

**HUBZONE PROGRAM EXAMINATION
AND RECERTIFICATION PROCESSES**

REPORT NUMBER 6-23

MAY 23, 2006

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**U.S. Small Business Administration
Office of Inspector General
Washington, D.C. 20416**

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| MANAGEMENT ADVISORY REPORT |
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| Issue Date: May 23, 2006 |
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| Report Number: 6-23 |
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TO: Michael P. McHale
Associate Administrator for the HUBZone Program

/S/ Original Signed

FROM: Robert G. Hultberg
Acting Assistant Inspector General for Auditing

SUBJECT: HUBZone Program Examination and Recertification Processes

We recently performed follow-up work on a 2003 audit of the HUBZone program (*Audit of the Eligibility of 15 HUBZone Companies and a Review of the HUBZone Empowerment Contracting Program's Internal Controls, #3-05*), and have some observations and concerns related to the program examination and recertification processes that we believe warrant your attention. The observations and concerns set forth in this memorandum are based on interviews with officials from the Office of the HUBZone Program and the Washington District Office, as well as data received from the program office.

OBSERVATIONS AND CONCERNS

The 2003 audit report recommended that a plan be developed and implemented to conduct an adequate number of program examinations each year to protect program integrity and lessen opportunities for contracting fraud. A program examination plan was subsequently developed and implemented and final action was reached on that recommendation in November 2004. As a follow up, from January through March 2006, we interviewed program officials and requested data on the results of the Fiscal Year (FY) 2004 and FY 2005 applications for certification, FY 2004 and FY 2005 program examinations, and FY 2005 recertifications.

We found that in FY 2004 and FY 2005, SBA approved nearly 70 percent of the firms that applied for HUBZone certification.¹ Although the Office of the HUBZone Program had put in place both program examination and recertification processes to ensure that only eligible firms participate in the program, we found that the results of those processes contrasted sharply with the relatively high approval rate at the time of initial application. Specifically, we found:

- Over 56 percent of firms were decertified or proposed for decertification as a result of the FY 2004 and FY 2005 program examinations.
- Over 81 percent of firms were decertified or proposed for decertification as a result of the three-year recertification process conducted in FY 2005.
- Firms proposed for decertification as a result of FY 2004 program examinations were not processed timely.
- Recordkeeping practices related to the program examination process should be improved.

The high percentages of firms decertified or proposed for decertification as a result of the program examination and recertification processes also raises the potential effect of certain firms inappropriately receiving HUBZone contracts between the time they are initially certified and subsequently examined/recertified.

We also found that a request to the Federal Acquisition Regulation (FAR) Council to revise HUBZone contract certifications should be monitored to ensure that it is implemented in a timely manner, and that system modification requests made to officials who maintain the Federal Procurement Data System-Next Generation (FPDS-NG) should continue until various enhancements needed to measure HUBZone program performance are implemented.

Over 56 Percent of Firms Were Decertified or Proposed for Decertification as a Result of the FY 2004 and FY 2005 Program Examinations

According to data received from the program office on January 25, 2006, of the 589 program examinations conducted in FY 2004, 29 firms were subsequently decertified, 303 proposed for decertification (with many of those still being processed, we were told), and only 141 recertified. Results of the 693 program examinations conducted in FY 2005 also showed disconcertingly high numbers for firms decertified (365) or proposed for decertification (33). Based on our examination of the data and interviews with program officials, we believe the results are indicative of significant turnover in the portfolio of certified HUBZone firms, with many firms changing their address, going out of business, or otherwise failing to respond to program examination inquiries possibly due to a lack of continued interest in the program.

¹The 70 percent figure does not include firms that initiated applications, but subsequently decided not to complete and submit them. The HUBZone application is Internet-based and contains a built-in screening system that informs potential applicants that their applications will be declined if submitted with certain responses to the online questions, thus likely discouraging some applicants from completing the application process.

Additionally, although program officials do not track the various reasons that firms are decertified or proposed for decertification following program examinations, and the number of firms under each reason, an indeterminate number of firms failed to meet the program examination's four criteria for continued participation as a certified HUBZone firm.²

Over 81 Percent of Firms Were Decertified or Proposed for Decertification as a Result of the Three-Year Recertification Process

HUBZone program regulations require a firm to recertify every three years to SBA that it remains a qualified HUBZone firm. We obtained data on the 753 recertifications scheduled for FY 2005 (the first year the electronic recertification process was fully functioning) and, much like the results from the program examinations, found alarmingly high numbers for firms either decertified (20) or proposed for decertification (593). These numbers together, 613 out of 753, show that slightly over 81 percent of those firms undergoing recertification in FY 2005 were found to be unresponsive or otherwise unable to meet continued requirements for program participation. Furthermore, the results of these recertifications are much like the results of the program examinations and indicate significant turnover in the portfolio of certified HUBZone firms.

Firms Proposed for Decertification as a Result of FY 2004 Program Examinations Were Not Processed Timely

According to information received from program officials on January 25, 2006, there were 303 firms proposed for decertification as a result of FY 2004 program examinations that were still being processed and had not yet been removed from SBA's list of certified HUBZone firms. Although we recognize that the Office of the HUBZone Program's staff size has decreased to two-thirds that of 2004—from 12 full-time equivalent employees that year to 8 in 2006—we nonetheless were concerned that workload resources had not been adequately devoted to eliminating this two-year old backlog. Since these proposed decertifications had not yet been completed, these firms remained on SBA's list of certified HUBZone firms and were seen by contracting officers as eligible to receive government contracts under the program.

Updated numbers received from the program office two months later, on March 21, 2006, showed that the backlog in processing firms proposed for decertification had been reduced to 1, while the number of firms decertified had increased to 313. Although program officials eliminated that backlog, we nonetheless remained concerned about such processing delays occurring in the future, and suggest that program officials set a maximum acceptable timeframe for decertifying firms and removing them from SBA's list of certified HUBZone firms once a decision has been made that such firms no longer meet the criteria for HUBZone participation.

Recordkeeping Practices Related to the Program Examination and Recertification Processes Should Be Improved

² The four criteria are: (1) the company must be small by SBA size standards; (2) the company must be owned and controlled at least 51% by U.S. citizens, or a community development corporation, or an Indian tribe, or an agricultural cooperative; (3) the company's principal office must be located in a HUBZone; and (4) at least 35% of the company's full-time/full-time equivalent employees must reside in a HUBZone.

Program officials were unable to provide a breakdown of the reasons why firms were decertified or proposed for decertification following program examinations and recertifications, or the number of firms under each reason, although those officials indicated that a majority simply could not be contacted because they had changed their address, gone out of business, or were otherwise unresponsive. We believe it is important to track the various reasons firms are decertified or proposed for decertification following program examinations and recertifications, and the number of firms under each reason, so corrective actions can be identified for reducing turnover within the portfolio of certified HUBZone firms. Such tracking and categorizing will also be helpful in taking appropriate action against firms that misrepresent their HUBZone eligibility status.

On another issue related to recordkeeping, we met with staff members of the Washington District Office to discuss their procedures for conducting program examinations and the results of 13 program examinations completed in FY 2005. Although we visited just this one district office, which is not necessarily indicative of procedures used by other district offices, we were concerned that supporting documentation received from HUBZone firms undergoing a program examination by this district office is typically not retained once an examination is completed, according to staff of the Washington District Office interviewed at the time. We believe that to support the program office's decision to decertify or propose to decertify a firm, any documentation received from the firm should be retained for some time thereafter.

Request of the FAR Council to Revise the HUBZone Contract Certification Should be Monitored to Ensure Timely Implementation

We understand that the Associate Administrator for the HUBZone Program (AA/HUBZone) has concurred with a revision of the HUBZone contract certification proposed by the OIG, and that this revision has been submitted to the FAR Council to ensure that principals of HUBZone firms are held liable for representations and certifications made at the time of their application submission. The current FAR language merely requires the contractor to certify that it is on SBA's list of certified HUBZone firms and that there has been no material change in the firm's circumstances since SBA certified the company. It does not cover the representations made to SBA to obtain admission to the program in the first place. The requested change would expand the scope of the certification to include these representations. We believe obtaining the contractor's signature on the contracting documents will assist in the prosecution of false statements made to obtain admission to the HUBZone program. Furthermore, we believe it is important that this request to revise the HUBZone contract certification be monitored to ensure that it is implemented in a timely manner.

Requests of FPDS-NG Officials for Needed System Modifications Should Continue

We also understand that the Office of the HUBZone Program has made several requests of officials who maintain FPDS-NG, the authoritative source for determining the number and dollar amounts of Federal contracts awarded under procurement preference programs. HUBZone program officials have requested various system modifications and enhancements to enable them to determine the number and dollar amounts of HUBZone contracts awarded to

qualified HUBZone firms. Presently, FPDS-NG only captures data on contracts awarded to HUBZone firms and it does not distinguish whether the contracts were HUBZone contracts, that is, contracts awarded to those firms based exclusively on their HUBZone certification. Such information is necessary to evaluate program performance.

Recommendations:

We recommend that the AA/HUBZone:

- 1A. Set a maximum acceptable timeframe for decertifying firms and removing them from SBA's list once a decision has been made that such firms no longer meet the criteria for HUBZone participation.
- 1B. Begin tracking the various reasons firms are decertified or proposed for decertification following program examinations, and the number of firms under each reason, so corrective actions can be identified for reducing turnover within the portfolio of certified HUBZone firms.
- 1C. Implement a policy that requires program examiners to determine if firms decertified or proposed for decertification have received any HUBZone contracts (upon implementation of Recommendation 1E), and refer to the OIG any firms that are suspected to have obtained a HUBZone contract when they were no longer eligible to participate in the program.
- 1D. Monitor the request to the FAR Council to revise the HUBZone certification and ensure that the request is implemented in a timely manner so principals of HUBZone firms are held liable for representations and certifications made at the time of their application submission.
- 1E. Continue to make requests of FPDS-NG officials until the needed modifications and enhancements are implemented to enable program officials to determine the number and dollar amounts of Federal contracts awarded to HUBZone firms based exclusively on their HUBZone certification.

SBA Management's Comments and OIG's Evaluation of Management's Comments

The AA/HUBZone had certain concerns regarding some of the conclusions found in the report, but generally agreed with the report's recommendations. The AA/HUBZone's comments, and our evaluation of them, are summarized below.

The AA/HUBZone noted that the seemingly high rate of HUBZone application approvals is a reflection of the logic function of the online application process, which effectively "pre-screens" many potential applicants, resulting in only those most-qualified actually submitting a completed application. While we agree that this is an accurate description of the online

application process, and one of the virtues of having such a system, we nonetheless stand by our point that the high rate of approvals of actual applications contrasts sharply with the subsequent high rate of decertifications following program examinations or recertifications.

In support of this high rate of decertifications, many of which are presumed by HUBZone officials to result from HUBZone concerns simply going out of business, the AA/HUBZone cited studies on small business survivability rates published by SBA's Office of Advocacy to statistically support the outcomes of the program examination and recertification processes. While such statistical support may be valid and attributable to the high rate of decertifications, our concern remains that many businesses on SBA's list of certified HUBZone firms that have not yet undergone a program examination or been recertified may, in fact, no longer be qualified and yet remain on SBA's list and thus eligible for certain contracting preferences. Additionally, although the scope of our review did not include determining if any decertified HUBZone firms had obtained contracts when they were no longer eligible for the program, we nonetheless stand by our point that there is a potential effect of certain firms inappropriately receiving HUBZone contracts between the time they are initially certified and subsequently examined/recertified.

Regarding program examination recordkeeping issues, the AA/HUBZone noted that district office liaison staff have been informed, both during training and in monthly conference calls, of the need to retain for at least six years the hard-copy documentation submitted by firms that have undergone a program examination and subsequently been recommended for decertification. To support this statement, HUBZone officials provided an April 2006 conference call agenda, which showed program examination documentation retention as one of the agenda items. Since the district office liaison staff have been informed of the requisite documentation retention policies, and related requirements are mentioned in the HUBZone program examination review guide, we deleted the corresponding recommendation from the draft report.

The AA/HUBZone also provided several proposed text edits, some of which were incorporated into the final report. Since the AA/HUBZone provided comments and proposed text edits electronically, to prevent confusion we have attached an excerpted version, which only includes the cover letter from SBA management. That excerpted version of SBA management's comments is provided as Attachment 1.

* * * * *

The recommendations in this audit report are based on the conclusions of the Auditing Division. **The recommendations are subject to review, management decision and action by your office in accordance with existing Agency procedures for audit follow-up and resolution.**

Please provide us your management decision for each recommendation within 30 days. Your management decisions should be recorded on the attached SBA Forms 1824, "Recommendation Action Sheet," and show either your proposed corrective action and target date for completion, or explanation of your disagreement with our recommendations.

Should you or your staff have any questions, please contact Robert G. Hultberg, Acting Assistant Inspector General for Auditing, at (202) 205-[FOIA Ex. 2].

Attachments



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

Attachment 1

MEMORANDUM

DATE: May 12, 2006

TO: Robert G. Seabrooks,

SBA OIG Assistant Inspector General for Auditing

[FOIA Ex. 6]

5/17/06

THRU: Anthony Martoccia, Associate Deputy Administrator
Office of Government Contracting & Business Development

Calvin Jenkins, Deputy Associate Deputy Administrator
Office of Government Contracting & Business Development

[FOIA Ex. 6]

5/10/06

FROM: Michael P. McHale
Associate Administrator
HUBZone Program

[FOIA Ex. 6]

SUBJECT: HUBZone comments on draft management advisory report

Thank you for the opportunity to review the subject draft management advisory report. We have noted certain concerns regarding some of the conclusions found in the report, but generally agree with the recommendations and will begin to take action to address and follow up on same.

The HUBZone comments and proposed text edits will surface in red and blue type when the document is viewed in WORD using the 'showing markup' feature.

Thank you again for your assessment of the HUBZone Certification Tracking System. We sincerely appreciate the time and effort expended by your staff to compile and complete this report.

Once this document has been cleared by the ADA for GC&BD and the DADA for GC&BD, it will be forwarded electronically.

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