United States Government Accountability Office

GAO

Testimony

Before the Committee on Small Business and Entrepreneurship, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Thursday, March 3, 2011

8(a) PROGRAM

The Importance of Effective Fraud Prevention Controls

Statement of Gregory D. Kutz, Director
Forensic Audits and Investigative Service

GAO-11-440T

Madam Chair, Ranking Member Snowe, and Members of the Committee:

Thank you for the opportunity to discuss the results of our prior investigation of the Small Business Administration's (SBA) 8(a) Business Development Program. 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 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. In March 2010, GAO issued two companion reports on the 8(a) program, one focused on internal control procedures and processes that SBA has implemented to ensure that only eligible firms participate in the program and one focused on fraud prevention.[1] My testimony today is based on the latter report, and addresses three issues: (1) whether ineligible firms were participating in the 8(a) program, (2) the results of our proactive testing of the application process, and (3) strengths and weaknesses in SBA's fraud prevention system.

To determine whether firms were participating in the 8(a) program through potentially fraudulent misrepresentation, we used a risk-based approach to identify firms that exhibited signs that they were not qualified for the program. We also reviewed allegations of fraud and abuse sent to our e-mail address established to receive reports about small business contracting programs. 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 conducted both announced and unannounced site visits and interviewed firm employees and executives. The selection of the 14 firms we investigated was not representative and

[1] 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) and GAO, *8(a) Program: Fourteen Ineligible Firms Received $325 Million in Sole-Source and Set-Aside Contracts*, GAO-10-425 (Washington, D.C.: Mar. 30, 2010).

the findings from these 14 cases cannot be projected beyond those cases. 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. To determine what strengths and weaknesses, if any, existed in SBA's fraud prevention system, we made observations based on our case studies and proactive testing. Furthermore, we compared controls in place at the time of our review of the 8(a) program to a fraud-prevention model we developed and utilized in prior small business contracting investigations. A full description of our scope and methodology is included in appendix I of our report.[2] We also requested an update from SBA on any actions that it had taken on our recommendations. We did not validate any representations made by SBA.

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).

My testimony today summarizes our findings on each of the three issues discussed in our report. Specifically, we found that:

- ***Ineligible firms are participating 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. These 14 firms received another $1.2 billion in other federal obligations since entering the 8(a) program, including $17 million in awards through the American Recovery and Reinvestment Act of 2009.[3] We found evidence that showed that officials at 13 of these firms misrepresented their eligibility for the program to fraudulently acquire or maintain 8(a)

[2] GAO, *8(a) Program: Fourteen Ineligible Firms Received $325 Million in Sole-Source and Set-Aside Contracts*, GAO-10-425 (Washington, D.C.: Mar. 30, 2010).

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

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) 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. A description of all 14 case studies is included in Table 1 of our report.[4] Subsequent to issuing this report, we referred all 14 cases to SBA and the agency's Office of Inspector General.

- ***SBA's application process has both strengths and weaknesses.*** SBA had certain strengths in its 8(a) application process that allowed the agency to correctly determine that three of the four bogus firms from our proactive testing were not eligible for the 8(a) program. We also identified vulnerabilities that demonstrate weaknesses ineligible firms could exploit to fraudulently receive program certification. In the first of our three unsuccessful applications, SBA stated that it denied our application because the firm lacked the financial capacity to perform 8(a) contracts. For the other two 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. A description of the scenarios and outcomes for all four bogus firm applications is included in our report.[5]

---

[4] GAO, *8(a) Program: Fourteen Ineligible Firms Received $325 Million in Sole-Source and Set-Aside Contracts*, GAO-10-425 (Washington, D.C.: Mar. 30, 2010).

[5] GAO, *8(a) Program: Fourteen Ineligible Firms Received $325 Million in Sole-Source and Set-Aside Contracts*, GAO-10-425 (Washington, D.C.: Mar. 30, 2010).

- ***SBA's fraud prevention system has both strengths and weaknesses.*** 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. 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. A well-designed fraud prevention system 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 effective (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 our report we describe specific strengths and weaknesses that we identified during the course of our review. For example, a strength we identified was SBA's use of certain third-party sources, such as Dun and Bradstreet and the Credit Bureaus, to verify some information about our bogus firm that was certified for the program. Nevertheless, these controls did not allow SBA to identify the fake documents we submitted. We also reported that based on our limited review there was indication that SBA staff responsible for assessing firms' continued eligibility did not always follow established program criteria during the annual review process. As mentioned previously, some of the 14 firms 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.

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 prevention program. Victims of the fraud and abuse in this program are legitimate economically and socially disadvantaged small businesses. To address the vulnerabilities we identified, our report provided 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 sixth 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.[6] Although SBA needs time to implement these changes, and we have not done a comprehensive follow-up on their actions, SBA has taken action on some recommendations, while according to SBA, implementation of others is in progress. For example, SBA enacted final regulation changes on February 14, 2011 which address three recommendations relating to firm eligibility requirements. The regulations provide more clarification on factors that determine economic disadvantage as it relates to total assets, gross income, retirement accounts and a spouse of an 8(a) company owner when determining the owner's ability to access capital and credit. These changes take effect on March 14, 2011. In addition, SBA officials told us that they have been evaluating the use of third-party data systems to verify firm information when conducting initial certification reviews. SBA officials also stated that they have provided forensic accounting training to all SBA staff responsible for conducting these initial certification reviews, and the agency plans to expand this training in fiscal year 2011 to all SBA field staff responsible for annual reviews. SBA officials also stated that they will revise the program's standard operating procedures to reflect the regulatory changes, to increase certain reporting requirements and to provide more detailed and concrete guidance on initiating suspensions and debarments. In addition, according to SBA, the agency has taken steps to terminate some of the firms identified in our report, and has referred other cases to the SBA Office of Inspector General.

Madam Chair, and Ranking Member Snowe, this concludes my statement. I would be pleased to respond to any questions you or other Members of the Committee may have.

[6] Our companion report on the 8(a) program's internal controls also contained six recommendations to SBA that included providing more guidance to help ensure staff more consistently follow procedures, reassessing certain staff workload distribution, and developing more standard processes for documenting and analyzing certain program data. SBA agreed with each of the six recommendations. See, 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).

Contacts and Acknowledgments

For additional information about this testimony, please contact Gregory D. Kutz 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 statement.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to www.gao.gov and select "E-mail Updates."

Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, http://www.gao.gov/ordering.htm.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548