

**AUDIT OF THE ELIGIBILITY OF 15
HUBZONE COMPANIES AND A REVIEW OF
THE HUBZONE EMPOWERMENT
CONTRACTING PROGRAM'S INTERNAL
CONTROLS**

AUDIT REPORT NUMBER 3-05

JANUARY 22, 2003

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**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416**

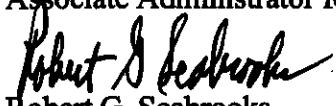
AUDIT REPORT

Issue Date: January 22, 2003

Report Number: 3-05

TO: Lloyd A. Blanchard
Chief Operating Officer

Michael P. McHale
Associate Administrator for HUBZone Empowerment

FROM: 
Robert G. Seabrooks
Assistant Inspector General for Auditing

SUBJECT: Audit Report on the Eligibility of 15 HUBZone Companies and a Review of the HUBZone Empowerment Contracting Program's Internal Controls

The Office of Inspector General (OIG) completed an audit after a complaint was received by SBA's Office of HUBZone Empowerment about a relatively large number (15) of certified HUBZone companies operating in a small census tract in Idaho Falls, Idaho. The complainant expressed concern that some of those companies may not be qualified to participate in the program. To address questions that were subsequently raised over program vulnerability to contracting fraud, we expanded the audit to include determining whether the internal controls over the selection and monitoring of participating companies were adequate to ensure that only eligible firms are certified and remain certified. This report presents the results of the audit.

BACKGROUND

The Historically Underutilized Business Zone (HUBZone) Act of 1997 created the HUBZone Empowerment Contracting Program to provide Federal contracting assistance for qualified small business concerns located on Indian reservations and in metropolitan area census tracts or non-metropolitan counties where high unemployment rates or low-income levels predominate. The program's intent is to increase employment opportunities, investment, and economic development in those areas.

A small business concern located in a designated HUBZone is eligible for HUBZone contracting benefits, including sole-source, price evaluation preference, and set-asides, if SBA certifies that it meets the following four criteria:

- (1) the company must be small by SBA size standards;
- (2) the company must be exclusively owned and controlled by U.S. citizens;
- (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.

According to program officials, the List of Qualified HUBZone Small Business Concerns maintained on SBA's World Wide Web site contained the names and addresses of 7,555 certified firms as of January 21, 2003. Data from the Federal Procurement Data System (FPDS) showed that 2,415 government contracts, valued at \$425,059,000, were awarded to certified HUBZone companies as of March 30, 2002. A General Accounting Office (GAO) report issued in October 2001, "HUBZone Program Suffers From Reporting and Implementation Difficulties" (GAO-02-57), concluded that FPDS data on contracts for fiscal year 2000 were grossly inaccurate and could be off by hundreds of millions of dollars. The inaccuracies resulted from data entry errors and insufficient guidance to contracting officers on how to report agency data.

Companies can apply electronically for certification and inclusion on the List of Qualified HUBZone Small Business Concerns. The initial determination for HUBZone eligibility, while based on a sophisticated electronic application, does not require the applicant to provide validating documentation such as a copy of a business owner's birth certificate as proof of U.S. citizenship or a copy of a lease agreement to verify the business concern's principal office location is in a qualified HUBZone.

The Office of HUBZone Empowerment developed a validation process, called a program examination, to verify that approved firms meet the four criteria for HUBZone certification. Program examinations were first conducted in Fiscal Year (FY) 2001 by SBA district office personnel. Limited staff resources permitted a review that year of only 142 (about four percent) of the approximately 4,000 certified firms participating in the program as of September 30, 2001. For FY 2002, no program examinations were conducted due to resource constraints.

AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objectives were to determine (1) if the 15 subject companies met the four criteria for participation in the HUBZone program, and (2) whether the program office's internal controls over the selection and monitoring of participating companies were adequate to ensure that only eligible firms are certified and remain certified.

The scope of the audit was limited to the 15 certified companies operating in the Idaho Falls, Idaho HUBZone as of March 14, 2002, and a review of the HUBZone program's internal controls. Our scope did not include analysis of federal contracting data, however, since the GAO found fiscal year 2000 data to be inaccurate and unreliable. Travel costs precluded our visiting the Idaho companies to personally inspect their facilities.

Our audit methodology included reviewing program regulations and materials from SBA's World Wide Web site on "HUBZone Empowerment Contracting Opportunities,"

examining PRO-Net firm profiles and copies of the on-line applications for the 15 subject companies, searching Federal database records for any HUBZone contracts that might have been awarded to the companies, and reviewing requested documentation from the companies to verify that they met the four criteria for program participation. Specifically, we requested the following information:

- Size standard: copies of company federal income tax returns for the past three years. When the size standard was based on number of employees, we used payroll records for verification.
- U.S. citizenship requirement: a copy of either a voter registration card, passport, birth certificate, or naturalization papers for each company owner.
- Principal office criterion: the address of each company's principal office, and all other offices, as well as a copy of the lease agreement(s), and the names of all employees, by office.
- 35% HUBZone residency requirement: a copy of the company's most recent payroll record that showed a listing of all employees and the residential address for each employee. If the payroll records did not include employee addresses, we asked for copies of Form W2s for each employee residing in a HUBZone in addition to the company's most recent payroll record.

To determine if internal controls were adequate to ensure that only eligible companies were on the list of certified firms, we examined the on-line application and program examination processes to determine whether they effectively validate that each concern meets the four certification criteria. We also interviewed officials of the Office of HUBZone Empowerment to determine if they had conducted a risk assessment or internal control assessment for the program and to gather their input on the effectiveness of controls currently in place and how such controls could be improved. Finally, we examined program office budget materials to determine if resources were sufficient to provide proper oversight of the certified firms.

We performed fieldwork from April, 2002 to January, 2003. The audit was conducted in accordance with Government Auditing Standards.

AUDIT RESULTS

We found that over two-thirds of the 15 subject companies were either not in compliance with HUBZone eligibility requirements or had presumably gone out of business. We also found that the Office of HUBZone Empowerment's internal controls were inadequate to ensure that only eligible firms are certified and remain certified. Therefore, there is little assurance that the program will provide increased employment, investment and economic development for depressed areas. Since ineligible companies could receive HUBZone contracts, the program is also vulnerable to federal contracting fraud.

Most Of The 15 Idaho Falls HUBZone Companies Were Ineligible

Eleven of the 15 subject companies either did not comply with one of the four HUBZone eligibility requirements or could not be contacted by phone or mail. Specifically:

- Seven companies did not meet the 35% HUBZone residency requirement.
- Three companies did not respond to our inquiries, and had inactive mailing addresses and phone numbers. We presumed they have gone out of business.
- One company relocated out of the Idaho Falls HUBZone to a neighboring town that is not in a HUBZone.

Controls Were Not Adequate To Ensure HUBZone Companies Are Eligible

The control environment for the Office of HUBZone Empowerment is positive and supportive. Program officials recognize the need for controls, are aware of potential risks to program integrity, and express interest in working cooperatively with OIG auditors and management to assure that only qualified companies receive benefits and to prevent fraud. Current controls, however, are inadequate to provide reasonable assurance that the 7,555 firms on SBA's List of Qualified HUBZone Small Business Concerns meet all eligibility requirements. Company qualifications as disclosed on the application for HUBZone certification are typically not verified by SBA unless a program examination of that company is later conducted. Over one-third of the firms receiving program examinations in FY 2001 and over two-thirds of the firms included in this audit were found to be ineligible. Given the 7,555 certified firms participating in the program, and the small number for which examinations have been conducted, it is possible that some firms may never have their qualifications verified unless the number of firms reviewed is significantly increased.

As of August 31, 2002, the program office had a permanent, full-time staff of seven employees (including two departmental managers) and has had to depend on other SBA staffing resources, particularly in the district offices, to verify company qualifications. Employees in the Office of HUBZone Empowerment are involved in other program administration tasks such as reviewing applications for HUBZone certification, assisting companies in obtaining contracts, and handling protests to contract awards, according to program officials. Staff from district offices performed a limited number of program exams in FY 2001, but the Office of HUBZone Empowerment did not reimburse the district offices for staff salaries and was only able to budget minimal funds for travel to accomplish this task. Also, conducting program exams is not included in district office goals, which could make support for such reviews even more difficult to obtain. Given the program's budget and staff resources, it is not possible to verify eligibility for all the 7,555 companies currently certified nationwide. The results from the limited number of program exams and audits suggest that greater verification of HUBZone company qualifications is necessary.

Program exams conducted in FY 2001 found that over one-third of the 142 companies reviewed were ineligible for continued program participation for one reason or another. Over

two-thirds of the 15 subject companies in this audit were similarly found to be ineligible. These results are not based on a randomly selected statistically valid sample and may be greater than the percentage of ineligible firms participating in the HUBZone program overall, since both the program exams and the audit focused on specific firms for which questions had been raised about their qualifications. The 2001 program exams specifically targeted firms in the service and construction industries to test compliance with regulatory amendments enacted in February, 2001 that pertained to firms in the service and construction industries. Moreover, this audit was conducted in response to a complaint about companies in a specific HUBZone.

The results of the program exams and our audit nonetheless suggest the need for greater verification of company qualifications to ensure program integrity and prevent contracting fraud. Interviews with officials from the Office of HUBZone Empowerment indicate that the program is, in fact, vulnerable to such fraud since it is possible for ineligible companies to receive HUBZone contracts, thus diminishing contracting money available for truly qualified firms. Furthermore, having ineligible companies on SBA's List of Qualified Small Business Concerns inflates the success of the program by overstating the number of eligible firms.

We also found that the program office did not have the administrative resources necessary to decertify firms and remove them from SBA's list on a timely basis after such firms had notified SBA that they no longer met program eligibility requirements. Owners of two of the audited companies stated they had notified the program office several months prior to our request for information that their firms no longer met one or more of the certification criteria, and yet no action was taken by the Office of HUBZone Empowerment to decertify those firms. Program officials acknowledged that this lack of follow-through was due to resource constraints and a backlog in processing company decertifications, which further overstates the number of HUBZone firms supposedly qualified for federal contracting benefits.

According to program officials, the number of certified HUBZone companies has increased six-fold over less than a three-year period, from approximately 1,000 as of March 31, 2000 to over 6,000 as of August 2, 2002, and yet annual funding for the program has remained at \$2 million or less over that period. Since SBA is presently operating under a continuing resolution, the program has not yet received its funding level for FY 2003. Increased funding could be used to provide greater program oversight, generally, and specifically to conduct more program exams or implement an alternative process for verification of company qualifications.

Program officials in the Office of HUBZone Empowerment are developing alternative proposals, subject to budget availability. One proposal may be to hire additional staff, while another would consider a possible outsourcing of the office's program examination responsibilities. While we are not recommending a specific plan to improve program oversight and reduce the potential for contracting fraud, we believe that additional oversight is needed.

During the audit, the findings were brought to management's attention. Upon being notified of the results of this audit, management removed nine of the Idaho Falls companies from the List of Qualified HUBZone Small Business Concerns. According to program officials, two other companies will be monitored to ensure that they take immediate steps to comply with certification requirements, or those companies will be mailed notices of proposed decertification.

RECOMMENDATIONS

1. We recommend that the Associate Administrator for HUBZone Empowerment either decertify the remaining two companies found to be ineligible for continued program participation and remove them from the List of Qualified HUBZone Small Business Concerns maintained on SBA's World Wide Web site, or ensure that they are brought into compliance with the eligibility requirements.
2. We recommend that the Associate Administrator for HUBZone Empowerment develop a plan to conduct an adequate number of program examinations each year to protect program integrity and lessen opportunities for contracting fraud.
3. We recommend that the Chief Operating Officer approve or modify the plan as developed for Recommendation 2 and provide the budget and/or staff resources necessary to implement that plan.

SBA MANAGEMENT'S COMMENTS

SBA's Associate Administrator for HUBZone Empowerment and Chief Operating Officer agreed with the recommendations. Text changes suggested by SBA's Associate Administrator for HUBZone Empowerment were also incorporated. Their responses are included as Attachments 1 and 2.

* * * * *

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, Director, Business Development Programs Group at (202) 205-7204.

Attachments



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

MEMORANDUM

DATE: January 13, 2003

TO: Robert G. Seabrooks, Assistant Inspector General for Adults

THRU: Darryl Hairston, Deputy Administrator for GC/BD *DH*

FROM: Michael McHale, Associate Administrator for HUBZone Program *Michael McHale*

SUBJECT: HUBZone Office Response to draft audit

The overall reaction by the Office of the HUBZone Program to the draft text of the audit is positive. You and your staff have identified the major challenges facing the HUBZone Program, especially in the area of continuing eligibility and program examinations.

With regard to particular text changes, we would like to see the following incorporated before the draft is finalized: On page 4, please increase the number of firms referenced in the second to last paragraph as, "Given the over 7,000 certified firms..." Next on page 6, to properly reflect the HUBZone officials comments, the first full paragraph should read, Program officials in the Office of HUBZone are developing alternative proposals, subject to budget availability; one proposal may be to hire additional staff. The next proposal would consider a possible outsourcing of the office's program examination responsibilities.

As recommended, we are initiating communication with the two firms included in your review that still require some measure of action before the identified issues can be resolved. The communication will either confirm their compliance with the HUBZone eligibility requirements or result in de-certification as was done with the nine other firms considered non-compliant.


We appreciate working with you and your OIG staff on this collaborative effort to maintain the integrity of the HUBZone Program.



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

DATE: January 12, 2003

TO: Robert Seabrooks
Assistant Inspector General for Auditing

FROM: Lloyd A. Blanchard 
Chief Operating Officer

SUBJECT: Remarks on the IG draft audit report on the HUBZone Empowerment Program

CC: Michael P. McHale
AA/HUBZone Empowerment

Thank you for providing me with the opportunity to review and comment on the discussion draft of the IG audit report on the eligibility of 15 HUBZone companies and a Review of the HUBZone Empowerment Contracting Program's Internal Controls.

I believe your recommendations are reasonable and I generally agree with them. Per your recommendation, I will review and modify the plan developed by AA/HUBZone Empowerment as necessary. Further, I will work closely with that office in meeting its resource needs to implement the plan.

Again, I appreciate the opportunity to comment on your discussion draft. Should you have any questions, please feel free to contact me at (202) 205-6610.

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