Comments and Our Evaluation

We provided a draft of this report to SBA for comment. In response, the Associate Administrator for the Office of Government Contracting and Business Development provided written comments. SBA fully endorsed five of our six recommendations and indicated that it would evaluate one recommendation based upon the comments it received as a result of the proposed 8(a) rule change. SBA stated that it looked forward to resolving the issues outlined in this report and strengthening the 8(a) program. SBA's comments are reprinted in appendix II.

SBA agreed with our recommendation that called for evaluating the feasibility of using additional third-party data sources and unannounced site visits. SBA stated that it will evaluate the third-party data validation sources it currently uses to determine the need for an independent verification of firm-reported data. The agency also stated that it will use individualized and group training to re-emphasize the requirement to conduct unannounced site visits, where appropriate. SBA agreed with our recommendation to evaluate the use of fraud detection tools, such as data-mining techniques, and financial and analytical training. SBA stated that the agency has already begun this evaluation process and plans to conduct on-going training on determining 8(a) participant eligibility. SBA agreed with our recommendations related to specifying economic disadvantage with respect to an 8(a) participant's income and asset levels, and limiting new firms from participating in the program if an immediate family member is, or has been an 8(a) participant in the same line of work. SBA noted that these changes are included in the proposed 8(a) regulation changes. SBA agreed with our recommendation to develop a more consistent enforcement strategy for contractors who knowingly misrepresent themselves to qualify for the program, and stated that it would disseminate guidance to all business development personnel outlining a consistent strategy for recommending immediate enforcement action for firms that knowingly misrepresent their eligibility.

For the remaining recommendation related to requiring adjusted net worth and/or total asset calculations to include assets held by the spouses of 8(a) participants, SBA indicated that it would evaluate this recommendation based upon the comments it received as a result of the proposed 8(a) rule change. While we are respectful of the rule-making process, our investigation found that by not evaluating a spouse's assets in determining a participant's eligibility there is a significant loophole that allows 8(a) participants to hide assets by transferring or holding them in a spouse's name.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies of this report to interested congressional committees and members, federal agencies, and other interested parties. In addition, this report will also be available at no charge on GAO's Web site at http://gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-6722 or kutzg@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who contributed to this report are listed in appendix III.

Sincerely yours,

Gregory D. Kutz

Gregory Kutz
Managing Director
Forensic Audits and Special Investigations

Appendix I: Scope and Methodology

To determine whether ineligible firms are participating in the 8(a) program, we used a risk-based approach to identify firms that exhibited signs that they were not qualified for the program.[1] For example, we used data from the Federal Procurement Database System-Next Generation (FPDS-NG) to determine which firms in the Washington, D.C., Metropolitan Statistical Area received the most 8(a) contracts in 2006 and 2007. Next, we used data from the Small Business Administration's (SBA) Dynamic Small Business Search (DSBS) Web site to identify current 8(a) firms that were operating at the address of a graduated 8(a) firm. We limited this search to Washington, D.C., because there are significantly more firms located there than in any other area in the country. We used information about 8(a) firms provided by SBA to data mine for potentially fraudulent activity. In addition, we pursued leads found during the course of our work on the Service Disabled Veteran Owned Small Business and HUBZone programs. Finally, we established a new hotline, SmallBizFraud@gao.gov, to receive allegations of fraud related to SBA contracting programs. We advertised this hotline on GAO's Web site and in a major newspaper in the Washington, D.C., region. We received over 30 allegations of fraud and abuse in the 8(a) program through the hotline—far more than we were able to investigate given time and resource constraints. Six of these allegations were substantiated during the course of this work.

From these sources, we selected 14 cases for further investigation based on a variety of factors, such as facts and evidence provided in allegations and whether a firm received multiple 8(a) contracts. For the purposes of our investigation, we defined a case as one or more affiliated firms or joint ventures that obtained an 8(a) contract. To investigate these case studies, we reviewed documentation available from SBA in the firms' official files, including initial application materials, and documentation required by the annual review process. We worked with SBA's audit liaison to request this documentation; in some instances we received information directly from officials in SBA district offices and other times information was transmitted through this liaison. In some cases, we conducted both announced and unannounced site visits and interviewed firm owners, managers, and previous employees. We requested supporting documentation from some firms. We used a variety of investigative methods—such as analyzing firm payroll data, verifying the value of assets, and reviewing information from investigative databases—to gather

[1]We excluded Alaskan Native Corporation (ANC) 8(a) firms from our investigation due to different qualification standards.

information about the firms and to determine whether the firms' or their principals met 8(a) program criteria. In some cases, we also met with SBA staff responsible for annually recertifying these firms for the 8(a) program. Although 8(a) firms must meet several eligibility criteria to enter and remain in the program, we did not test all criteria. Generally, our investigations focused on whether firms' presidents were economically disadvantaged, and whether they managed the day-to-day operations of the firm because we felt these eligibility criteria posed the highest risk of being misrepresented to SBA. We did not, for example, attempt to independently verify whether the presidents of any 8(a) firms were United States citizens. We also analyzed data from FPDS-NG to identify 8(a) contracts received by the firms during their participation in the program.

In order to determine whether SBA only certifies firms that are qualified and capable of meeting the business development objectives of the 8(a) program, we established four fictitious companies and used fabricated documentation in our applications. For one firm, we employed the services of a private company that offered "8(a) Certification Services" to determine if such businesses offer the advantage that they advertised. We selected this particular firm because it described itself as deft at helping individuals who are not generally classified as disadvantaged obtain 8(a) certification for their firms. The firms we created were designed to appear as credible businesses that met basic 8(a) program eligibility criteria. These criteria require SBA to consider the following factors when screening applicant firms: (1) technical competence and managerial experience of the applicant firm's managers; (2) the operating history of the firm; (3) the firm's record of performance on previous federal and private sector contracts in the primary industry in which it is seeking 8(a) certification; (4) its financial capacity; and (5) the requisite licenses if the firm is engaged in an industry requiring professional licensing. As part of SBA's application process, agency officials review financial statements, conduct credit checks, and request copies of personal and business tax transcripts from the applicant as well as directly from the Internal Revenue Service (IRS). If SBA requested tax information associated with our bogus firms from the IRS, no record would have existed and our firms may have been deemed ineligible. Because SBA standard operating procedures require verification of tax information with the IRS, our tests did not focus on whether SBA carried this step out in any of the four cases. Therefore, to allow us to proactively test SBA's 8(a) program application process, we used Employer Identification Numbers (EIN) and undercover Social Security numbers to file real tax returns with the IRS for our four bogus individuals. In order to minimize our costs associated with paying taxes, we created tax scenarios in which our firms reflected net business losses over multiple tax years. While these income scenarios minimized our costs, they limited our testing scenarios to firms that were not profitable, and thus the likelihood that our firms could meet SBA's definition of success.

To determine what vulnerabilities, if any, existed in SBA's fraud prevention system, we made observations based on our case studies and proactive testing. We did not perform a systematic evaluation of the 8(a) program's fraud prevention system. We reviewed relevant regulations and guidance governing the program. We also interviewed officials from the Office of Inspector General, 8(a) program office, and SBA General Counsel about their responsibility over the program and controls currently in place to prevent, detect, and monitor fraud and abuse. Furthermore, we compared current controls in the 8(a) program to a fraud-prevention model developed by GAO and utilized in prior small- business contracting investigations. Our work was not designed to identify all fraud and abuse in the 8(a) program or estimate its full extent for the entire population of 8(a) firms.

We conducted our audit work and investigation from October 2008 through January 2010 in accordance with U.S. generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our objectives. We performed our investigative work in accordance with the standards prescribed by the Council of the Inspectors General on Integrity and Efficiency (CIGIE).

Appendix II: Comments from the Small Business Administration

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

March 8, 2010

Mr. Gregory Kutz
Managing Director
Forensic Audits and Special Investigations
U.S. Government Accountability Office
Washington, DC 20548

Dear Mr. Kutz:

The U.S. Small Business Administration (SBA) is pleased to provide a response addressing the issues outlined in your draft Government Accountability Office (GAO) Report Number: GAO-10-425, entitled, "8(a) Program – 14 Ineligible Firms Receive $325 million in Sole Source and Set Aside Contracts."

BACKGROUND:

As you are aware, since its inception, the 8(a) Business Development (BD) Program has significantly enhanced the SBA's mission and contributed toward the growth of the American economy. Although the 8(a) BD Program has enjoyed numerous successes, we recognize that there are weaknesses and areas that require increased monitoring and oversight. In an effort to address these weaknesses, in October 2009, SBA drafted proposed regulatory revisions aimed at strengthening opportunities for disadvantaged small businesses to benefit from its 8(a) BD program. The proposed 8(a) regulation changes are the result of the first comprehensive review of the 8(a) BD program in a number of years and were published in the *Federal Register*. The rules cover a variety of areas of the program, ranging from providing further clarification on determining economic disadvantage to requirements on Joint Ventures and the Mentor-Protégé program. The public comment period was extended to January 28, 2010, in an effort to obtain comments from our broad customer base as well as other stakeholders.

The 8(a) BD program has a proven track record as an effective program for helping socially and economically disadvantaged small businesses gain access to training and contracting opportunities to help them grow, create jobs and ultimately succeed in the marketplace upon leaving the program. We believe that the proposed 8(a) changes build on that foundation of success, and will strengthen the program and maximize its benefits for eligible small businesses.

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ROLES AND RESPONSIBILITIES:

SBA's 8(a) BD program is delivered collaboratively between two departments of the SBA. The Office of Business Development (OBD) is responsible for policy formation and the certifications of 8(a) applications, approval of mentor- protégé applications as well as the approval of existing 8(a) firms that are exiting the program (early graduations, approval of change of ownerships, approval of voluntary withdrawals, approval of terminations, and suspensions). OBD is also responsible for the virtual training and relevant policy briefings provided to SBA staff across the country responsible for executing the 8(a) BD program on an on-going basis throughout the year.

The Office of Field Operations (OFO) is responsible for supporting the Business Development Specialists (BDS) who are tasked with executing the 8(a) BD program and are located in 68 District offices across the country. Selected BDSs will have 8(a) firms assigned to them. The BDSs work directly with 8(a) firms to help prepare business plans, provide technical assistance, review continuing eligibility, coordinate with resource partners that provide counseling, training, loans, and other assistance to small businesses, and coordinate additional assistance and training for firms through another SBA program.

The following is SBA's response to the six recommendations made by GAO regarding SBA's need to minimize the potential for fraud and abuse in the 8(a) BD program. Some of the responses include corrective measures already implemented and actions that are planned to be implemented in the near future.

GOVERNMENT ACCOUNTABILITY OFFICE'S RECOMMENDATIONS:

RECOMMENDATION 1:

As part of implementing our previous recommendation to assess the workload of business development specialists, evaluate the feasibility of using additional third-party data sources and unannounced site visits, based on random or risk-based criteria, to allow more independent verification of firm-reported data during both initial certification and subsequent annual reviews.

SBA RESPONSE TO RECOMMENDATION 1

SBA agrees with the recommendation.

OFO will assess the workload of BDSs to determine the need for additional staffing resources.

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An internal data verification process is currently being conducted by OBD. In addition, we will evaluate the third party data validation sources we currently use (IRS transcripts, CAVIRS, and Experian) to determine the need for an independent verification of firm-reported data. Through individualized and group training, we will re-emphasize the requirement to conduct unannounced site visits, where appropriate in determining a participant's continuing 8(a) BD program eligibility.

RECOMMENDATION 2:

Evaluate the use of fraud detection tools, such as the use of data-mining techniques (e.g. matching addresses of applicants and previous participants), and financial and analytical training of business opportunity specialists.

SBA RESPONSE TO RECOMMENDATION 2:

SBA agrees with this recommendation.

OBD has already begun this evaluation process. SBA will conduct on-going training of BD personnel for purposes of determining 8(a) participant's continuing eligibility. Several staff in OBD are currently participating in a comprehensive agency-sponsored data training course which will significantly enhance their data analytical skills. Also, OBD has developed the course content and format for a National Training Conference, planned for June 2010, which is intended to provide in-depth training in the areas of financial and data analysis.

RECOMMENDATION 3:

Enact proposed regulation changes that would specify economic disadvantage with respect to participant's income and asset levels at the time of application and annual recertification.

SBA RESPONSE TO RECOMMENDATION #3:

SBA agrees with this recommendation and has included this change in the proposed regulations.

The proposed changes to the 8(a) regulations specifically address the area of economic disadvantage. In addition, OBD has revised Chapter 5, *"Participant Review Process"* and Chapter 10, *"Leaving the 8(a) Business Development Program"* of the 8(a) Standard Operating Procedures 80 05 3 (SOP) to provide improve the guidance available to BD personnel related to determining a participant's income and asset levels as it relates to continuing eligibility. SBA intends to evaluate whether additional SOP revisions will be required once the proposed rule making is complete.

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RECOMMENDATION 4:

Evaluate changing program regulations to require adjusted net worth and/or total asset calculations to include assets held by the spouses of 8(a) participants.

SBA RESPONSE TO RECOMMENDATION 4:

SBA will evaluate this recommendation based upon the comments received as a result of the proposed 8(a) rule change.

The proposed 8(a) regulatory change will evaluate and clearly define when and how a family member's assets will be included in the assets of the 8(a) participant. The proposed 8(a) regulations stipulate that SBA may consider a spouse's financial situation in determining an individual's access to capital and credit. It is anticipated the revised 8(a) regulations will be finalized by October 2010.

RECOMMENDATION 5:

Enact proposed regulation changes that would limit new firms from participating in the 8(a) BD program if an immediate family member, is, or has been an 8(a) participant in the same line of work.

SBA RESPONSE TO RECOMMENDATION 5:

SBA agrees with this recommendation and has included this change in the proposed regulations.
In order to prevent disadvantaged individuals from using family members to extend their program terms and to prevent fronts, SBA proposes to amend 13 C.F.R. § 124.105(g) to provide that an individual may not use his or her disadvantaged status to qualify a firm if such individual has an immediate family member who has used his or her disadvantaged status to qualify another firm for participation in the 8(a) BD program. However, the proposed rule will permit the SBA's Associate Administrator for Business Development (AA/BD) to waive this prohibition under certain circumstances.

RECOMMENDATION 6:

Develop a more consistent enforcement strategy, to include the suspension and/or debarment of contractors who knowingly misrepresent themselves to qualify for the 8(a) BD program.

SBA RESPONSE TO RECOMMENDATION 6:

SBA agrees with this recommendation.

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OBD will disseminate guidance to all BD personnel outlining a consistent strategy for recommending immediate enforcement action for firms that knowingly misrepresent themselves to obtain 8(a) BD program certification.

Again, thank you for the opportunity to provide comments on this draft GAO Report. My staff and I look forward to working with you in resolving the issues outlined in this draft GAO Report as we seek to strengthen the SBA's 8(a) Business Development program.

If you have additional questions or comments, please contact me directly.

Sincerely,

Joseph G. Jordan
Associate Administrator
Office of Government Contracting
and Business Development

Appendix III: GAO Contact and Staff Acknowledgments

GAO Contact

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Staff Acknowledgments

In addition to the individual named above, Cindy Brown Barnes, Eric Eskew, Dennis Fauber, Grant Fleming, Matthew Harris, Heather Hill, Ken Hill, Jason Kelly, Julia Kennon, Vicki McClure, Jeffrey McDermott, Andrew McIntosh, Steve Martin, Lerone Reid, and Kira Self also provided assistance on this report.

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