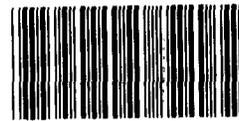


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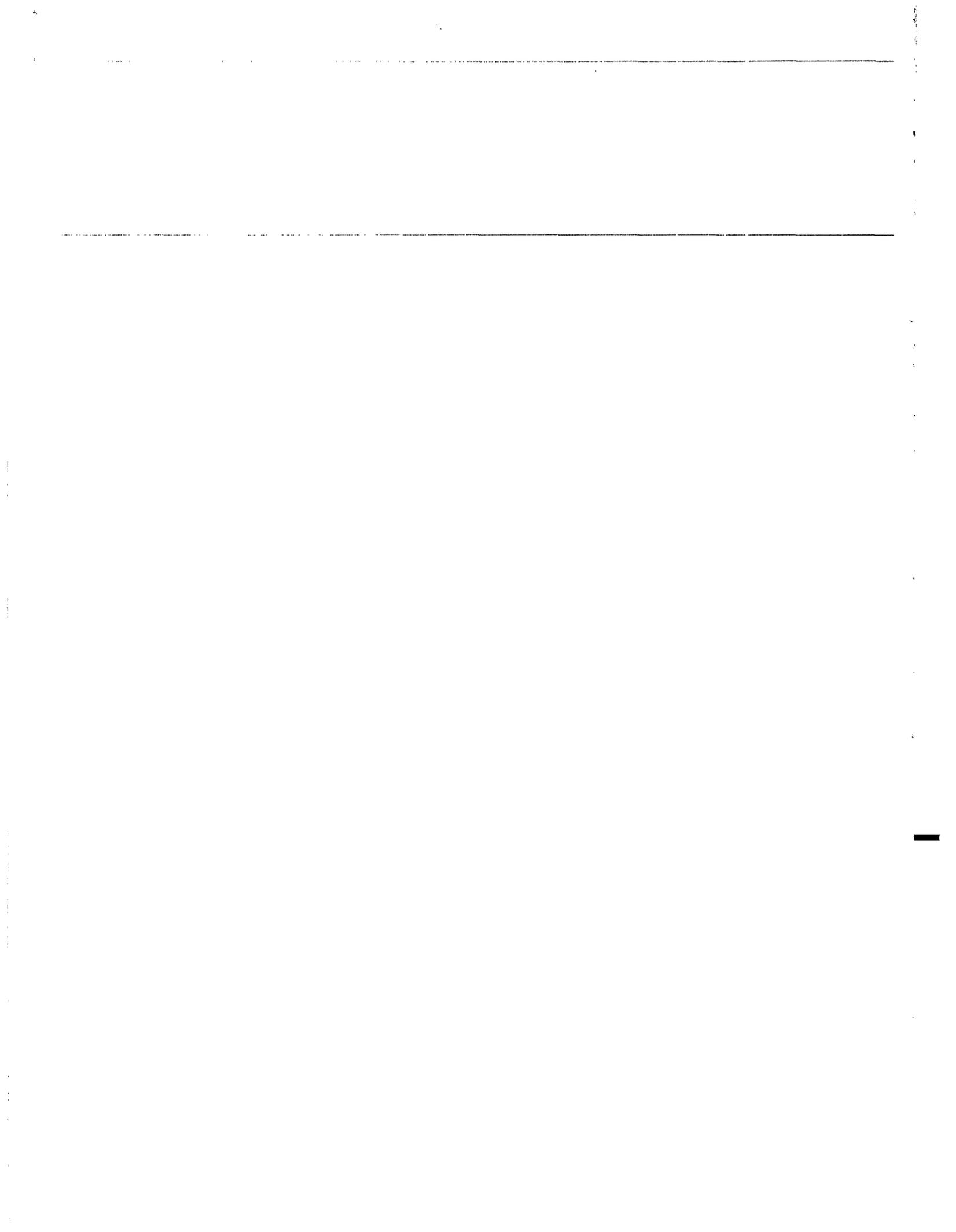
DEFENSE
CONTRACTING

Interim Report on
Mentor-Protege
Program for Small
Disadvantaged Firms



146376





**National Security and
International Affairs Division**

B-247530

March 30, 1992

The Honorable Sam Nunn
Chairman, Committee on
Armed Services
United States Senate

The Honorable Les Aspin
Chairman, Committee on
Armed Services
House of Representatives

This report responds to the statutory requirement that we provide an interim report on the Mentor-Protege Pilot Program within the Department of Defense (DOD). As specified by section 831 of the National Defense Authorization Act for Fiscal Year 1991 (P.L. 101-510), our objectives were to

- evaluate the regulatory implementation of the program,
- assess the initial participation of eligible mentor and protege firms,
- identify any deficiencies in the statutory and regulatory framework of the program that are likely to impair success, and
- recommend corrections to any impediments to the program.

Background

In 1986, congressional concern about the low participation of small disadvantaged businesses¹ (SDBs) within DOD's procurement system resulted in section 1207 of the National Defense Authorization Act for Fiscal Year 1987 (P.L. 99-661). This section established a goal that 5 percent of the total dollar amount subcontracted by DOD prime contractors be awarded to SDBs. The Congress originally set the goal for fiscal years 1987 through 1989, but extended it through fiscal year 1993. The goal has never been met.

To provide incentives for prime contractors to increase SDB participation in DOD subcontracting, the Congress in 1990 mandated the Mentor-Protege Pilot Program. Under the program, prime contractors (mentors) are to

¹To qualify as a small disadvantaged business, a company must not exceed the Small Business Administration's standards for number of employees or annual sales and must be independently owned (at least 51 percent) and operated by socially and economically disadvantaged individuals.

assist SDBs (proteges) in enhancing their capabilities as subcontractors and suppliers for DOD and other federal agencies. The program provides incentives for prime contractors in the form of cash reimbursement, credit towards SDB subcontracting goals,² or a combination of both. The program, among other things, authorizes mentors to award noncompetitive contracts to proteges and to provide loans or make other investments in the protege firm.

DOD published proposed regulations for comment in May 1991 and issued final regulations for partial implementation of the program in August 1991. The program began on October 1, 1991. The DOD Office of Small and Disadvantaged Business Utilization (OSADBU) is responsible for program management and administration, and DOD program managers are to be a source through which mentors identify funding.

In December 1991, the Congress authorized \$30 million in fiscal year 1992 funds for the program. The Congress is to evaluate the pilot effort in 1994 and consider reauthorization and extension of the program governmentwide. We are required to provide a final report on the implementation of the pilot program by February 1, 1994.

Results in Brief

DOD's program policy and procurement regulations are consistent with legislative requirements and congressional intent for the Mentor-Protege Pilot Program. As a result of comments on the proposed regulations that characterized some provisions as restrictive or burdensome, DOD incorporated changes into the final regulations. Although some provisions considered restrictive or burdensome remain, these are generally necessary for program implementation and are unlikely to be major impairments to the success of the program.

The program was not fully implemented on October 1, 1991, as originally intended, because the Congress did not provide specific funds for cash reimbursement until December 1991. In addition, DOD did not adopt an aggressive implementation strategy. For example, DOD did not take action to involve program managers in sponsoring mentor-protege agreements until December 5, 1991. The lack of an aggressive strategy initially was

²In acquisitions exceeding \$500,000 (\$1 million for construction), prime contractors are required to establish a subcontracting plan that specifies the percentage goal of subcontract awards to SDBs. This requirement was in over 13,000 contract actions in fiscal year 1990 valued at more than \$82 billion.

understandable because of uncertainty about the amount and timing of program funds. However, the President has since proposed that the fiscal year 1992 funds for the pilot program be rescinded as part of a budget-cutting effort. With participation essentially limited to mentors seeking credit towards subcontracting goals, OSADBU had approved 8 agreements and had 12 applications in process as of March 6, 1992. OSADBU plans to modify regulations to permit cash reimbursement through separate contracts, but only if funds become available. With full implementation delayed about 1 year, the Congress's reauthorization and extension decision scheduled for 1994 could be affected.

DOD has not established internal controls for reviewing and approving applications or monitoring the program. An internal control system could serve to protect the integrity of the program. Our review indicated that OSADBU neither verified nor test-checked data in the mentor-protege applications.

Identifying impediments to the pilot program is difficult at this early implementation stage; however, we identified the following potential impediments:

- Success will be difficult to determine using existing program measures. These measures do not quantify specific program accomplishments or rates of progress, and therefore do not provide adequate evaluation criteria for determining program success.
- Current incentives may not be sufficient inducement for significant participation by prime contractors. As structured within the program, both credits against subcontracting plan goals and cash reimbursements are limited incentives.

Regulations Consistent With Statute and Congressional Intent

DOD established policies and related procurement regulations for the Mentor-Protege Pilot Program that are consistent with the statute and congressional intent. Areas of consistency include the seven allowable types of developmental assistance, the incentive structure for credit, the timetable for implementation, and terms and definitions. The regulations also include provisions that add to but do not conflict with the statute, such as application and termination procedures, protege progress reporting requirements, and program success measures. In comments to OSADBU on the proposed regulations, some respondents (primarily SDBs) characterized provisions as burdensome—involving undue paperwork or

difficult administration—or restrictive—limiting eligible participants or benefits. The following are examples:

- Of those respondents who found the regulations restrictive, the most often cited concern was that proteges were limited to one mentor while mentors could have an unlimited number of proteges.
- An application for the program, which is limited to 20 pages, must include historical information; an assessment of the assistance capability of the mentor; data on the needs of the protege, the extent of subcontract awards, and the mentor's estimated costs; and terms and conditions of the mentor-protege relationship.

Although DOD made changes based on some comments, some provisions that led to the concerns remain in the final regulations. These provisions, however, are generally necessary for program implementation and are unlikely to be major impairments. For example, the restriction of one mentor per protege is specified in an amendment to the statute. Accordingly, DOD could not address this concern. In addressing the concern about the information required for the application, OSADBU officials said that a letter of intent would be accepted in lieu of a formal mentor-protege agreement. However, all the other information requirements must be included with an application.

Implementation Strategy Limits Initial Participation

The pilot program was authorized under the National Defense Authorization Act for Fiscal Year 1991 and was expected to be fully implemented by October 1991. However, funds to reimburse mentors' costs were not authorized until the National Defense Authorization Act of 1992, which was enacted in December 1991. Subsequently, the President proposed that these funds be rescinded. Without the availability of these funds, mentor firms are limited to receiving credit towards their subcontracting goals or seeking reimbursement from DOD program managers. Because the program is voluntary, DOD's initial implementation approach was to wait for prime contractors to submit applications. As of December 31, 1991, OSADBU had received six applications and had approved two mentor-protege agreements. An OSADBU official told us that potential mentors wanted to be reimbursed for assistance provided to proteges and that mentor participation was expected to increase substantially after funds for reimbursement become available. We were told by a DOD official that OSADBU had approved 8 mentor-protege agreements and had 12 applications in process as of March 6, 1992.

According to the National Defense Authorization Act of 1991, a mentor may be reimbursed for assistance given to a protege either through an existing contract or through a separate contract entered into between the Secretary of Defense and the mentor. Because funds were not appropriated until after the program began, the option of using a separate contract had not been available to prime contractors. OSADBU officials had planned to publish an amendment to the policy regulation in March 1992 to provide for separate contracts. However, the President proposed to the Congress that the funds appropriated for the program be rescinded as part of a budget reduction proposal. Should the rescission not be approved, changing the regulations to provide for separate contracts will not result in increased participation in the program within the next several months because of the time it takes to prepare a solicitation, advertise for mentors, evaluate proposals, and award contracts. If funds become available, OSADBU hopes that some separate contracts can be awarded before the end of fiscal year 1992.

In an effort to increase participation, the Under Secretary of Defense for Acquisition, in December 5, 1991, memoranda, urged the military service acquisition executives and the directors of defense agencies to encourage their program managers to work with prime contractors and identify the money to fund at least one mentor-protege agreement during fiscal year 1992. Program managers' participation is a key program feature; however, the memoranda may not stimulate interest because it requires neither action nor follow-up.

Because DOD did not fully implement the program on October 1, 1991, and did not have an aggressive implementation strategy, the Congress's reauthorization and extension decision scheduled for 1994 could be affected. The proposed rescission of program funds could further affect the decision. With the slow program start, sufficient information may not be available to evaluate program features and incentives and decide if the program should be reauthorized and extended governmentwide.

Internal Controls Lacking

An area of program management that OSADBU has not addressed is internal controls for the program. Sound internal controls are essential to achieve program managers' objectives by serving as checks and balances against undesired actions or consequences. Within the Mentor-Protege Pilot Program, the application, review, and evaluation processes do not have controls to (1) validate or test-check information in mentors' applications, (2) ensure separate accounting treatment for reimbursement and credit, or

(3) verify the progress reports on protege development. OSADBU processed and approved the initial applications for credit without these controls. As a result, these approvals were based on information provided solely by the participants in the applications. Without any verification and validation, DOD has no assurance that the assistance to be provided will enhance proteges' capabilities to participate in federal and commercial contracts. In December 1991, OSADBU was considering asking the Defense Logistics Agency to update its small business program operations manual, which provides internal control procedures for SDB programs.

Program Impairment Issues

The early status of the Mentor-Protege Pilot Program makes the identification of impediments difficult. The program addresses some of the factors needed for increased participation of SDBs, such as developing the capability to manufacture DOD weapon systems, fostering long-term relationships with prime contractors, and financing the cost borne by prime contractors who choose to develop SDBs. However, we have identified two potential impediments to the program. First, the existing measures of program success are inadequate. Second, current program incentives may not prove sufficient to induce sufficient numbers of prime contractors to enter into mentor-protege agreements.

Lack of Adequate Criteria for Success

The Mentor-Protege Pilot Program does not have adequate evaluation criteria to determine accomplishments or the rate of progress in achieving its goal. Although the authorizing legislation and implementing regulations provide program success measures, these measures do not quantify specific accomplishments to be achieved under the program. They therefore do not provide an adequate basis for determining program success. Also, some of the results that will be used to determine its success, such as increases in subcontracts to proteges and improvements in their participation in DOD contracts, might or might not occur independent of the program.

The purpose of the Mentor-Protege Pilot Program is to provide incentives for major DOD contractors to furnish SDBs with assistance to enhance their capabilities to perform as subcontractors and suppliers in order to increase the participation of such businesses. The legislative intent, as expressed in the Joint Explanatory Statement of the Committee of Conference, is that the success of the program will be measured largely by whether the number of subcontracts awarded to SDBs increases. The DOD policy has eight measures by which DOD intends to judge overall program success.

These include increases in the number and value of contract and subcontract awards to proteges, the development of competitive proteges, and the involvement of "emerging" SDBs. See appendix I for more detailed information on the program measures.

The program success measures, however, do not indicate the amount of improvement or the rate of increase that DOD is seeking to achieve. Accordingly, determinations about success will be subjective.

Also, even if the numerical value of change were specified and success objectively defined, SDB performance may not be directly attributable to the Mentor-Protege Pilot Program. Expected decreases in DOD contracting dollars could more directly affect percentages and dollar amounts of SDB subcontracts than could the Mentor-Protege Pilot Program. For example, the percentage of subcontracts awarded to SDBs increased from 1.9 percent in fiscal year 1987 to 2.9 percent in fiscal year 1990. This equated to a \$550 million, or a 54 percent, increase in the dollar value of subcontracts awarded to SDBs. The first three quarters of fiscal year 1991 showed continued progress, with 3.2 percent of subcontract awards going to SDBs. However, this latest improvement in the percentage of subcontracts to SDBs is attributable more to a reduction in overall subcontract awards than to an increase in awards to SDBs. DOD's report, Companies Participating in the DOD Subcontracting Program, showed that for the first three quarters of fiscal year 1991 overall subcontract awards were \$5 billion less than in the previous comparable period while the value of SDBs' subcontracts increased by \$35 million. Accordingly, changes outside the program can significantly affect the percentage and dollar amount of awards to SDBs.

Incentives Might Not Be Sufficient

Program incentives—credit toward subcontracting goals and cash reimbursement for assistance provided—might not be sufficient to attract significant numbers of prime contractors. Specifically, credit cannot be used to earn incentive fees, and its value depends on DOD effectively managing prime contractors' subcontracting plans. Furthermore, the appeal of cash reimbursements is diminished because prime contractors cannot earn a profit on the developmental assistance provided to proteges.

Mentors can earn credit under the program based on the amount and type of assistance provided to proteges. Each dollar of credit that mentors earn counts toward meeting their subcontracting goals the same as the dollar value of subcontracts awarded to SDBs. Accordingly, the value of credit

depends on the effective management of subcontracting goals and on the incentives and penalties used in achieving these goals. As part of its subcontracting plan, a contractor can receive fees of up to 10 percent of the SDB subcontract amount in excess of the goal. On the other hand, if the contractor does not make a "good faith effort" to comply with the subcontracting plan in the contracting officer's opinion, funds can be withheld. However, Mentor-Protege Pilot Program regulations prohibit the use of credit to earn incentive fees. Also, DOD officials believe that contracting officers have not withheld funds from prime contractors for insufficient effort to meet subcontracting goals.

The credit feature of the program is important for other organizations identified in the statute as potential participants in mentor-protege agreements. These organizations are small business development centers, historically black colleges and universities, minority institutions, and procurement technical assistance centers. If mentors use these organizations in developing proteges, they receive credit at four times the total amount of their costs. Otherwise, mentors receive credit at either two or three times the cost of assistance provided. This legislative preference for selected assistance would be affected if the value of credit is limited.

If the restriction on the use of credit is lifted, DOD's effective management of prime contractors' subcontracting activities becomes more critical. However, DOD officials did not have data that demonstrate the extent to which its existing programs increased SDB participation in the subcontractor base. Data on subcontract plans and incentives, although not compiled and analyzed, are available in various DOD reports. For example, DOD has data on SDB subcontracting goals, dollar amounts and percentages of awards given to SDBs, reasons given by prime contractors for their failure to improve on the previous year's percentage, and prime contractors' overall performance under subcontracting plans. Without data on the effectiveness of existing programs, DOD cannot determine the extent to which credit could serve as an incentive.

With credit of limited value to prime contractors, funds for cash reimbursement will likely become the major program incentive. As previously stated, OSADBU believes that prime contractors are waiting for cash reimbursement provisions to be implemented. However, the appeal of cash reimbursements to prime contractors is reduced because program regulations specifically prohibit profits on the developmental assistance provided to a protege. The reason for this decision, according to a DOD official, was that the result of a mentor-protege relationship was

considered too subjective on which to base profits. However, OSADBU has since indicated that the profit restriction may be lifted in subsequent changes to the policy regulation.

Recommendations

We recommend that the Secretary of Defense direct OSADBU to

- develop and implement adequate internal controls in the application and approval process and in the oversight of protege development;
- work with congressional representatives to develop evaluation criteria that, to the extent feasible, quantify desired program accomplishments; and
- compile and analyze available data on subcontract goals and the use of incentives and penalties to achieve these goals, and consider ways to enhance Mentor-Protege Pilot Program incentives for prime contractor participation.

Agency Comments and Our Evaluation

In oral comments on a draft of this report, DOD generally concurred with our findings and recommendations. However, DOD expressed concern in three areas. DOD commented that a significant part of the program's effectiveness measures have to be qualitative, not quantitative, because the level and type of technical assistance provided to proteges, as well as their ability to develop, will differ from protege to protege. Also, DOD commented that the regulatory provision that prohibits prime contractors from earning incentive fees for technical assistance ensures that such fees are provided only to encourage subcontract awards to SDBs. Finally, DOD acknowledged the need for internal controls but expressed concerns about the difficulty of verifying developmental assistance needed by SDBs and data from non-DOD prime contractors. Nevertheless, DOD said it would ensure that agreed-upon assistance is provided and would determine whether this assistance had resulted in increasing subcontract awards.

After considering DOD comments, we believe our recommendations remain valid. We recognize that a part of program success measures will be qualitative; however, our recommendation is based on the fact that none of the program's criteria identify specific targets even though a number of the success measures require quantifiable data such as an increase in the number and value of subcontracts awarded to proteges. We believe that agreeing on such targets now would be useful in determining later whether the pilot program was a success. Although DOD's prohibition on using credit to earn incentive fees does prevent credit from being used in a manner that could decrease subcontract awards to SDBs, it also lessens the

incentive for prime contractors to participate as mentors. Finally, we recognize that effective internal controls can prove difficult in some situations. However, this does not preclude the need for DOD to assess program risk and, based on the specific risks for the Mentor-Protege Pilot Program, develop internal control objectives and procedures, and accounting and monitoring requirements.

The scope and methodology of our review are discussed in appendix II.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from the date of this letter. At that time, we will send copies of this report to the Chairmen, House and Senate Committees on Small Business and on Appropriations, Senate Committee on Governmental Affairs, and House Committee on Government Operations; the Secretary of Defense; and the Director, Office of Management and Budget. We will also make copies available to others upon request.

If you have any questions on this report, please call me on (202) 275-4587. Other major contributors are listed in appendix III.



Paul F. Math
Director, Research, Development,
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Program Success Measures

The following measures of program success are excerpted from the statutory purpose, the legislative intent, and the Department of Defense's (DOD) policy regulation for the Mentor-Protégé Pilot Program.

Authorization Statute

Section 831(b) of the National Defense Authorization Act for Fiscal Year 1991, Public Law 101-510, November 5, 1990:

The purpose of the program is to provide incentives for major Department of Defense contractors to furnish disadvantaged small business concerns with assistance designed to enhance the capabilities of disadvantaged small business concerns to perform as subcontractors and suppliers under Department of Defense contracts and other contracts and subcontracts in order to increase the participation of such business concerns as subcontractors and suppliers under Department of Defense contracts, other Federal Government contracts, and commercial contracts.

Legislative Intent

Joint Explanatory Statement of the Committee of Conference, Conference Report 101-923, October 23, 1990:

The conferees emphasize that the success of this program will be measured largely by whether the number of subcontracts awarded to SDBs [small disadvantaged businesses] increases.

Policy Regulation

DOD Mentor-Protégé Program Policy Regulation, 48 CFR Parts 219, 232, and 252, Notice of Partial Implementation and Final Rule, August 9, 1991:

DOD will measure the overall success of the Program by the extent to which the Program results in:

- (1) An increase in the dollar value and percentage of subcontracts awarded to SDBs by mentor firms under DOD contracts;
- (2) An increase in the dollar value of contract and subcontract awards to protégé firms (under DOD contracts, contracts awarded by other Federal agencies and under commercial contracts) since the date of their entry into the Program;
- (3) An increase in the number and dollar value of subcontracts awarded to a protégé firm (or former protégé firm) by its mentor firm (or former mentor firm);
- (4) An improvement in the participation of SDBs in DOD, other Federal agencies, and commercial contracting opportunities that can be attributed to the development of SDBs as protégé firms under the Program;

Appendix I
Program Success Measures

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- (5) An increase in subcontracting with SDB concerns in industry categories where SDBs have not traditionally participated within the mentor firm's vendor base;
 - (6) The involvement of emerging SDBs in the Program;
 - (7) An expanded relationship between mentor firms and protege firms to include non-DOD programs; and
 - (8) The development of protege firms that are competitive as subcontractors and suppliers to DOD or in other federal agencies or commercial markets.

Scope and Methodology

To evaluate the regulatory implementation of the Mentor-Protege Pilot Program, we reviewed the DOD policy regulation and changes to the defense acquisition regulations for the program to determine if they were consistent with the legislation and congressional intent. We analyzed respondent comments to the draft policy regulations and procurement regulation changes to determine the most significant concerns and concerns by type of respondent. DOD provided us with 62 comments on the draft regulations and 1 comment on the final regulations. Also, we determined what changes were made by DOD to the draft regulations in response to comments.

We performed an internal control assessment to determine if DOD had identified program risk and established internal control objectives and techniques. Internal control procedures for SDB programs are contained in the Defense Logistic Agency's Small Business Programs Operations Manual (DLAM 9100.1).

To assess initial participation in the program, we reviewed two DOD-approved applications and mentor-protege agreements to determine compliance with program policy and procurement regulations. We also documented and assessed OSADBU's application review and approval process for program participation.

Due to the early, restricted, and sensitive nature of initial program implementation, our assessment of participation was limited. We did not interview mentor or protege firms, nor did we survey prime contractors to determine possible interest in participation.

To identify deficiencies in the program, we analyzed program regulations and legislative intent to determine if goals were measurable and results obtainable. We also identified other mentor-protege programs and efforts and compared them to DOD's program for features, implementation strategy, status, and measures of success.

We also interviewed OSADBU officials to determine the status and details of the program's implementation. We interviewed Defense Logistics Agency officials on the effectiveness of existing SDB program incentives and internal controls. We interviewed officials from other federal agencies, private industry, associations, and academia about mentor-protege efforts.

We performed our review from August through December 1991 in accordance with generally accepted government auditing standards. We

obtained DOD's oral comments on a draft of this report and have incorporated them in the report.

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