SMALL BUSINESS ADMINISTRATION'S CONTRACTING PROGRAMS AND GAO'S EXAMINATION OF THOSE PROGRAMS

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

HEARING HELD
JULY 17, 2008

Small Business Committee Document Number 110-106
Available via the GPO Website: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

40–869 WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON SMALL BUSINESS

NYDIA M. VELÁZQUEZ, New York, *Chairwoman*

HEATH SHULER, North Carolina
CHARLES GONZALEZ, Texas
RICK LARSEN, Washington
RAUL GRIJALVA, Arizona
MICHAEL MICHAUD, Maine
MELISSA BEAN, Illinois
HENRY CUELLAR, Texas
DAN LIPINSKI, Illinois
GWEN MOORE, Wisconsin
JASON ALTMIRE, Pennsylvania
BRUCE BRALEY, Iowa
YVETTE CLARKE, New York
BRAD ELLSWORTH, Indiana
HANK JOHNSON, Georgia
JOE SESTAK, Pennsylvania
BRIAN HIGGINS, New York
MAZIE HIRONO, Hawaii

STEVE CHABOT, Ohio, *Ranking Member*
ROSCOE BARTLETT, Maryland
SAM GRAVES, Missouri
TODD AKIN, Missouri
BILL SHUSTER, Pennsylvania
MARILYN MUSGRAVE, Colorado
STEVE KING, Iowa
JEFF FORTENBERRY, Nebraska
LYNN WESTMORELAND, Georgia
LOUIE GOHMERT, Texas
DAVID DAVIS, Tennessee
MARY FALLIN, Oklahoma
VERN BUCHANAN, Florida

MICHAEL DAY, *Majority Staff Director*
TIM SLATTERY, *Chief Counsel*
KEVIN FITZPATRICK, *Minority Staff Director*

STANDING SUBCOMMITTEES

Subcommittee on Finance and Tax

MELISSA BEAN, Illinois, *Chairwoman*

RAUL GRIJALVA, Arizona
MICHAEL MICHAUD, Maine
BRAD ELLSWORTH, Indiana
HANK JOHNSON, Georgia
JOE SESTAK, Pennsylvania

VERN BUCHANAN, Florida, *Ranking*
BILL SHUSTER, Pennsylvania
STEVE KING, Iowa

Subcommittee on Contracting and Technology

BRUCE BRALEY, IOWA, *Chairman*

HENRY CUELLAR, Texas
GWEN MOORE, Wisconsin
YVETTE CLARKE, New York
JOE SESTAK, Pennsylvania

DAVID DAVIS, Tennessee, *Ranking*
ROSCOE BARTLETT, Maryland
SAM GRAVES, Missouri
TODD AKIN, Missouri
MARY FALLIN, Oklahoma

Subcommittee on Regulations, Health Care and Trade

CHARLES GONZALEZ, Texas, *Chairman*

RICK LARSEN, Washington
DAN LIPINSKI, Illinois
MELISSA BEAN, Illinois
GWEN MOORE, Wisconsin
JASON ALTMIRE, Pennsylvania
JOE SESTAK, Pennsylvania

LYNN WESTMORELAND, Georgia, *Ranking*
BILL SHUSTER, Pennsylvania
STEVE KING, Iowa
MARILYN MUSGRAVE, Colorado
MARY FALLIN, Oklahoma
VERN BUCHANAN, Florida

Subcommittee on Rural and Urban Entrepreneurship

HEATH SHULER, North Carolina, *Chairman*

RICK LARSEN, Washington
MICHAEL MICHAUD, Maine
GWEN MOORE, Wisconsin
YVETTE CLARKE, New York
BRAD ELLSWORTH, Indiana
HANK JOHNSON, Georgia

JEFF FORTENBERRY, Nebraska, *Ranking*
ROSCOE BARTLETT, Maryland
MARILYN MUSGRAVE, Colorado
DAVID DAVIS, Tennessee

Subcommittee on Investigations and Oversight

JASON ALTMIRE, PENNSYLVANIA, *Chairman*

CHARLES GONZALEZ, Texas
RAUL GRIJALVA, Arizona

MARY FALLIN, Oklahoma, *Ranking*
LYNN WESTMORELAND, Georgia

CONTENTS

OPENING STATEMENTS

	Page
Velázquez, Hon. Nydia M.	1
Chabot, Hon. Steve	2

WITNESSES

Carranza, Hon. Jovita, Acting Administrator, Small Business Administration	4
Shear, Mr. William; Director, Financial Markets and Community Investment, U.S. General Accountability Office	6
Kutz, Mr. Gregory, Managing director, forensic Audits and Special Investigations, U.S. General Accountability Office	8

APPENDIX

Prepared Statements:

Velázquez, Hon. Nydia M.	37
Chabot, Hon. Steve	39
Altmire, Rep. Jason	40
Carranza, Hon. Jovita, Acting Administrator, Small Business Administration	41
Shear, Mr. William; Director, Financial Markets and Community Investment, U.S. General Accountability Office	45
Kutz, Mr. Gregory, Managing director, forensic Audits and Special Investigations, U.S. General Accountability Office	67

Statement Submitted for the Record:

Associated General Contractors	95

SMALL BUSINESS ADMINISTRATION'S CONTRACTING PROGRAMS AND GAO'S EXAMINATION OF THOSE PROGRAMS

Thursday, July 17, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:06 a.m., inRoom 1539, Longworth House Office Building, Hon. Nydia M. Velázquez [Chair of the Committee] Presiding.

Present: Representatives Velázquez, Shuler, Cuellar, Braley, Ellsworth, Chabot, Bartlett, Akin, and Fallin.

Chairwoman VELÁZQUEZ. Good morning. I call this hearing of the House Small Business Committee to order.

STATEMENT OF THE HONORABLE NYDIA VELÁZQUEZ, CHAIRWOMAN OF THE COMMITTEE ON SMALL BUSINESS

The economy is still mired in a recession. In addition to 6 straight months of job losses, we are now facing considerable drop-offs in consumer spending and exports. Meanwhile, inflation continues to climb, and it seems no financial sector has been left out or left untouched. Just this week, news of the crumbling Freddie Mac and Fannie Mae prove that the housing crisis is far from over.

Amidst this otherwise weak economy, one bright spot continues to shine. The Federal marketplace is booming. Last year alone, this industry grew by more than 9 percent. But while it should hold great potential for entrepreneurs, small firms are still fighting to break into the Government sector.

During the past 8 years, the Bush administration has missed every single one of its small-business goals. In 2005 alone, entrepreneurs lost $4.5 billion in contracting opportunities.

A broad array of programs exist to help small firms enter the Federal marketplace. These programs seek to give opportunities to the most important sector of our economy, small businesses. Entrepreneurs not only create greater economic diversity and competition, but they also offer the best value for the taxpayers' dollar.

Today we are going to look at one such program, which, while having very commendable goals, has ultimately failed our entrepreneurs and our taxpayers. HUBZones were originally designed to help small businesses in low-income communities. Today the program has fallen short of that mission. As a result of insufficient controls by the SBA and inherent flaws in the underlying program, we now have widespread fraud.

This Committee has long been concerned about the potential for HUBZone fraud. After a preliminary investigation confirmed these fears, we asked the GAO to conduct an investigation. Their results were nothing short of appalling.

In their review, investigators found that a majority of HUBZone businesses failed to meet program criteria. And, yet, these firms still managed to collect over $100 million in Federal contracts; 24 million of those dollars came directly out of HUBZone funds—funds that should have gone to low-income communities.

These numbers are high, but they are not surprising. As noted in prior reports, SBA is notorious for failing to vet its programs. In fact, it conducts annual examinations on a mere 5 percent of certified HUBZones. When it comes to the businesses themselves, only 36 percent of applicants are asked to show any form of documentation. It is so easy to break into the HUBZone program that investigators using fake addresses and forged credentials were able to do so in a matter of weeks. The entire process was easier than getting a library card.

Perhaps not surprisingly, con artists have little trouble gaming SBA's broken system. Countless unqualified corporations have applied for and been awarded millions of dollars in Government contracts. Meanwhile, entrepreneurs looking for an honest break have been pushed to the margin.

Earlier this year, the House passed several provisions in attempts to stem this fraud. But the administration opposed these steps, including requirements for onsite inspections. President Bush went so far as to argue that, and I quote, ″This provision will create a large burden on the Small Business Administration.″ It seems the President prefers burdens of the multimillion-dollar fraud variety, the kind of burden we unfortunately face today.

Small-business contract programs are important, and we need them. But if not adequately funded and properly managed, they turn into what we have today. Rather than lifting up underprivileged firms, HUBZones are lining the pockets of big corporations and otherwise fraudulent businesses. And they are doing so on the taxpayers' dime.

Today's hearing will be an important part of understanding the fraud and figuring out the next steps towards overhauling the SBA. It will not be an easy process, but we owe this review to our taxpayers and we owe it to our small businesses.

I thank today's witnesses in advance for their testimony.

And, with that, I now yield to Ranking Member Chabot for his opening statement.

Mr. CHABOT. Thank you, Madam Chairwoman.

STATEMENT OF THE HONORABLE STEVE CHABOT, RANKING MEMBER OF THE COMMITTEE ON SMALL BUSINESS

And good morning. And I thank all of you for being here this morning to examine the Small Business Administration's HUBZone, or Historically Underutilized Business Zone, program. I would also like to thank the chairwoman for holding this important hearing.

As early as World War II, Congress recognized that a strong economy and industrial base requires a robust small-business econ-

omy. At the end of the Korean conflict, the Small Business Administration was created to provide assistance to small businesses.

One aspect of that policy is the requirement that small businesses be awarded a fair proportion of contracts for the purchase of goods and services by the Federal Government. That policy not only ensures that the Federal Government will have a diverse set of contractors from which it can obtain goods and services, it also provides an important tool to help grow small businesses.

Last session, the Committee examined all of the SBA Government contracting programs. Today we are specifically focusing on the HUBZone program in response to two separate assessments done by the GAO. I have been briefed on the studies, and the results are troubling, as the chairwoman indicated, to say the least.

I am a strong supporter of the HUBZone program, because I believe that Federal procurement can be used not just to purchase goods and services or even grow small businesses, but to provide needed assistance in the economic revitalization of poor urban and rural communities.

However, if firms not actually located in HUBZones are taking contracts away from legitimate HUBZone firms, it defeats the purpose of the program. I will be interested in hearing from the SBA the steps the agency will take to ensure that only legitimate HUBZone firms are awarded contracts.

The HUBZone program is designed to provide economic development in poor areas. According to a study by the Office of Advocacy, some HUBZone contractors are generating as much as an additional $100 per person in additional income in particular areas. Of course, when it costs that much to fill your car's gas tank, the benefits of the HUBZone contracting program are dissipated. Revitalization requires not only building businesses in these areas but providing the people with affordable fuel. This requires increasing the supply of petroleum produced in this country.

Although I recognize that this hearing is primarily about SBA's management of the HUBZone program, I would be remiss not to mention that there are Members on both sides of the aisle whose constituents are severely affected by recent floods, for example, in the Midwest. I suspect that the Acting Administrator may receive some questions on this issue, and we would be very interested in hearing about the agency's response in that area as well.

Again, I want to thank the chairwoman for holding this important hearing, and look forward to working with her and the SBA to make necessary improvements to the HUBZone program so that it can truly assist in the economic revitalization of our poor urban and rural communities.

And, again, I thank the chairwoman for holding this hearing, and yield back my time.

Chairwoman VELÁZQUEZ. Thank you, Mr. Chabot.

And now I welcome the Honorable Jovita Carranza. Ms. Carranza is the Acting Administrator of the Small Business Administration. She was nominated by President Bush and sworn in on December 15, 2006, as Deputy Administrator of SBA.

Ms. Carranza, I just want to say, thank you for agreeing to testify today. I really appreciate your willingness to come before our Committee. I realize that you have been at SBA just 18 months

and that many of these HUBZone program problems predate you joining the agency. But today you are sitting in the hot seat, and so thank you for being here.

STATEMENT OF THE HONORABLE JOVITA CARRANZA, ACTING ADMINISTRATOR OF THE U.S. SMALL BUSINESS ADMINISTRATION

Ms. CARRANZA. Thank you.

Mr. CHABOT. That is due warning, I think.

Ms. CARRANZA. It has been hot since I arrived here.

Good morning, Chairwoman Velázquez, and thank you very much for the invitation, and also Ranking Member Mr. Chabot. Once again, good morning, and thank you for the opportunity to testify today.

While I am proud of the reforms I have made in my time at SBA, more work remains. As other panelists will describe, the administration of our HUBZone program leaves considerable room for improvement. In fact, in September 2007, I testified about our concerns over flaws that needed attention. But the more work we identified to fix these problems, the more we uncovered.

Mr. CHABOT. Could you possibly pull the mike a little bit closer?

Ms. CARRANZA. Certainly.

We welcome the GAO's report and work. And as our response to their audit makes clear, we agree with their assessment. In fact, GAO's conclusions only confirm what we had already uncovered. Now we are working so that this program will better accomplish its goals, and I would like to describe our specific actions.

First, GAO recommended immediate steps to correct the HUBZone map. Further, they recommended that we ensure it is frequently updated with the most recent data.

Problems with the map were, in fact, what uncovered the program's serious mismanagement. In response to a congressional inquiry about whether a specific county qualified, the HUBZone program determined that it did. Then, several days later, SBA found that it was, in fact, not qualified.

In determining how much a mistake was made, senior managers learned the initial determination was done manually. This pointed to the fact that the map hadn't been updated for more than 18 months. This, in turn, set off a cascading series of revelations.

In getting to the bottom of these issues, a process that accelerated as time went on, the extent of the program's problems became increasingly clear. It also became increasingly clear that the program needed new leadership. We have brought on new program management who are committed to our reform.

Completing an objective that predates GAO's call to fix the map, on July 3rd a new contract was executed. This contract provides strict timetables and procedures so that, going forward, the map remains current. The new map will be available August 29th.

In its second recommendation, GAO urged more consistently obtaining supporting documents in the application process. Also, they recommended more frequent site visits to ensure eligibility. In response, a draft of our new application processing manual was completed July 2nd. It establishes guides about supporting documents,

what is required, and how to handle these requests. It also includes instructions regarding site visits.

We believe that by more effectively marshalling our district office resources, we can quickly accomplish this objective. And HUBZone is working with the field operations to produce clear procedures. Presently, this draft is being reviewed and finalized. This process will be completed by September.

The third GAO recommendation was to eliminate the recertifications backlog and, going forward, to stay current. In response, SBA hired contract employees to assist. Our goal is to clear the backlog by the end of fiscal year 2008, and we are on track to meet this benchmark.

HUBZone's new leadership is implementing reforms so that, with the backlog cleared, recertifications will be timely. I can assure you that SBA senior staff will oversee this task.

The fourth GAO recommendation was to formalize time frames for processing proposed decertifications. In response, SBA is adding explicit timelines to the applicable SOP. This process will be completed by the end of August.

The fifth and final recommendation was to develop ways to assess HUBZone's overall effectiveness, and this largely mirrors a similar finding by SBA's Office of Advocacy. In response, SBA is developing an assessment methodology to measure HUBZone's economic benefits. This is being done by the senior economist in our Office of Policy and Strategic Planning. Once completed, this will allow HUBZone to issue regular public reports. The methodologies development is well under way, and the final product is expected by August.

To ensure the participation of all stakeholders, SBA will publish this methodology for public comment. I encourage the Committee and all interested parties to examine the work and make suggestions about how we can better assess HUBZone's impact. After evaluating the comments, SBA will publish a final methodology detailing the measures that will be used.

In response to GAO's forensic investigation, I have taken immediate steps to require site visits for those firms with HUBZone contracts. Additionally, we will pursue suspension and debarment proceedings against firms that have intentionally misrepresented their status. For example, we will begin the process to suspend and debar the 10 firms that GAO has discovered. SBA has already pursued firms for false certification, and we take very seriously the responsibility to ensure that the Government's contracting partners are trustworthy.

As I acknowledged earlier, HUBZone faces many challenges. Please know that I am committed to solving them, and I believe that integrity and transparency are crucial. This commitment has brought dramatic gains to other SBA programs, and I look forward to applying these lessons to HUBZone.

For example, by month's end, we will roll out our new Business Development Management Information System, which permits electronic 8(a) and small disadvantaged business certifications and annual reviews. This is a major upgrade to more effectively manage this vital program.

Last month, we released our third procurement scorecard, this one focused on meeting contracting goals. Improving the integrity of contracting data and tightening the rules to qualify are other examples. SBA's tough-minded work has reduced the miscoding errors in contracts that had a cumulative value of more than $10 billion. The result is a more accurate, more useful and more transparent measure of small-business contracts.

While these efforts have taught us valuable lessons, the reform process for HUBZone especially reminds me of the earlier need to re-engineer SBA's Disaster Assistance program. Disaster Assistance, like HUBZone today, had obvious needs. But while facing problems head-on can be difficult, the dividends are also obvious.

Because of our reforms, SBA was able to respond quickly and professionally to help victims of the recent Midwest flooding and tornadoes. Personally, I have been to the Midwest three times since the flooding, and I have seen these reforms in action.

So while it pains me to have to describe these problems with our HUBZone program, I am also confident that we can solve them and ensure that HUBZone accomplishes the noble purpose for which it was established.

Thank you. And I would be pleased to answer any questions.

[The prepared statement of Ms. Carranza can be found in the appendix at page X.]

Chairwoman VELÁZQUEZ. Thank you, Ms. Carranza.

Our next witness is Mr. Bill Shear. He is the director of the GAO's Office of Financial Markets and Community Investment. The Financial Markets and Community Investment team works to improve effectiveness of regulatory oversight in financial and housing markets. He also oversees the management of community development programs by examining the effectiveness of specific programs and administrative functions. To do so, the office evaluates programs at several agencies, including SBA.

Welcome, sir.

STATEMENT OF MR. WILLIAM SHEAR, DIRECTOR OF FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SHEAR. Thank you very much. Madam Chairwoman, Representative Chabot and members of the Committee, it is a pleasure to be here this morning to discuss our program audit of SBA's HUBZone program.

My testimony is based on a report which is being released today that addresses, first, the criteria and process that SBA uses to identify and map HUBZone areas; second, SBA mechanisms to ensure that only eligible small businesses participate in the HUBZone program; and, third, steps SBA has taken to assess the results of the program and the extent to which Federal agencies have met their HUBZone contracting goals.

In summary, first, because SBA relies on Federal law to identify qualified HUBZone areas, recent statutory changes have resulted in an increase in the number and types of HUBZone areas, changes that could diffuse the economic benefits of the program.

Further, the map that SBA uses to help firms interested in participating in the program to help determine if they are located in

a HUBZone area is inaccurate. Specifically, the map incorrectly includes 50 metropolitan counties as difficult development areas. In addition, 27 non-metropolitan counties that are eligible based on their unemployment rates were excluded, because SBA has not updated its maps since August 2006. As a result, ineligible businesses participated in the program and eligible businesses have not been able to participate. We recommended that SBA take steps to correct the map and to update the map on a more frequent basis.

Second, the mechanisms that SBA uses to certify and monitor HUBZone firms provide limited assurance that only eligible firms participate in the program. For certification and recertification, firms self-report information on their applications. However, we found that SBA requested documentation or conducted site visits of firms to validate the self-reported data in only limited instances.

Our analysis of the 125 applications submitted in September 2007 show that SBA requested supporting documentation for 36 percent of the applications and conducted one site visit. While SBA's policies and procedures require program examinations, the one process that consistently includes review of supporting documentation, the agency conducts them on 5 percent of certified HUBZone firms each year.

We also identified deficiencies in SBA's recertification and decertification processes. As a result of a lack of controls and weaknesses in the application and monitoring-related processes, SBA lacks assurances that only eligible firms participate in the program. We made recommendations to SBA to address these deficiencies.

Finally, SBA has taken limited steps to assess the effectiveness of the HUBZone program. SBA tracks the number of firms certified or recertified, the annual value of contracts awarded to HUBZone firms, and the number of program examinations completed annually, but has not devoted resources to completing an evaluation of the program.

Consequently, SBA lacks key information that could help it better manage and assess the results of the program and provide information to this Committee and the Congress. We recommended that SBA further assess the effectiveness of the program.

It is a pleasure to present our work before this Committee. I would be happy to answer any questions you may have.

[The statement of Mr. Shear can be found in the appendix at page X.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Shear.

Our next witness is Mr. Greg Kutz. He is the managing director of Forensic Audits and Special Investigations at GAO. The FSI unit investigates waste, fraud and abuse related to Government programs and taxpayers' dollars. FSI has recently investigated abuses of Hurricane Katrina relief dollars, border security, and overtime and minimum wage complaints, among other topics.

Also sitting with the panel from GAO's FSI unit is Mr. Bruce Causseaux, a senior-level specialist who participated in the HUBZone investigation. Although Mr. Causseaux will not be offering testimony, he will be available to answer questions about FSI's findings.

Thank you, and welcome.

STATEMENT OF MR. GREGORY KUTZ, MANAGING DIRECTOR OF FORENSICS AUDITS AND SPECIAL INVESTIGATIONS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE.

Mr. KUTZ. Madam Chairwoman and members of the Committee, thank you for the opportunity to discuss the HUBZone program.

Today's testimony highlights the results of our investigation of this program. My testimony has two parts. First, I will discuss our covert testing of the application process, and second, I will discuss several cases that we investigated.

First, our covert testing shows that SBA does not have an effective fraud-prevention program.

To test the application process, we created several bogus companies with fictitious officers and employees. Over the course of several months, we submitted four HUBZone applications. In all four cases, SBA approved our applications and certified our bogus companies. The picture on the wall shows an example of one of the letters we received from SBA that approved our bogus company.

The entire application process was online. We never had to speak to any SBA officials. For our first application, SBA requested several documents by e-mail. In response, we created bogus documents, using publicly available hardware and software, and then we faxed the information to SBA. For our other three applications, SBA did not request any supporting documentation. It appears that SBA did nothing to validate any of the information that we provided.

To participate in this program, the office where the greatest number of employees work, which is referred to as the principal office, must be located in a HUBZone. The most sophisticated principal office that we established was a virtual office that we never visited except to sign the original lease agreement and to collect the mail. Two of our HUBZone companies were actually mailboxes that we rented for less than $25 a month. The picture on the monitors shows our fourth HUBZone principal office, which is a Starbucks coffee shop.

Moving on to my second point, given SBA's ineffective fraud-prevention controls, it is not surprising that we were able to easily identify 10 HUBZone companies that are clearly not eligible for this program. Six of these companies failed to meet the principal office test. The other criteria we tested requires that 35 percent of the company's employees live in a HUBZone. None of these 10 companies met this requirement.

Here are some of the more egregious examples.

First, the picture on the wall shows, on the left, the supposed principal office for one of our case studies. The owner of this building told us that no one had been there in some time. As it turns out, the picture on the right represents the real principal office for this company, located in McLean, Virginia.

In another case, the company's supposed principal office was actually a rundown duplex in Landover, Maryland. The vice president of this company admitted to us that nobody actually worked at this location. Two other companies had supposed principal offices located in HUBZones. However, nobody actually worked at these locations. The real principal offices for these two companies

were in Hyattsville, Maryland, and, once again, in McLean, Virginia.

And finally, the four companies that passed the principal office test clearly failed the 35 percent employee test. The actual percentage of employees living in a HUBZone for these companies was 17, 15, 6 and 0.

In conclusion, our work clearly shows that anybody with a computer and a mailbox that is willing to lie to the SBA can become a HUBZone company. Most of the companies that we investigated made false representations to stay in this program.

These companies have been awarded tens of millions of dollars as prime contractors using their HUBZone status. However, rather than stimulating economically distressed areas, these HUBZone contract dollars are stimulating areas such as McLean, Virginia, one of the richest areas in the country.

Madam Chairwoman, this ends my statement. Mr. Causseaux and I look forward to your questions.

[The statement of Mr. Kutz can be found in the appendix at page X.]

Chairwoman VELÁZQUEZ. Thank you very much, Mr. Kutz.

Mr. Shear, to tell you the truth, I don't know where I should start. But let me try.

Mr. SHEAR. Okay.

Chairwoman VELÁZQUEZ. GAO analysis of the 125 HUBZone applications showed that SBA requested supporting documentation for only 36 percent and conducted only one visit. In addition, the agency conducted program examinations on only 5 percent of certified HUBZone program firms each year.

It appears that SBA has virtually no control over who is participating in this program. Is this the case?

Mr. SHEAR. We say that there is limited assurance, based on our program evaluation, there is only limited assurance that only eligible firms are participating.

We did identify it as a program that is susceptible to fraud. And that was one reason it led us to say there should be a fraud investigation.

What we look for when we look at internal controls is some finding of reasonable assurance. And here we clearly do not see it for this program.

Chairwoman VELÁZQUEZ. Okay. Do you believe that the agency's current approach to implementing the HUBZone program is conducive to promoting effective internal controls?

Mr. SHEAR. No, it is not. It relies too heavily on self-reported information without verification and a lack of site visits. It relies too much on self-policing by the companies themselves and if self-policing going to occur it is difficult to do, given the information requirements.

So the current approach just does not provide what we would consider reasonable assurance.

Chairwoman VELÁZQUEZ. Ms. Carranza, given the potential that billions of dollars of taxpayer funds are at risk, will you make a commitment to not certify any new HUBZone companies until SBA implements the improvements you lay out in your testimony?

Ms. CARRANZA. Chairwoman Velázquez, I would appreciate the opportunity to expound on the controls that we have put in place immediately after we reviewed the GAO audit. And with the five recommendations we have expanded—

Chairwoman VELÁZQUEZ. Ms. Carranza, with all due respect, I asked you a question and I need an answer.

Given the fact that there is a potential that billions of dollars of taxpayers' funds are at risk, will you make a commitment not to certify any company, any HUBZone company, until you have in place internal controls that will guarantee taxpayers in this country that it is fraud-free?

Ms. CARRANZA. I would like to emphasize again and respond to your question with a level of confidence, Chairwoman Velázquez, that we have addressed the applications that have been received. We have also addressed a thousand applications, firms that received Government contracts, and we have taken the position of validating all of the information that has been submitted on those applications much more aggressively than we have in the past.

Chairwoman VELÁZQUEZ. Your answer to my question is a no. And so you would allow for fraud to continue. And what we are saying to Federal agencies here today is that they shouldn't be using this program because you are opening your agency to fraud. So SBA has a responsibility to give these Federal agencies assurances that the HUBZone program is free of fraud. It is not today.

Ms. Carranza, SBA has come before this Committee several times in recent years, and I often take the opportunity to voice my concern regarding fraud in the HUBZone program. I would like to take a minute to read to you some of the most recent responses I have had from your agency.

The first response, and I quote, ″I am not aware of any fraud involved in the program,″ Anthony Martoccia, Associate Deputy Administrator, Office of Government Contracting and Business Development, March 30, 2006.

Another response, and I quote, ″We have recognized the flaws. We have actually taken the position we are going to implement, if not 90 percent, approximately 100 percent of the SBA IG recommendations to address problems in the HUBZone program,″ Jovita Carranza, Deputy Administrator, September 19, 2007.

Another response, ″We have taken many actions that we think significantly tighten up the process around HUBZones. And I should also mention that we have met with our IG, and we are in concurrence and acting on every single one of those recommendations,″ Steven Preston, Administrator, October 4, 2007.

And finally, I most recently asked Mr. Preston on February 7, 2008, the following question, just 5 months ago: ″I want to ask you—and I want a 'yes' or 'no' answer—do you believe that the HUBZone program has sufficient internal controls to prevent fraud?″ He replied, ″I think we have sufficient internal resources to address this issue.″

So, Ms. Carranza, when you say that you will solve these problems, I cannot help but think that we have heard this before, and yet clearly nothing has changed.

How is today any different from the last four times that I have asked the SBA about the program and we were told that it was

under control? Why should this Committee believe that you will actually do something this time, rather than just give us lip service?

Ms. CARRANZA. Chairwoman Velázquez, it has gone beyond speculation or an assumption. There is hard data from the GAO assessment of the vulnerabilities that we have. I am just as frustrated, and I was shocked to learn the depth of the issues that we have, both on data accuracy with the mapping a weak maintenance or management of our contractor.

As a result of that, we have reassigned management personnel. We are recruiting additional staff with different skill-sets who will be totally focused on the reform agenda that we have for the Government Contracting Office. We have made significant progress in various divisions in Government contracting. Not only are we addressing resources that are in play as we speak, but we are also identifying the contractors' problem areas and we have developed a new contract agreement with stringent timelines, with deliverables within 30 and 60 days.

So there is tangible evidence of the changes that we have instituted, with timelines that we are prepared to report to your office, as well as to work closely with Bill and his staff.

Chairwoman VELÁZQUEZ. You will?

Ms. CARRANZA. Yes.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Kutz, GAO was four out of four in gaining fraudulent access to the HUBZone program. Without getting into specifics of other GAO investigations, can you tell us how susceptible the HUBZone program is to fraud, as compared to other programs GAO has reviewed for similar programs?

Mr. KUTZ. Clearly, it is very susceptible to fraud. There is no question about that. They do not really have, from what we saw, a fraud-prevention program, which has many elements to it.

And it is interesting, one of the charts you have put up there, that they have tightened their controls, well, what we tested was the tightened controls, obviously. So I would hate to see what they were before that.

But, clearly, this opens the door to billions of dollars of contracts. That is why people will lie to get into a program like this, because there is a lot of money at stake.

Chairwoman VELÁZQUEZ. Let me ask you, how does the potential for fraud in the HUBZone program compare to what you saw in Katrina-related disaster payments?

Mr. KUTZ. It is substantially worse. We looked at the individual assistance program, which has eligibility controls. To get individual payments for Katrina, people had to actually live in the disaster area at the time that Katrina or Rita hit. And so FEMA did not have effective fraud-prevention controls in that program, although they did have some validation. Here we saw little or none, so this is as bad or worse.

Chairwoman VELÁZQUEZ. In your estimation, do you believe that self-policing is a valuable policy for reducing fraud in the program?

Mr. KUTZ. Not in and of itself, certainly. If you look at a broad fraud-prevention program, it is an element of it, but it is, by far, one of the less significant elements, in my view.

Chairwoman VELÁZQUEZ. What makes the program so susceptible to fraud?

Mr. KUTZ. Well, again, the lack of fraud-prevention controls. I would say this, if you are going to put your money into anything for this program, it has to be at the application process. Here you have a situation where anybody can get in, basically, that wants to. And, again, hopefully, most people are honest.

But you not only have that problem now and you want to cut them off at the beginning, I have heard in your questioning here, but you also have the bigger problem of 10,000 or more companies already in there and how you deal with that situation at this point.

Chairwoman VELÁZQUEZ. Let me ask you a final question here. What potential actions would you recommend or suggest to SBA to rectify this problem?

Mr. KUTZ. Well, a fraud-prevention program consists of three things: people, processes and technology. They need to have the right people, the right training, the right outlook.

They need to have strong processes, for example, random, unannounced site visits, with technology behind that, where, before they do the site visit, they have the research tools to determine whether or not people own the businesses, whether they were renting them, or whatever the case may be.

So it is a combination of those three areas.

Chairwoman VELÁZQUEZ. Thank you.

And I recognize Mr. Chabot.

And I have tons of other questions. We will stay here until I am able to get all those questions out.

Mr. Chabot?

Mr. CHABOT. Thank you, Madam Chair.

Mr. Kutz, let me ask you, first of all, if I can, of the firms that received contracts through the HUBZone program in the DC metropolitan area that you referred to this morning, how did you select the 17 for detailed investigation?

Mr. KUTZ. We did data-mining. It was not a random sample, so we cannot project this to the population. So we used data-mining for various types of characteristics of a company.

And even the 17 is not all. We looked at the virtual offices. I don't know if you saw part of this, too. We data-mined, in that case, for people where there was a suite with 10 HUBZone companies using the same suite, which is a high indicator of fraud. So, various characteristics like that.

Mr. CHABOT. Thank you. So there are indications that indicate that there may be problems, there may be a reason to go further.

Mr. KUTZ. That is correct. And those are some of the tools that we would recommend SBA consider as part of a fraud-prevention program.

Mr. CHABOT. How many was that out of, approximately, in that particular HUBZone area? How many firms are we talking about?

Mr. CAUSSEAUX. In DC, I think there are about 280-some, but we also looked in suburban Maryland and northern Virginia. The actual 17 we looked at, HUBZone companies that had received a HUBZone sole source set-aside or price-preference award, not just that they were a HUBZone company. We selected companies that had received, with only one exception, at least $450,000 in those

HUBZone-specific contracts in 2006 and 2007, obligations on those contracts.

Mr. CHABOT. Thank you.

Now, of those where you did determine that there is clear evidence of fraud, will you turn this over to another agency in order to pursue this criminally?

Mr. CAUSSEAUX. We have referred the 10 case examples to the SBA IG for further investigation, yes, sir.

Mr. CHABOT. And, Ms. Carranza, is that what your agency will do?

Ms. CARRANZA. Congressman Chabot, we have also assigned what we call a suspension and debarment official who will address the 10 companies once we have a list of them and assess whether we should suspend or debar, and up to and including prosecution, as we have done so successfully in Kentucky with the support of Department of Justice.

So there are memorandums that are out already for public review. We believe not only in detection, because, as GAO staff has informed me, detection is just one part of the solution. We need to look at deterrence.

There is reference to the application and the validation of information. I am here not to deny that it was lax. I am here to compel you to learn adequately, concisely, that we are now expanding not only the validation and verification but also the search engines that were not previously utilized to verify the information on the application. And that is all to prevent fraud or misrepresentation of information.

Mr. CHABOT. It is my understanding that back some years ago, maybe it was 2002-2003 approximately, that the SBA's Inspector General did an inspection, I believe it was in Idaho, and I think they found two-thirds or so of those that were on the rolls were ineligible, as well.

I see some nodding of heads. Would anybody want to touch on that?

Mr. SHEAR. Yes. Over the years, the IG has done a number of examinations looking at control issues. And while ours was more current and might have been more expansive, we basically come to a very similar place in that there is a very big problem up front with the certification process and the problem is also there for the recertification process, that there isn't validation. This is where the biggest problems occur, through the front door.

And then what we see is that, in those instances where SBA looks very closely at all, asks for verification of information, you see a large number of decertifications, which is, rather than saying that shows that they are on top of the situation, because they are only looking at a few firms closely, it shows that when there is a close look, there is a problem.

So our results are very consistent with what the IG has found over time.

Mr. CHABOT. And for the record, Ms. Carranza, if you are aware, or whoever is, approximately how many HUBZones are there nationwide? I don't need an exact number but just approximately.

Ms. CARRANZA. There are approximately 14,000.

Mr. CHABOT. 14,000 HUBZones. Now, the one that is at issue today and then the one that I mentioned in Idaho are just two of literally 14,000. Is it reasonable to assume, if you have looked very closely at these and found real problems, that it is reasonable to assume that there are problems in other areas throughout the country?

Ms. CARRANZA. I would like to answer that question on the affirmative. And that is why we have taken some very aggressive measures to train the district personnel who are currently performing site visits to physically go out and perform the site visits.

And Chairwoman Velázquez had mentioned that at one of our previous hearings, and we went back and looked at assessing how many we could accomplish. And we referred to the IG audit, where we came to an agreement that if we could adequately perform 5 percent, that that would be a good measure for us to detect any issues. It is quite evident that we did not comply effectively to that commitment.

Mr. CHABOT. And obviously one of the reasons that this is so disturbing is that the HUBZone goal of the program is to help areas that are economically challenged, whether they are in an urban area—I have many of those types of areas in my district, in the city of Cincinnati, and there are also rural areas that have these same challenges. And there are limited tax dollars available to help start up and grow small businesses to hopefully improve those communities and create jobs for people. And if those dollars are being essentially ripped off by those participating in these fraudulent situations, certainly that is unacceptable.

And so I would be pleased to join the chairwoman in reforming and improving this program so that it is doing what its intended purposes were.

Let me just conclude by, one more time, Ms. Carranza, when did you receive the report?

Ms. CARRANZA. Last Thursday.

Mr. CHABOT. Just last Thursday.

Ms. CARRANZA. Yes. And it was a verbal report, not a written report, Congressman.

Mr. CHABOT. All right. So it would probably be unrealistic to expect to you have a whole list of things that have already been implemented and a timetable and that sort of thing. But I would assume that this would be a high priority, in reforming the program and making sure that these things are dealt with very quickly and very thoroughly.

And, again, I would be pleased to—

Chairwoman VELÁZQUEZ. Would the gentleman yield?

Mr. CHABOT. I would be happy to yield.

Chairwoman VELÁZQUEZ. Ms. Carranza, isn't it a fact that you had a draft of the report months ago from the GAO?

Ms. CARRANZA. The first time that was—

Chairwoman VELÁZQUEZ. From Mr. Shear's report.

Ms. CARRANZA. The first time that we sat down and reviewed the particulars of the fraud investigation with Mr. Shear and Mr. Causseaux was on Thursday, was given an overview, one-on-one with a couple of the staff members. At that time, I knew the depth and breadth of the issues.

Chairwoman VELÁZQUEZ. Mr. Shear, for the record, when did you provide a draft to the SBA?

Mr. SHEAR. It was, I believe, during the month of May that we gave a draft report. And, as you will see in the report that is released today, that SBA's comment letter is included. I think the comment letter was from the first week in June, responding to the recommendations of our program audit.

Chairwoman VELÁZQUEZ. I yield back.

Mr. CHABOT. All right. Thank you very much, Madam Chairman, for clearing that up.

So then would you, just once again—I am not asking for a long, detailed report—but tell us what has occurred since that time and where you intend to head with this in the future?

Ms. CARRANZA. The time that I learned the details of the exposures or problems, serious problems with the program, was last week. I immediately assembled the top management in the agency. At that point, I was quite determined to fix the problem immediately and address contractors who could deal with improving and correcting and updating the data, the map data. They had already started a couple months prior, but we put some very strict guidelines and timelines. So, by August 29th, that should be completed.

We identified a couple of other contractors; first one to look at the overall HUBZone processes, so that they can assess not only the impact that the program has on economic development and job creation but also the overall impact of our procedures, which either we failed to comply with, adhere, or are insufficient to ensure the impact of the HUBZone program.

In addition to the resources and developing some accountability tools, we also have looked at new enforcement rules so from new leadership to new processes, including more compelling enforcement on any discrepancies that we may find either in the eligibility or the recertification process which would involve up to and including suspension and debarment, as well as, subject to legal grounds, prosecution.

Mr. CHABOT. Thank you.

Madam Chair, I yield back.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Ellsworth?

Mr. ELLSWORTH. Thank you, Madam Chairwoman.

Thank you all for being here.

Mr. Shear, whose request—was it this Committee's request to do this audit, go in and do this study or this operation?

Mr. SHEAR. We began our—I am making a distinction between the program audit and the investigation—we began this program audit at the request of Chairwoman Velázquez.

Mr. ELLSWORTH. And to your knowledge, is this the first time this type of an audit has been done of this, the HUBZone program?

Mr. SHEAR. I am not quite sure what you mean by ″this type of audit,″ because, as I responded to Mr. Chabot, the IG has done, some work evaluating the HUBZone program. We have, further back in the beginning years of the program, before my time doing small-business work, there were some evaluations of the HUBZone program.

So I think that there have been evaluations. It is just a question of, what we did is more recent, and we looked at a different set of questions than what some of the other evaluations did.

Mr. ELLSWORTH. Do you think that these methods of defrauding our Government and our people, are they anything new? Are using a different storefront, doing it online, are these all just brand-new things that you all, in your experience, have never seen before or the IG may have seen? Or is this—I mean, that is not a rocket-science way of doing this new technology of being a criminal, I don't think.

Mr. KUTZ. No, there is not a whole lot of sophistication necessary to beat this program, at this point. I mean, it just isn't really significant.

Mr. ELLSWORTH. So, Ms. Carranza, in your experience—and I know you came from UPS.

Ms. CARRANZA. Yes.

Mr. ELLSWORTH. And thank you. And I know that company is a wonderful company. But I also know they build in—they pay so much attention to detail. I was visiting a hub not too long ago, and they even talked about they don't take left turns to build efficiencies and check their system to reduce accidents and to cut down on time. So I know their security system is also very sophisticated.

Was there a time in your—and I know your tenure is short as the director—was there a time when you brought these or anyone brought concerns to the previous director?

And I would go back to this. It seems like the heads of agencies change about maybe every 8 or 9 months, and then there is always that, "I have only been here this long." And I am not accusing you of that, because I respect what you did, and I think we can always borrow from the private agency.

But were there times when you brought these concerns to your predecessor and they fell on deaf ears? And I saw the testimony of Chairwoman Velázquez about the previous answers, that you were frustrated because you didn't get cooperation on these things.

Ms. CARRANZA. I would like to address that question about my previous experience of the attention to detail. And you can appreciate why I was so frustrated to learn from Mr. Shear and others that the attention to detail, the management of not only data but procedures, was not adhered to in the HUBZone program office.

We spoke adamantly, I believe, Mr. Shear, about how this could actually occur with very senior management in play and very highly automated systems where you can capture a lot of data.

What I believe has occurred is that we have a combination of factors that caused this problem. One, the management became totally reliant on technology to perform their tasks. Second, for the validation of information, since it is a self-certifying process, they took the applicants on full face value. Based on a couple of documents to validate certain information, that was sufficient to get into the program.

Thirdly, the site visits were desktop visits in the district offices which is not sufficient to capture what we have just seen on screen. You do an onsite, you verify.

I cannot sit here and tell you that none of those have occurred, because I just met with the region administrators this week, yesterday, along with the district directors. It is an advisory field group that we have. And I challenged them on the procedure or process that they manage on these site visits and learned very quickly that they did desktops, but when they had an inclination or a flag that they should pursue an onsite visit, they would perform that too.

And I asked, what resulted from your interaction? And they indicated, typically it resulted in decertification.

Mr. ELLSWORTH. Mr. Shear, Mr. Kutz, from what you heard of Ms. Carranza's original 5-minute testimony, will the plan that she intended to implement solve some of these things?

And let me go on.

And then, Mr. Kutz, would you explain your background before you went to GAO; and would it then not be prudent for possibly SBA to hire people that maybe are of an investigative background, maybe that are a little more suspicious minded? Not that we don't trust people, but that could look into these things on a full-time basis, as opposed to when a committee has to call for an investigation?

So will what she says works, work? And why do we have to wait so long for these things to get investigated?

Mr. KUTZ. Well, it is too early to tell whether it is going to work.

And I don't want to minimize the problem. This problem developed potentially over a long period of time. And so you have again the issue of preventing new people from getting in the program that shouldn't be. And how do you clean up the mess you have got with maybe hundreds or thousands in there now that shouldn't be, who are taking business away from legitimate HUBZone companies?

My background is, everybody in my unit is a certified fraud examiner. I am a Certified Public Accountant. We have criminal investigators with 20, 30, 40 years of law enforcement experience from around the executive branch. We have tremendous data, analysis, and technology tools available; and we use many, many processes, including covert testing which we do for many congressional committees, which gives you an inside look at what is really happening with a program like the HUBZone program. Because how else can you get that unless you actually go out and try to commit the fraud yourself?

And so, again, the first question would be, do they have the right people to put an effective fraud prevention program in place? That is doubtful at this point. That requires people with certain types of skill sets.

Again, could they do better than they can with the people they have got? Probably. Do they need different types of people? Possibly. And additional training? I expect so.

Mr. ELLSWORTH. I would steal him, Ms. Carranza.

Chairwoman VELÁZQUEZ. Mr. Akin.

Mr. AKIN. Thank you, Madam Chair.

I guess the first thing that occurred to me, and I listened to your audit on what happened after Katrina, and I was mad for about 3 weeks afterwards—particularly one of your closing comments.

I said, Of all these different people outlined, there are tens of thousands of people that have defrauded the government and my taxpayers. I said, What is going to happen to them? And you said, Candidly, you really want to know? And I said, Yeah. And you said, Nothing.

And in this situation, I assume that what happens is that you have got somebody over in the Department of Justice that has prosecutors. The prosecutors are going after people that are shopping cocaine and doing all these other sort of high-tech, more spectacular things. And the guys that are just ripping off the taxpayer on a daily basis, making an honest living ripping off taxpayers, are probably going to be ignored just the same as they were in Katrina.

So I guess my first question is, does that suggest that you would almost put some law enforcement people in the SBA, or something, so that you have at least a dedicated resource of people going out? Because if you let all these people know that if you lie, you get busted, that is going to clean up an awful lot of stuff right there.

I have always thought we should do that on voter fraud. Nobody ever gets prosecuted for that, and it gets worse and worse, or at least it stays bad.

Is that something? That is my first question. Let me start with that.

Mr. KUTZ. Well, certainly investigators and forensic auditors and things like that would be best in this type of environment.

And it is interesting, the experience on Katrina; and that is even the best case. We set up a Katrina fraud task force, as you may be aware, we referred 22,000 cases to them of potential fraud. And that is what we identified, and as you said, it is probably tens of thousands more.

Mr. AKIN. Those are just the dumb people that photocopied their drivers license living in Minnesota saying they got hit by Katrina. These aren't really bright criminals exactly.

Mr. KUTZ. Exactly. And out of 22,000, at least 50 or 60 of them have been indicted. So that is not a high percentage, and that is kind of predicted, what probably would happen.

So here, though, I do think it is important that there are consequences to people who do lie about this program and who take away business from legitimate HUBZone companies. So we would certainly support SBA and anything this committee can do to help them—working with U.S. Attorneys, for example, on making some examples of these. Because I would predict, if you make examples of people and you publicize it, you will have a lot of people coming forth during an amnesty program that are going to decertify themselves before they get a chance to lose all their other government business.

Mr. AKIN. From a structural point of view, would it just mess everything up to have a couple prosecutor types attached specifically to a program like this?

Maybe I don't understand the structure of the administration, but do you have anybody that you can go to, Ms. Carranza, where they are going to work on your cases for you and make sure people get busted? Or are you at the mercy of the Justice Department?

Ms. CARRANZA. Congressman Akin, we have a couple of avenues that we have addressed already. One is working closely with the

IG. They have the appropriate skill sets to support us, and we can partner in that aspect.

Mr. AKIN. Do you have the resources there, though, to go after some of these people?

Ms. CARRANZA. Yes. I believe, as you stated earlier, that if we make an example of one or two, or follow through with the suspension—

Mr. AKIN. I understood that. But can you get the people to get on these things and start dealing with it or not? Do you have the power in your position? Or do you know yet?

Ms. CARRANZA. Yes, I have the authority. I have already deployed not only IG support, but also the district directors; and they are knowledgeable of the need to do more, and things better on the site visits and the recertifications process.

Mr. AKIN. So you do think you have the resources to do that—

Ms. CARRANZA. Oh, yes.

Mr. AKIN. —to make sure people, if somebody breaks the law, you can both criminally prosecute them and debar them from government contracts?

Ms. CARRANZA. Yes. We have an attorney who is actually our suspension and debarment officer.

Mr. AKIN. Let me just cross-examine then.

What is your sense, Mr. Kutz? Does she have the resources to go after some of these people, do you think? Or not? Because you have been around longer than she has.

Mr. KUTZ. Well, I don't know. I haven't looked at her human capital. But I suspect she doesn't necessarily have the right people. She may have people, but they may not be the right people. I don't know.

I think the other issue of actually prosecuting and something is not an easy issue. If you look at suspension and debarment in the government, typically people don't get suspended and debarred unless they are proven to be guilty of a crime. But the law says you can actually suspend or potentially debar without having to prove someone is criminally responsible.

So if they can prove some of these cases, that people are the in the program inappropriately, they can still potentially suspend and debar without going through the prosecution, I believe.

Mr. AKIN. I guess the other question I have—a couple of them—and that is, my understanding is, working in the administration is even more frustrating than being in Congress. And our job is like watching glacier races many days.

But do you—because of all of the different union things with government employees, if you have got a bunch of incompetent people who are currently working for you, can you get rid of them and move people around? Or does it take you a year and a half to build a case to get rid of somebody who is basically some toad that is doing nothing?

Ms. CARRANZA. I will address that from an operator's perspective, because I have 30 years as an operations manager, working with thousands of employees. Recognizing many times that you didn't have top performers, you have an A team, B team, C team, you look at their strengths or capacity.

What we have done in the agency, because we have employees with limited capacity or lack of focus or perhaps not the skill sets, we have trained in the past 2 years over 1,500 employees to look at the quality controls, quality improvements. We look at metrics, we look at employee relations, and we also look at the importance of auditing.

Chairwoman VELÁZQUEZ. Time has expired.

Mr. AKIN. Thank you, Madam Chairwoman.

Chairwoman VELÁZQUEZ. Mr. Shuler.

Mr. SHULER. Thank you, Madam Chair.

Mr. Kutz and the gentleman from the GAO, I want to commend you for your work.

Mr. Kutz, in your testimony you talked about the firms who had gained fraudulent access to the HUBZones. When you had the conversation and confronted them, what was their response?

Mr. KUTZ. I will let Mr. Causseaux answer that.

Mr. CAUSSEAUX. In many cases, they were sort of, well, this is how the game is played. They didn't seem to have any fear, if you will, of any consequences, whether it was prosecution or suspension or debarment. It was: It is easy to get in the program, there is lots of money that is out there, and nobody is going to come after me.

Mr. SHULER. Ms. Carranza, if you suspend someone or debar someone, the debarment is, what, a 1-year? A suspension that could be a 1 year?

Mr. CAUSSEAUX. Suspension is typically 12 months; that can be extended for 6 months and actually can be extended beyond that for various reasons. They both have the same effect.

Debarment, the typical is 3 years. However, the suspension and debarment official has the prerogative, based on the gravity of the circumstances, to make it longer than that.

But the effect of suspension and debarment is the same: It precludes that entity from doing business with the Federal Government in contracting, receiving Federal loans, receiving Federal grants or any other Federal monies.

Mr. SHULER. And that is what I understand that you have looked at, is doing the suspension and debarments?

Ms. CARRANZA. Yes.

Mr. SHULER. Will the SBA go after criminal indictment of these 10 people? Because I have not heard you say anything about criminal indictment yet. Do they actually go criminally after these folks?

Ms. CARRANZA. Congressman Shuler, once we assess the severity of the issues, our immediate action would be to follow the same pattern we did with the firm in Kentucky. That was not only heard in court; it wasn't strictly a suspension or debarment; it was prosecution, so he will have his day in court. And that is what we expect to do with not only those 10 companies, but other companies that we may come across. We are very determined, focused, to work through that as soon as we have the specific companies.

Mr. SHULER. If we are looking at just these 10 companies, what was the amount of contracts—dollars?

Mr. CAUSSEAUX. In 2006 and 2007, the amount of Federal contracts received, obligations now, was $105 million. One of the companies had a $40 million HUBZone set-aside contract. It is a—that

is the ceiling amount. They haven't been—that much money has not been obligated yet.

We estimated something over $24 million of that $105 million was in actual HUBZone type of contracts. But many, many companies get a HUBZone certification, and then they may or may not get a HUBZone prime contract. They may be getting subcontracts using that certification, or it may make them more attractive to contracting officers because, as you may know, companies that have multiple certifications, that receive a contract, get credit against those—each individual entity—for the small business goaling requirements.

Mr. SHULER. So, theoretically, we could be talking billions of dollars in fraud?

Mr. CAUSSEAUX. Theoretically, yes.

Mr. SHULER. Those are our tax dollars.

Madam Chair, you know, the SBA, the former director, the good thing about the SBA, he is no longer with the SBA, correct? The former administrator?

Ms. CARRANZA. The administrator has been assigned as Secretary of HUD.

Mr. SHULER. So he is with HUD now, correct?

Ms. CARRANZA. Yes.

Mr. SHULER. And with our housing crisis that we have, now he is administrating HUD. So we are talking about a guy that—essentially, despite his lack of oversight of billions of dollars; and is now with HUD with the housing crisis that we have now.

Madam Chair, I think there needs to be extensive and more investigation going on because these are our tax dollars. These are people, their hard-paying tax dollars that are going to these programs, and we have got a crisis on our hands.

I want to thank you and the ranking member for having this hearing and the good work that the whole committee and the staff has done. I yield back.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Bartlett.

Mr. BARTLETT. Thank you very much.

How big was the universe from which these 17 companies were selected?

Mr. CAUSSEAUX. Total HUBZone firms in the United States, 13,000.

Mr. BARTLETT. 13,000, 14,000. Did you mine the whole universe of 14,000 to find?

Mr. CAUSSEAUX. No, sir. We focused on the Washington, D.C., metropolitan area.

Mr. BARTLETT. I understand. But what was the universe from which these—

Mr. CAUSSEAUX. There were several hundred. But, again, we selected the companies, only those who had received HUBZone contracts of at least—

Mr. BARTLETT. How big is that universe?

See, to get some idea as to how significant these findings were, we have to know how big the universe was.

Mr. CAUSSEAUX. It was at least dozens in the D.C. Metro area, and then we drilled down.

Mr. BARTLETT. If you could make that available to us for the record, we would be very pleased, because in evaluating the significance of this, we have to know how big the universe was from which you chose this.

[The following information was provided to the Committee by the SBA: ″The 17 HUBZone firms discussed in the testimony were selected from a population of 44 HUBZone firms in the greater Washington, DC metropolitan area that met certain criteria.

Specifically, with one exception, each of the 44 had received at least $450,000 in obligations related to HUBZone set-aside, HUBZone sole source, or 8(a) with HUBZone price preference contracts in fiscal years 2006 and 2007.

The one exception was a HUBZone firm that was included in the population and our selection due to allegations received via the GAO FraudNet.″]

Mr. BARTLETT. I would like to first say a couple words about the HUBZone program in general. I have a lot of HUBZones in my district. One is a whole county.

One of the HUBZone contractors in that county has done two very admirable things. He has brought jobs to that county where the base pay is four times the average income of that area. That obviously is going to be a huge economic lift.

The other thing he has done is a really big benefit to taxpayers. The same contractor has similar work that—he works for NSA; that is not in a HUBZone. And he had an employee come to him, and he had two different positions the employee could have gone to. One was in Howard County for $100,000, the other was in Garrett County for $70,000. He wisely chose to go to Garrett County in my district for $70,000, because you live better with $70,000 in Garrett County than you do with $100,000 in Howard County.

What this means is that if all of NSA's work was done in Garrett County, they, for the same amount of money, could hire 50 percent more people.

So the HUBZone program is not only a very good program for the disadvantaged areas it serves, it is a very good program for the taxpayer, because you get the work done much more economically there.

I was disappointed, but not surprised by your results because I know human nature, I have been watching it for 82 years now. And what the HUBZone program relied on was self-reporting and self-certification. This requires honest people, and what it also required was peer policing. And I am distressed that we have so many dishonest people that took advantage, that gamed the system.

I am also distressed that the peer policing isn't working as well as it should, because the companies that have tried that get punished. And I know one of them, particularly, who has been punished because he has availed himself of this opportunity for peer policing.

I think that if you could assure your contractors that they were not going to be punished for peer policing, that they would do a better job than you could do, Madam Secretary, because there are a whole lot of them out there and they are really smart and they know what is going on in their communities.

I am distressed that we are going to have to take on more manpower and spend more money in supervising this program because there are too many dishonest people out there who want to game the system, and because we have not made it advantageous for peers to police the system because when they police the system, they get punished.

How can we change? We can't change the honesty of people. How can we change the peer policing so that it works?

Ms. CARRANZA. Congressman Bartlett, we can and we have and we will continue improving the controls, the internal stringent controls that are very necessary and that have been pointed out by GAO and the IG.

And I want to assure you that it is not the SBA personnel, strictly, who are going to have oversight in this area. Our associate administrator of our government contracting office has already drafted a memorandum to share with the 24 large agencies, government agencies, so that we can alert them to our areas of concern and the exposures of this audit.

Also, I have personally spoken to the key government contracting leaders, in a separate meeting, to share with them the vulnerabilities of our program and that we are going to need their support.

So there is a memorandum. I have met with them personally, and I have plans to continue to communicate so that it is a contracting community obligation to ensure that the noble mission of this HUBZone program is kept intact. Because, as was stated earlier, it is all about job creation and it is all about economic development in the most challenged areas of our community.

Mr. BARTLETT. When we know of peers being punished for policing, can we come to you for help?

Ms. CARRANZA. Absolutely.

Mr. BARTLETT. Thank you.

Chairwoman VELÁZQUEZ. Ms. Carranza, GAO was able to perpetrate fraud with a photocopier and whiteout.

Why are your internal controls so weak that such an unsophisticated scam is able to defraud the Federal Government? I need to understand why.

Ms. CARRANZA. Chairwoman Velázquez, it has been noted a couple times that this is a self-certifying process—program. And so, as noted also, we relied on the integrity of the applicant. And because we did not have sufficient validation and verification of the information that is supplied, it allowed loopholes. As a deterrent, we don't want to continue with the lax processes that would enable someone to defraud or misrepresent the information.

So it is a matter of tightening the controls, monitoring those controls for adherence and compliance, and documenting it in our SOP. Our SOP, as we speak, is being modified to incorporate those new procedures.

Chairwoman VELÁZQUEZ. You are telling us today you are going to have internal controls in place and you are going to have oversight?

Ms. CARRANZA. Better controls and greater oversight, yes.

Chairwoman VELÁZQUEZ. In trying to understand the magnitude and if any structural changes are later needed to take place, I am going to ask you the following question:

Fraud seems to be something you hear mentioned regularly in conjunction with SBA. Last year, the Department of Justice and Secret Service uncovered massive fraud in the SBA loan programs; and now, GAO has found similar, if not greater, fraud in SBA's contracting programs.

We have also heard about problems with Katrina, a former Bush administration official being awarded work in the 7j program, and big businesses getting small businesses' contracts.

Ms. Carranza, what has occurred over the last few years that has made your agency so susceptible to fraud?

Ms. CARRANZA. I can explain very—

Chairwoman VELÁZQUEZ. Is it the reduced budget, 40 percent in the last 7 years? Have the agency buyouts forced out more experienced staff? Is it because there has been high turnover in the administrative portion? What is it?

Ms. CARRANZA. Congresswoman Chairman, to delineate every one of them would take greater than 5 minutes. But I will explain that we have addressed every one of those areas and have put in place—I can answer for the past 2 years that I have been here—with Secretary Preston a reform agenda that not only looked at simplifying processes, developing the skill sets of the existing workforce.

We have actually added employees, over 100, since we were addressing the resource allocation or alignment. We have also put significant controls in our ODA, Office Disaster Assistance. In our Office of Capital Access, as you know, we are addressing oversight.

Chairwoman VELÁZQUEZ. But we are here today. Thank you Ms. Carranza.

Ms. Fallin.

Ms. FALLIN. Thank you, Madam Chairman.

I appreciate you coming today, all of you, to testify on a very important subject; and it is certainly very disturbing, some of the information that we have heard.

And I know, Madam Administrator, you are relatively new to this job and new to this position, so I appreciate what you are trying to do with your agency and some of the steps that you have been taking to identify the challenges, map out an appropriate course of action to remedy some of these issues that have been revealed by the various other government entities.

I want to ask you a question. Do you think the HUBZone program is worth keeping?

Ms. CARRANZA. What I can—

Ms. FALLIN. Is it beneficial to our economy, beneficial to small business?

Ms. CARRANZA. Yes, Congresswoman Fallin. The noble mission of HUBZone is about job creation and economic development and in the most challenging areas. As I explained earlier, to suspend a program that meets the needs of so many - this is not about a program problem, this is about a program management problem.

And it is my responsibility to ensure that we put in the controls and address all those efficiencies so a program such as HUBZone

and others are not negatively impacted by the loose controls that we have and are then accessible to fraud or misrepresentation or the eligibility of the applicants.

Ms. FALLIN. That is good to hear. And let me ask you something else.

What would happen, and I will ask maybe all of you, if we had an announcement—and maybe you have already done this—but an announcement by all of you that said we are not going to tolerate fraud and abuse of government taxpayer dollars, especially as it deals with HUBZones or any other program within the SBA, and here are some cases we identified that are going to be prosecuted promptly; we are going to take care of them, and we are going to give everybody in the Nation a warning, who may be taking advantage improperly of this program, that we are going to crack down, and you'd better get ready?

Ms. CARRANZA. Congresswoman Fallin, I believe we have accomplished that already by being named collectively with GAO and IG on a press release that just went out. That is just the beginning, because the proof is in the suspensions and the debarment activity, as well as making sure that we communicate this in the forums that we participate in.

As you know, we attend government contracting matchmaking events, summits, conferences, and that is our platform to make sure that we articulate this stringent observation.

Ms. FALLIN. Did you want to say something here?

Mr. KUTZ. I think you are on a target.

Advertising that people are being held accountable and giving people an opportunity under an amnesty program to come forth and decertify themselves, I think would have an effect. The suspension and debarment, as Mr. Causseaux said, that pretty much takes you out of the government business for a year, 2 years, 3 years; plus, you can't get government grants and other types of payments.

So that is a real consequence; and if people knew that their lifeline was at stake, basically, from a business perspective, they would come forth.

Ms. FALLIN. Let me ask you this. After hearing the plan of action that she has laid forth—and it takes a long time to change government at times; it is unfortunate, but it just does. It is hard to work through. People have been in government for a long time, and even the red tape and the bureaucracy itself.

But do you feel like the plan that the Administrator has laid forth with the time lines, with the procedures and what her agency hopes to do with restructuring and the goals that they have in place, is moving in the right direction?

Mr. KUTZ. Let me talk about fraud, and Mr. Shear can talk about from a performance standpoint.

But from the fraud standpoint, we haven't seen a fraud prevention plan yet, so I am not aware of one. They are working towards one, it sounds like. They just heard from us last week.

When we do covert testing, we don't tell them we are coming. We don't tell them until we are done. So it is going to take some time to see.

But you have a mess on your hands, effectively. I mean, you have got to fix the application process, to put fraud prevention controls in place.

And then you have to figure out what you are going to do with 10,000-plus companies in the system. You can't audit all 10,000 of them. So that is why your idea of publicizing some poster children-type cases could potentially do some of your work for you in the early stages.

So that is kind of where we are with the fraud side.

Mr. SHEAR. When we make recommendations to an agency—and in this case, it is a program where we have what I will call—we identified ″very severe deficiencies″ in this program and recommended corrective action. We are always glad when the agency agrees with us and states that they are going to take action.

This is the concern I would raise here for Administrator Carranza and for this committee, that the response we received at the beginning of June to our program audit in terms of agency comments and the response today, I think there might not be a recognition of the size of the task that is involved.

Some things can be done fairly easily to try to get a handle on the issue, which could be using data smarter, to try to identify the virtual offices, the locations where you have multiple HUBZone firms, and the like. But some of these things, especially verification of employees, all these other types of actions we recommended, are more difficult.

So I do have—we have a concern as far as the ability to do this quickly. At a minimum, we would like to see a process in place so that it could lead to success down the road.

And as far as the specific plans, such as developing regulations and policies and procedures around certification and recertification, it is in the draft stage. It hasn't been shared with us yet. We would be glad to work constructively with the agency as they move forward, but we don't know what the plan is.

Ms. FALLIN. Let me ask, are you willing to work with him as they move forward on these plans?

Ms. CARRANZA. Last week when we met—to answer your question, Congresswoman Fallin, 30 days from now. I am not supposed to give exact dates, but 30 days from now I invited him back to the office, so we can look at our strategy and evaluate whether it is sufficient or not.

Chairwoman VELÁZQUEZ. Mr. Kutz, can you please explain to this committee, how are taxpayers affected if a company fraudulently gains access to the program and receives a contract or a price evaluation preference?

Mr. KUTZ. Well, certainly from the standpoint of this whole issue we are talking about here, they are ripped off from the standpoint of the wrong areas are being stimulated.

I mentioned McLean, Virginia. McLean doesn't need any stimulation. McLean is a very wealthy area, as some of you may know, the Tyson's Corner area where some of these companies were.

The other thing we haven't talked a lot about here is the legitimate HUBZone companies, like in Garrett County, Maryland, for example, may be losing out on business to fraudsters who are taking the business away from them.

And from a price standpoint, in some cases you might be paying more because you are limiting the competition, you are setting aside to a limited number of companies or you are doing sole-sourcing. So these things.

So there are a number of reasons where taxpayers are not getting what they paid for.

Chairwoman VELÁZQUEZ. Thank you.

Ms. Carranza, last year, the House passed H.R. 3867. And in this legislation, we included a provision to require onsite verification of HUBZone status prior to the award of a second contract. The administration voiced their opposition to this provision, and I quote, ″This provision will create a large burden on the Small Business Administration. The firms are already required to certify their status prior to award of a contract.″

Given the GAO's investigation and the evidence of substantial fraud in regard to the HUBZone program, do you still feel that this will put such a burden on the SBA? And will you continue to oppose onsite verification?

Ms. CARRANZA. What I am committing to you, Chairwoman Velázquez, is to further assess that situation with the new information that we received up to and including having a contractor come in and conduct an assessment of what it would take to ensure that recertification is accomplished.

Chairwoman VELÁZQUEZ. Let me remind you also that that legislation passed overwhelmingly, bipartisan support, over 300 votes.

Mr. Kutz, to get a library card from the local library a person is generally required to bring identification, as well as a recent bill with a local address on it, to prove residency.

In your experience, would you say that it is easier to get into the HUBZone contracting program, making one's company eligible for millions of dollars of contracts, than to get a public library card?

Mr. KUTZ. I don't have a library card, but given what you said, and back quite a few decades ago when I actually had a library card, showing up and having to prove who you are is more than was required for the HUBZone. So under that scenario, yes, it would require more diligence to get a library card than a HUBZone.

And that gets into some of the solutions here. Rather than this being an entirely Internet/e-mail-driven process, a little more like the site visits we are talking about would be a good step.

Chairwoman VELÁZQUEZ. Ms. Carranza, you spoke about electronic annual reviews in your testimony.

Can you tell me more about this system?

Ms. CARRANZA. Yes, Congresswoman Velázquez.

This is a mechanism that allows individuals, anywhere from the headquarters personnel to the district offices, to perform reviews, site reviews, firm reviews. And it facilitates and simplifies the process.

As I indicated earlier, we have reassessed that process because, again, we have allowed technology to manage the process versus the other way around.

Chairwoman VELÁZQUEZ. So it is exactly this sort of electronic system without verification that has caused the problems with the HUBZone program.

Let me ask, Mr. Causseaux, while you haven't examined this program, can you tell us if you will be concerned about the potential for fraud using this type of annual reviews?

Mr. CAUSSEAUX. Any system that is predicated on self-certified information without verification and validation is highly susceptible to fraud and abuse, particularly when millions, if not billions, of Federal dollars are at stake.

We sometimes use the term ″faith-based contracting,″ which is essentially a process where we kind of simply sit back and hope and pray that the company we are doing business with isn't ripping us off too badly. This is a situation where, if you don't do due diligence and validate that you are getting what you are paying for, that those you are paying are the ones that purport themselves to be, you are susceptible to fraud.

So it does take more than the electronic system, yes, ma'am.

Chairwoman VELÁZQUEZ. Ms. Carranza, I just would like for you explain to us what kind of fraud prevention measures will be put in place to supplement these electronic reviews, annual electronic reviews. Because it, by itself, will be open to fraud.

Ms. CARRANZA. Congresswoman Velázquez, as indicated by Mr. Causseaux and Mr. Kutz, it is about validating and verifying the information that is given, that we are now taking a more stringent and more aggressive manner in doing. If a drivers license was required, or a utility bill for validation or verification of address was allowed, now we will ask for copies of the office lease, now we will ask for much more in-depth and comprehensive documentation to validate and verify the information that is electronically shared with us.

Chairwoman VELÁZQUEZ. You are telling me that you are not going to rely only on annual electronic reviews?

Ms. CARRANZA. Exactly.

Mr. KUTZ. Chairwoman, could I comment on that?

Chairwoman VELÁZQUEZ. Of course.

Mr. KUTZ. Because verification is more than getting a copy of something. When we submitted our first application, they asked us for a copy of our lease. We dummied one up, faxed it to them, and they bought it. So validation means possibly maybe calling the lessor or doing something besides taking a piece of paper and saying, yep, I met the item on the checklist.

So I think when we talk about verify and validate at this discussion here, it is more than simply requesting a piece of paper.

Chairwoman VELÁZQUEZ. And getting the fax machine or e-mailing.

Mr. KUTZ. Especially by fax. A carbon drivers license by fax looks a lot better. With the holograms on a drivers license, if you faxed them in, you can't tell if it is a real license or not.

Chairwoman VELÁZQUEZ. How would you react to Mr. Kutz's assessment?

Ms. CARRANZA. Congresswoman Velázquez, I actually took a couple of addresses and pursued Google Earth. And I believe you are very familiar with Google Earth, where it will zoom in and catch that storefront Starbucks.

This is just one of about nine other types of search engines that we are expanding to ensure that we narrow down the focus of the

documentation that has been given to us. So these are going to be expanded search engines, they are going to be consistently utilized. And, once again, this is just one of many that will be utilized to verify the information and validate it.

Chairwoman VELÁZQUEZ. Mr. Bartlett.

Mr. BARTLETT. I was very pleased, Madam Secretary, that you noted that this was not a program problem, it was a program management problem.

I would like to again say something about HUBZone programs generically, because I know they are now under attack. Most of our other small business programs are very admirable in that they help people. You can be an 8(a) contractor and you can get a contract in McLean, Virginia, which doesn't need any economic help at all. And that is nice that we have programs that will help these disadvantaged companies no matter where they are.

The HUBZone program is one of those things that occasionally I note, and such a really creative idea that I say to myself, gee, why didn't you think of that? Because this is a program that not only helps people, individual companies, but it helps whole areas. And we don't have any other program like that in the Small Business Administration. It is an absolutely unique program.

The jobs that I mentioned that went to Garrett County, except for the HUBZone program they would not have gone there. This contractor inconvenienced himself by going to Garrett County, and he went there because it was a HUBZone area and because he knew that he would have some advantage in getting contracts from NSA because they have a checkoff of whether or not they are meeting a number of goals of subcontracting, and this is just one of them.

So I did want to appeal to fixing the problem, not putting the whole program in jeopardy, because I think this is a really unique program, a very worthwhile program. As I said, when I first saw it, I said, gee, why didn't you think of that? It is such a unique idea.

And the example I mentioned not only helps Garrett County which, when I came to office, had 14 percent unemployment. And I went there door-to-door, and I was surprised.

Most places I went door-to-door, it was very easy, because after I rang the doorbell, I filled out the little door hanger that said, I was here; and I give the time and the date and I hang it on the door, and I'm sorry I missed you. And almost nobody came because they were out working.

When I went to Garrett County, a lot of people came. And they were senior people that told me that during their working years they had to go to Pittsburgh or Baltimore to make a living, but when they would retire, they came back to Garrett County. I said, gee, this must be a great place to live; too bad that we have 14 percent unemployment here, that our people have to go away to Pittsburgh and Baltimore to make a living.

The HUBZone program is now changing that, and there are really good jobs there. As I mentioned, four times the mean annual salary is what is paid to these people. And that uplifts a whole community when you have that kind of salary.

So I just want to make an appeal that we need to be focusing on fixing this program. And, again, I am very disappointed that there are so many people out there that would—and the taxpayer maybe gets value from these contracts, but what is really hurt is the area that should have gotten the contract and didn't get the contract.

I think that probably pretty good work is done on these contracts, but the real tragedy is the area that should have got the contract, that should have been uplifted by it economically, missed that because it was fraudulently given somewhere else.

So I hope that our focus is on, what do we need to do to fix this program, so that it is really a viable, good program and not have any hint that the program should be at risk because of this.

This is just human nature that you have unearthed. And again, Madam Secretary, we are going to come to you, because we want to make sure that people who are trying to self-police, peer policing, that they don't get punished for doing that. And I know that happens and I know that is a huge detriment to the success of this program.

So thank you for your invitation to come to your office. We will be there.

Ms. CARRANZA. Thank you, Congressman Bartlett. And if you will allow us to visit your office, as we have done in the past, we would definitely look forward to giving you a report, and Congresswoman Velázquez, on the progress of our plan so that we can keep you updated.

Mr. BARTLETT. I would be honored. Thank you.

Chairwoman VELÁZQUEZ. Mr. Ellsworth.

Mr. ELLSWORTH. Thank you again, Madam Chairwoman.

I would associate my comments with Mr. Bartlett's and agree, this is a good program. It is doing good things.

But knowing some of the people that I know back home in Indiana, they would rather have no program at all than a program that is riddled with fraud and abuse, because they are the taxpayers that are paying these dollars. And so its incumbent upon us to fix it.

I was just sitting here, thinking out of the box, we want to keep government spending down. But contracting, if you offer these areas a stipend, even if it is not your agency, another Federal agency or even a local agency, to go out and make some of these spot visits and train them, there are companies that would love a $30,000 a year stipend to go out and make that part of their duties. A sheriff's department or police department or, like I said, a welfare department, they could do this. And there is nothing in replacement.

Like Mr. Kutz said, you can dummy these things up all day long with technology and fax in anything you want, and there is nothing like eye-to-eye contact and eyeball, and asking questions and seeing who is in and checking a payroll roster. There is just no substitute for that.

And so I think there is—if we think out of the box a little bit, we can do that.

Mr. Shear, we talked about self-policing, and I guess this is along that. Is self-policing, to you or Mr. Kutz, an effectively tool to mon-

itor HUBZones when—like I said, we just discussed it, but is it going to be effective, or do we have to go further?

Mr. SHEAR. Well, I will address it from the standpoint of our program audit. And our program audit focused on SBA because it is the agency that is in charge of administering and overseeing this program; and we think that agencies that play that role have a very important responsibility.

As Mr. Kutz said a little bit earlier, self-policing, the extent to which it occurs among recipients of a program can be useful. But the idea that SBA officials stated when conducted our program audit, and reference was made to self-policing in the program, there is a burden of proof: Is self-policing working and can it work?

And when we started asking questions about self-policing, such as self-policing status protest in the HUBZone program, we started asking questions, how many times are there status protests? And there aren't that many.

Then when we started asking questions—which is really out of fairness to the businesses that participate in this program in that many of these contracts, even though they are small businesses, they are in HUBZones, they are local businesses many times, especially with construction, you are talking about contracts that could be in other HUBZone areas and things of the like—how is it that a HUBZone concern or somebody with skin in the game would know enough information?

If SBA doesn't know the information, how are different participants in a program going to have the information to really self-police? And that is where we started getting nonanswers.

So we have a concern about self-policing in this program, the degree to which it has been used, the degree to which it has worked.

Now, given our focus on SBA's actions for internal control, I will say that what we observed in terms of the high level of firms that apply being certified, and then the large number of firms that, when anything is looked at very closely and where verification is asked for by SBA, for those small numbers of firms, the high numbers that end up being decertified, to us that is an indication that whatever policing is going on by SBA and self-policing is not working.

Mr. ELLSWORTH. Thank you very much. I have got about a minute left. Any suggestions, as you sit there and think about the same things that I was thinking about, short of hiring 30,000—how many HUBZones across the country, 30,000?

Ms. CARRANZA. Fourteen thousand.

Mr. ELLSWORTH. Short of hiring 14,000 new government employees, any suggestions that you can say that you have all been talking around the office and saying, if they would just do this, they would get that eyeball-to-eyeball check?

You know, let them split. Is there another agency? Have you all thought of anything?

Ms. CARRANZA. Thank you, Congressman Ellsworth.

We have not only looked at the density of the need to do onsite, the density of firms, but we also recognize that we have other agencies and other resource partners that can be deployed as well to perform some of those physical onsite versus site reviews.

In addition to that, we want to be a deterrent up front. So when we look at the application, we are going to ask for a lot more information up front and validate that information, and then take it personally that after that application is completed and the information validated, we zoom in with all of the search engines to again verify it, so that no business can be disruptive, the job creation can be realized and, of course, economic development.

Chairwoman VELÁZQUEZ. Would the gentleman yield?

Mr. ELLSWORTH. Sure.

Chairwoman VELÁZQUEZ. Ms. Carranza, it caught my attention that you said that you have other partners, and that you will use personnel from other agencies to go and do onsite visits.

How is that possible? That is the sole responsibility of SBA. Are they trained? Who will train them?

Ms. CARRANZA. Congresswoman Velázquez, when I say other resources and agencies, we have government contracting community members, whether it is other agencies that are out in the field. We also have our resource partners from the Entrepreneurial Development Office.

We are just looking for other avenues that could participate in this scrutiny. We have not locked it in yet; this is still going under assessment. But we have opportunities to offer the training that is required.

Again, we are going to first manage it from our office before we branch out and commit those resources, but I believe that there are other options that we can consider. It may be premature to say that at this time, because I haven't fully assessed it.

Chairwoman VELÁZQUEZ. I hope so. I hope that it is premature to say. This is too serious. This is fraud. This is about taxpayers' money. This is about hurting legitimate companies that are doing their job in our communities.

So to contract out or to give the responsibility due diligence that is your sole responsibility to other partners out there who do not have—first, do not understand the program; two, do not have the training—that really concerns me. So I hope that you will revisit that.

Ms. CARRANZA. I will take that under consideration.

Mr. ELLSWORTH. I yield back.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Cuellar.

Mr. CUELLAR. Thank you, Madam Chair.

Taxpayers expect efficient, effective, and accountable government. I think that is the basic premise when we talk about governance. There are different ways of doing this, and I think the gentleman just mentioned this.

You can go into a policing effort where you go in and say, we have a thousand places we have to search or we have to hire a thousand people, and that is hard to do with a budget. Or you can use more of a red-flag approach, where you look for certain areas that will say, hey, there is a red flag, so we need to go in and send somebody in there.

Customs, for example—I am from Laredo, the border area, one of the largest inland ports. We get thousands of trucks, actually we get about 10,000 trucks going up and down. If Customs were to try

to stop everybody coming across, they would stop the traffic coming in, the international trade. So they use specific methods to do spot-checking to go in and look for those red flags.

And I assume you all have some sort of model that we can employ or SBA can employ. I would like to have you all submit that to us to look at the different models we are looking at, because you can't send a thousand people out there, but there are ways that you can red-flag those areas and then send them in when there is a red flag.

You know, one of the things, for example—a red flag, for example, as Mr. Kutz, I think you mentioned the virtual offices in your testimony. Can you elaborate on what that term means and how that relates specifically to the HUBZone program?

Mr. KUTZ. Yes. It is an office that you can rent that could be a legitimate HUBZone if you were actually having people working there part-time and onsite part-time. But we also saw the other end of it where there was actually just a mail forwarding.

And the indicator you are talking about in this particular case would be, if 10 companies—and this is a real case here—10 companies using the same suite at the same address are all HUBZone companies. Well, that doesn't make much sense. And when you actually get behind that, you see that that is one of the ways companies can beat the system here.

So that will be the kind of red flag you are talking about, looking for virtual offices. And you can investigate all 10 of them by doing one visit in that particular case.

So that is a way to leverage your resources also. I think virtual offices is one thing SBA should build into their fraud prevention program.

Mr. CUELLAR. So what does it mean when you have a virtual office? Does that mean that there is an intent to commit fraud, or does that mean there is some legitimate? And I know the answer to that—

Mr. KUTZ. It could be either one.

Mr. CUELLAR. —but how do we use that red flag so we can send in individuals to do the personal visits? And how does the SBA use that model? I want to see models out there because, again, our resources are limited and we know that for a fact. But there has to be a system in place to bring in the red lights and the red flags to come up.

Do you all have a model that could be shared with the SBA? Could you send that to us, to the committee also?

Mr. KUTZ. We don't. But in this case, it was simply sorting the addresses and looking for multiple hits at the exact same address; and you can do that with multiple software packages out there.

So one of our fake companies was in a virtual office, and we were there in the same office with nine other companies. So the other companies there were suspicious.

So that is a basic software. We don't have a model in this particular case that would apply to the SBA situation necessarily.

Mr. CUELLAR. Should we have a model?

Mr. CAUSSEAUX. Clearly, the easiest tool in that situation is when a company makes an application for HUBZone certification,

if that address happens to be one that another firm or firms is at, that ought to send a flag. In fact, it is a fairly clear indicator.

As we said, in Rockville, Maryland, there is a very small HUBZone. There are 17 HUBZone firms in that particular sliver; 10 of those 17 firms are in the same suite in the same building in that one location.

Mr. CUELLAR. So shouldn't that have alerted somebody right there? I mean, that is what I am saying. There has got to be some sort of systematic approach to addressing this.

Ms. Carranza, I would ask you. A lot of times people look at GAO or any auditing firm as the enemy, but I have always looked at it, how do we improve the information that GAO provides? How do we use that?

Instead of saying, oh, my God, they found some weaknesses in the program and therefore that is negative. I would ask you to just work with them and look for—I am a big believer. I did my dissertation on performance-based budgeting. There are models that you can set up; there really are models.

So I would ask GAO to work with Ms. Carranza and look for—especially in these virtual offices. There should be a system in place for your employees to say, there is a problem right here; we have got an office and there are 17 different companies in the same place.

Mr. KUTZ. If you look at the monitor, that is what Mr. Causseaux was talking about. That is the building that has the suite.

Chairwoman VELÁZQUEZ. How big was the suite?

Mr. CAUSSEAUX. It was about 30 offices that are in this suite. It is a shared office arrangement. Some of the firms—or at least one of the firms paid $50 a month strictly for mail forwarding; and they could rent an office or a conference room on an a la carte hourly basis.

Some firms rented, they paid a couple hundred a month, and they received up to 4 hours or 6 hours use of an office on a scheduled basis. And there were two firms, I believe, that actually had a full-time office there.

But of the 10 offices, or the 10 HUBZone firms that were there, seven of them were on a virtual office situation; and those seven had another office that was not in a HUBZone area, one of which was in one of the larger—one of our case example firms was in McLean, another one in McLean.

Chairwoman VELÁZQUEZ. Mr. Kutz, I am so lucky I don't suffer from high blood pressure.

Mr. CAUSSEAUX. Me, too.

Chairwoman VELÁZQUEZ. Time has expired.

Mr. Bartlett, do you have any other questions?

Mr. BARTLETT. I just want to verify what I thought I heard emphasized in the discussion, is that the two major sins that are committed by these people, one is not having the major headquarters of the company in the district, and the other is not having 35 percent of the people live in the district.

These are the two main things?

Mr. CAUSSEAUX. That is correct. There are four attributes for being a HUBZone: You have to be a small business; you have to be 51 percent owned and controlled by U.S. citizens; 35 percent of

your employees have to live in a HUBZone; and the principal office where the majority of employees, essentially, work has to be in a HUBZone.

We tested the 35 percent and the principal office attributes for our case examples.

Mr. BARTLETT. Well, at least three of those are pretty obvious, if you are in the community, aren't they?

Mr. CAUSSEAUX. Yes, sir.

Mr. BARTLETT. Yeah, which would lead me to believe that pure policing, if we encouraged it, really would work. Because there has to be other HUBZone businesses in that area which are really mad when the contract goes to somebody who is cheating. Isn't that true?

Mr. CAUSSEAUX. If I could answer that question, I believe that is true. However, the problem with the peer policing is that it is based on a protest mode. And in order to protest, first of all, you have to have been a competitor for that particular award or that particular—

Mr. BARTLETT. But can't we change that, sir?

Mr. CAUSSEAUX. I can't. But perhaps you certainly can, yes.

Mr. BARTLETT. Well, if we need to change that, if the regulators can't change it, then we need to change it, Madam Chairman. We need to not limit who can say, ″Gee, that guy is cheating.″ And as far as I am concerned, it can even be anonymous. You know, I like a suggestion box, an anonymous suggestion box, outside my door.

I remember a very interesting case when General Shinseki wanted to have berets made for all his soldiers. And he was enormously embarrassed when he learned that they were going to be made in China. And I suggested that he maybe ought to have a suggestion box outside his door, because lots of people in that line of command knew they were being made in China but nobody dared tell the top guy that.

You know, you just need to be able to get this information. This isn't rocket science. These three things are really easy to discern. And I would think that if we made it easier and we didn't punish these people who were protesting—and it shouldn't be just the—if the only person who can signal this is the guy who was involved in the bidding process, then you really, really have limited—

Chairwoman VELÁZQUEZ. Time has expired, Mr. Bartlett.

Mr. BARTLETT. Yeah.

Can you do something to change that, or do we have to do it?

Ms. CARRANZA. Congressman Bartlett, at this time, I don't believe that we need additional legislation. What we need to do is adhere to the procedures we have in place.

We have referred to flags, red flags. I have a three-page description of, when red flags occur, the following should take place. And I mentioned earlier, it is program management and adherence and comply to procedures.

Chairwoman VELÁZQUEZ. The time has expired.

Mr. BARTLETT. Thank you.

Chairwoman VELÁZQUEZ. We are ready to wrap up. But before, I need to ask three questions for the record to reflect.

Mr. Shear, we hear talk about the economic benefits of the HUBZone program and how good they are. So do you have or saw

any ways where the benefits are quantifiable? Do you think that we can measure the benefits of the program?

Mr. SHEAR. We make recommendations in our report for SBA to come up with measurement and an evaluative approach to determine the benefits of the program. Because, to date, we see the benefits of the program tend to be on indicators that don't work very well. The indicators SBA has now, it is based on anecdotal information, which, while it can be very valuable to provide some insight, it isn't systematic looking more broadly at benefits.

Chairwoman VELÁZQUEZ. Thank you.

Mr. SHEAR. And this is a program where we think that such an evaluation to guide the Congress and the SBA is very important.

Chairwoman VELÁZQUEZ. Ms. Carranza, in your testimony you mentioned that you are undertaking several projects—hiring more staff, requiring site visits to firms that have received HUBZone contracts.

All this is going to cost money. How much was the mapping contract?

Ms. CARRANZA. I don't have that information, but I would be glad to supply that information to you.

Chairwoman VELÁZQUEZ. Okay. How much was the contract to add additional employees to clear the backlog of recertifications?

Ms. CARRANZA. We have had a contractor for a couple of months. I don't have the exact dollar amount. However, we are realigning our workforce because of other backlogs that we have worked through so that we can reallocate the resources. So we should not be adding additional personnel.

Oh, the mapping cost is about $30,000.

Chairwoman VELÁZQUEZ. $30,000.

Ms. CARRANZA. Yes.

Chairwoman VELÁZQUEZ. Okay. And I am asking all these questions because we know that putting together the plan that you lay out is going to cost money. And my concern now is that, in trying to fix the fraud issue with a HUBZone program, that we might create other problems with other programs, because we are going to rob Peter to pay Paul, since the budget of the agency for the last 8 years had been reduced by 40 percent.

So my question to you is, would you request a supplemental appropriation to pay for all these measures?

Ms. CARRANZA. Congresswoman Velázquez, at this point we have the resources in place and space in the contracts that we are in—currently. If it required, then we would revisit and come back to you. But, at this point, I am not in a position to give a dollar amount or if we need additional funds. But we would consider that.

Chairwoman VELÁZQUEZ. It just brings memories back when we all witnessed in our Nation the Katrina debacle, disaster. And the Administrator came before us, and I kept asking him, "Do you have the resources?" Eighteen months later, we saw that people were still waiting for assistance.

So I hope that, months from now, you don't have to come before our committee because some of the other programs are having the same concerns and the same issues that we are discussing today.

So, with that, I want to thank all of you for being here.

I ask unanimous consent that members would have 5 days to submit a statement and supporting material for the record.

Without objection, so ordered.

This hearing is now adjourned. Thank you.

[Whereupon, at 12:06 p.m., the Committee was adjourned.]

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

STEVE CHABOT, OHIO
RANKING MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
of the Honorable Nydia M. Velázquez, Chairwoman
United States House of Representatives, Committee on Small Business
Full Committee Hearing on
"Small Business Administration's (SBA) Contracting Programs and Recent GAO Examination of Programs"
Thursday, July 17, 2008

The economy is still mired in a recession. In addition to six straight months of job losses, we are now facing considerable drop-offs in consumer spending and exports. Meanwhile, inflation continues to climb and, it seems, no financial sector has been left untouched. Just this week, news of the crumbling Freddie Mac and Fannie Mae proved that the housing crisis is far from over.

Amidst this otherwise weak economy, one bright spot continues to shine. The federal marketplace is booming. Last year alone, this industry grew by more than 9 percent. But while it should hold great potential for entrepreneurs, small firms are still fighting to break into the government sector. During the past 8 years, the Bush administration has missed every single one of its small business goals. In 2005 alone, entrepreneurs lost 4.5 billion dollars in contracting opportunities.

A broad array of programs exist to help small firms enter the federal marketplace. These programs seek to give opportunities to the most important sector of our economy-- Small businesses. Entrepreneurs not only create greater economic diversity and competition, but they also offer the best value for the tax payer's dollar. Today, we are going to look at one such program which, while having very laudable goals, has ultimately failed our entrepreneurs and our tax payers.

HUBZones were originally designed to help small businesses in low income communities. Today, the program has fallen short of that mission. As a result of insufficient controls by the SBA and inherent flaws in the underlying program, we now have widespread fraud.

This committee has long been concerned about the potential for HUBZone fraud. After a preliminary investigation confirmed these fears, we asked the GAO to conduct an investigation. The results were nothing short of appalling.

In their review, investigators found that the majority of HUBZone businesses failed to meet program criteria. And yet these firms still managed to collect over 100 million dollars in federal contracts. Twenty-four million of those dollars came directly out of HUBZone funds-- funds that should have gone to low-income communities.

These numbers are high, but they are not surprising. As noted in prior reports, SBA is notorious for failing to vet its programs. In fact, it conducts annual examinations on a mere 5% of certified HUBZones.

When it comes to the businesses themselves, only 36% of applicants are asked to show any form of documentation. It is so easy to break into the HUBZone program that investigators--using fake addresses and forged credentials--were able to do so in a matter of weeks. The entire process was easier than getting a library card.

Perhaps not surprisingly, con artists have had little trouble gaming SBA's broken system. Countless unqualified corporations have applied for-- and been awarded—millions of dollars in government contracts. Meanwhile, entrepreneurs looking for an honest break have been pushed to the margin.

Earlier this year, the House passed several important provisions in attempts to stem this fraud. But the administration opposed these steps, including requirements for on-site inspections. President Bush went so far as to argue that "this provision would create a large burden on the Small Business Administration." It seems the president prefers burdens of the multi-million dollar fraud variety. The kind of burden we unfortunately face today.

Small Business contract programs are important, and we need them. But if not adequately funded and properly managed, they turn into what we have today. Rather than lifting up underprivileged firms, HUBZones are lining the pockets of big corporations and otherwise fraudulent businesses. And they are doing so on the tax payers' dime.

Today's hearing will be an important part of understanding the fraud and figuring out the next steps toward overhauling the SBA. It will not be an easy process, but we owe this review to our tax payers, and we owe it to our small businesses.

I thank today's witnesses in advance for their testimony. This morning's hearing certainly promises to be an interesting one.

U.S. House of Representatives
SMALL BUSINESS COMMITTEE
Representative Steve Chabot, Republican Leader

Thursday,
July 17, 2008

Opening Statement of Ranking Member Steve Chabot

The Small Business Administration's Contracting Programs and Recent GAO Examination of Programs

Good morning and thank you all for being here as we examine the Small Business Administration's management of the Historically Underutilized Business Zone or HUBZone program. I would like to thank Chairwoman Velazquez for holding this hearing.

As early as World War II, Congress recognized that a strong economy and industrial base requires a robust small business economy. At the end of the Korean conflict, the Small Business Administration was created to provide assistance to small businesses.

One aspect of that policy is the requirement that small businesses be awarded a fair proportion of contracts for the purchase of goods and services by the federal government. That policy not only ensures that the federal government will have a diverse set of contractors from which it can obtain goods and services. It also provides an important tool to help grow small businesses.

Last session, the Committee examined all of the SBA government contracting programs. Today, we are specifically focusing on the HUBZone program in response to two separate assessments done by the GAO. I have been briefed on the studies and the results are troubling to say the least.

I am strong supporter of the HUBZone program because I believe that federal procurement can be used, not just to purchase good and services or even grow small businesses, but to provide needed assistance in the economic revitalization of poor urban and rural communities. However, if firms not located in HUBZones are actually taking contracts away from legitimate HUBZone firms, it defeats the purpose of the program. I will be interested in hearing from the SBA the steps the agency will take to ensure that only legitimate HUBZone firms are awarded contracts.

The HUBZone program is designed to provide economic development in poor areas. According to a study by the Office of Advocacy, some HUBZone contractors are generating as much as an additional $100 per person in additional income in a particular area. Of course, when it costs that much to fill your car's gas tank, the benefits of the HUBZone contracting program are dissipated. Revitalization requires not only building businesses in these areas but providing the people with affordable fuel. This requires increasing the supply of petroleum produced in this country.

Although I recognize that this hearing is primarily about SBA's management of the HUBZone program, I would be remiss not to mention that there are members on both sides of the aisle whose constituents were severely affected by recent floods in the Midwest. I suspect that the Acting Administrator may receive some questions on this issue and will be very interested in hearing about the agency's response.

Again, I thank the Chairwoman for holding this important hearing and look forward to working with her and the SBA to make necessary improvements to the HUBZone program so that it can truly assist in economic revitalization of our poor urban and rural communities.

###

Statement of Rep. Jason Altmire
Committee on Small Business Hearing
"Small Business Administration's (SBA) Contracting
Programs and Recent GAO Examinations of Programs"
July 17, 2008

Thank you, Chairwoman Velazquez, for holding this hearing to discuss the Government Accountability Office's (GAO) findings regarding the Historically Underutilized Business Zone (HUBZone) Empowerment Contracting Program. Established in 1997, the HUBZone program was created to encourage economic development in areas with high unemployment rates, low income, and/or high poverty rates, by providing federal assistance to firms that meet certain qualifications.

Although this program was created with good intentions, it now appears to be overrun with fraudulent activity. With roughly 13,000 firms having participated in the HUBZone program, it is extremely important that the Small Business Administration (SBA) take the necessary steps to correct the problems associated with the program. Small business owners in our districts rely on SBA programs and we owe it to them to make sure these programs are assisting those who qualify and not just anyone who applies.

Thank you again, Madam Chair, for holding this hearing and requesting this GAO investigation. I look forward to hearing from today's witnesses in hopes that we can identify the best way to clean up the problems associated with the HUBZone program.

Statement of

The Honorable Jovita Carranza

Acting Administrator

US Small Business Administration

House Committee on Small Business

Hearing on GAO Examination of SBA Contracting Programs

June 17, 2008

Good morning; I want to thank the Committee for the opportunity to testify today. While I am proud of the reforms and improvements I have made in my time at SBA, more work remains.

As the other panelists have described, the administration of our HUBZone program leaves considerable room for improvement. In fact, in September 2007, I testified to you about how we were concerned about certain flaws that needed immediate attention. The more we worked to remedy these problems and inefficiencies, the more problems we uncovered.

We welcome the work of the GAO and its investigative team, and as our formal response to their audit makes clear, we agree with their assessment. In fact, GAO's conclusions only confirm much of what we had already uncovered. Now we are working diligently so that this program will better accomplish the goals for which it was established, and I'd like to describe the specific actions we are taking.

First, GAO recommended that we take immediate steps to correct and update the map that is used to identify HUBZone areas. Further, they recommended that we implement procedures to ensure that the map is updated on a more frequent basis with the most recently available data.

The issue of the HUBZone map was, in fact, the problem that uncovered how seriously the program was being mismanaged. In response to a congressional inquiry early this year about whether a specific county qualified as a HUBZone, the HUBZone program determined that it was qualified. Then, after further review several days later, SBA found that it was—in fact—not qualified. When senior managers attempted to determine how such a mistake could have occurred, we learned that the initial determination had been done manually, which led to the question of "why?" This pointed to the true state of the mapping contract and the fact that the map hadn't been updated for more than 18 months, which in turn set off a cascading series of revelations.

In the course of getting to the bottom of these issues—a process that accelerated as time went on—the nature and extent of the program's problems became increasingly clear. It also became increasingly clear that the program needed new leadership. We have brought on new program management, who are fully committed to reform.

In response to GAO's call to rectify the map and insure that it remains accurate and up-to-date, on July 3rd a new contract was executed. This contract provides strict timetables and establishes procedures to ensure that, going forward, the map remains current. As described in our formal response to the GAO, the contract also stipulates that the new map shall be available by August 29th.

In its second recommendation, GAO suggested the development and implementation of guidance to more consistently obtain supporting documentation during the application process. Also, they recommended more frequent site visits to ensure that firms applying for certification are eligible

In response, SBA has drafted a new "Application Processing Manual," the first draft of which was completed July 2nd. The procedures established will provide concrete guides about required supporting documents—what documents are required and how these requests should be handled. Furthermore, the procedures include explicit instructions regarding on-site visits. These procedures will emphasize the need for both increased visits as well as a thorough examination. Presently, this draft is being reviewed and finalized by the HUBZone program staff and the other SBA departments that will be charged with implementing it. We believe that by more effectively marshalling the resources of our district offices we can quickly accomplish this objective, and HUBZone is working with our field operations to ensure that the procedures are clear. The drafting and review process for this manual will be complete by September.

The third GAO recommendation was to establish a timeframe for eliminating the backlog of recertifications and take the necessary steps to ensure that recertifications are completed in a more timely manner.

In response, SBA has hired contract employees to assist in clearing this backlog. Our goal is to clear the entire backlog by the end of fiscal year 2008. As of July 11th, 82 percent of this goal—4,324 recertifications—has been met, and we are on track to complete the remaining 973 backlogged recertifications by the deadline.

The new leadership team has been charged with implementing reforms so that, once the existing backlog is cleared, new recertifications are processed in a timely manner. I can assure the Committee that SBA's senior staff will oversee this task.

The fourth GAO recommendation was that HUBZone formalize and adhere to a specific timeframe for processing proposed decertifications.

In response, SBA is in the process of updating the applicable SOP and adding explicit timelines. This process will be complete by the end of August.

The fifth and final recommendation was to develop measures and plans to assess the overall effectiveness of the HUBZone program. This recommendation largely mirrors a similar conclusion reached by SBA's Office of Advocacy that we need better ways to assess the economic and development impact of the HUBZone program.

In response, SBA is developing an assessment methodology that will measure the economic benefits that result from the HUBZone program. This work is being done by a trained economist and the analysis staff of our Office of Policy and Strategic Planning. Once completed, this methodology will be used by the HUBZone program to issue regular, public reports accompanied by the underlying data. It is important to note that in developing this new assessment SBA will rely on data that is already available to SBA, the HUBZone program, or publicly available through other Executive agencies. Reducing the burden of government is an important goal, and the small business community and their local and state governments will not be required to submit any new information.

The development of this methodology is well underway, and the final product is expected by August. To ensure the participation of all stakeholders, SBA will publish this methodology and then accept public comment for four weeks. I encourage the Committee and all interested parties to examine the work and make suggestions about how we can better assess HUBZone's impact. After the evaluating any received comments, SBA will publish a final methodology detailing the measures and procedures that will be used.

In response to the findings of the GAO's forensic investigation, which we learned about last week, I have taken immediate steps to require site visits for those HUBZone firms that have received HUBZone contracts. Additionally, we will be instituting suspension and debarment proceedings against firms that have intentionally misrepresented their status in CCR. For example, now that we have the specific names and information on the ten firms that GAO has discovered, we will begin the process to suspend and debar them. SBA has already prosecuted firms for false certification, and we take very seriously the responsibility to ensure that the federal government's contracting partners are trustworthy. As GAO has noted, deterrence is more effective than detection, but deterrence only works when participants know there are serious consequences for malfeasance.

As I acknowledged earlier, and the other panelists have described, today the HUBZone program faces many challenges. However, please know that I am committed to solving them, and I believe that integrity and transparency must guide all of our actions at SBA. This commitment has allowed us to make dramatic gains in other SBA programs, and I look forward to applying these lessons to HUBZone.

For example, at the end of this month we will roll out our new Business Development Management Information System, which is a comprehensive system that permits electronic 8(a) and Small Disadvantaged Business certifications and electronic annual review. This is a major upgrade that we allow us to more effectively manage this vital program. Last month we released the third iteration of our federal procurement scorecard, this one focusing on agencies' plans for meeting contracting goals.

Improving the integrity of small business contracting data and tightening the rules to qualify are other examples. SBA has led tough-minded efforts that have reduced the miscoding errors in contracts that had a cumulative value of more than $10 billion. This will result in a more accurate, more useful measure of the contracts going to small businesses, yet another step in greater transparency.

Internally, SBA has also faced other challenges. In 2006 SBA was ranked 30th out of 30 in the Best Places to Work survey among federal agencies. After only one year into the reforms, SBA morale skyrocketed, placing it among the top ten in respect for leadership, overall job satisfaction increasing nine percent, and satisfaction with leadership communication up 11 to 16 percent.

And while each of these efforts has taught us valuable lessons, the reform process for HUBZone especially reminds me of the earlier need to re-engineer SBA's disaster assistance program.

Disaster assistance, like HUBZone today, had obvious and pressing needs. But while facing problems head-on can be difficult, the dividends are also obvious. Because of our reforms, SBA was able to respond quickly and professionally to help victims of the recent Midwest flooding and tornados. Personally, I have been to the Midwest three times since the flooding, and in the course of those trips I've seen our reforms in action.

So while it pains me to have to describe these problems with our HUBZone program, I am also very confident that we can solve them, and in so doing, ensure that the HUBZone program accomplishes the noble purpose for which it was established.

Thank you, and I would be pleased to answer any questions.

United States Government Accountability Office

GAO

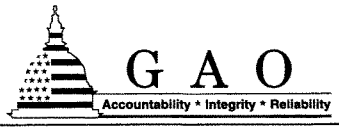
Testimony
Before the Committee on Small Business, House of Representatives

For Release on Delivery
Expected at 10:00 a.m. EDT
Thursday, July 17, 2008

SMALL BUSINESS ADMINISTRATION

Additional Actions Are Needed to Certify and Monitor HUBZone Businesses and Assess Program Results

Statement of William B. Shear, Director
Financial Markets and Community Investment



GAO-08-975T

July 17, 2008

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-08-975T, a testimony before the Committee on Small Business, House of Representatives

SMALL BUSINESS ADMINISTRATION

Additional Actions Are Needed to Certify and Monitor HUBZone Businesses and Assess Program Results

Why GAO Did This Study

The Small Business Administration's (SBA) Historically Underutilized Business Zone (HUBZone) program provides federal contracting assistance to small firms located in economically distressed areas, with the intent of stimulating economic development. Questions have been raised about whether the program is targeting the locations and businesses that Congress intended to assist. This testimony focuses on (1) the criteria and process that SBA uses to identify and map HUBZone areas; (2) the mechanisms SBA uses to ensure that only eligible small businesses participate in the program; and (3) the actions SBA has taken to assess the results of the program and the extent to which federal agencies have met HUBZone contracting goals. To address these objectives, GAO analyzed statutory provisions as well as SBA, Census, and contracting data and interviewed SBA and other federal and local officials.

What GAO Recommends

In the report upon which this testimony is based (GAO-08-643), GAO recommended that the SBA Administrator take steps to ensure that only eligible firms participate in the HUBZone program and further assess the effectiveness of the program. SBA agreed with these recommendations and outlined steps that it plans to take to address them.

To view the full product, including the scope and methodology, click on GAO-08-975T. For more information, contact William B. Shear at (202) 512-8678 or shearw@gao.gov.

What GAO Found

SBA relies on federal law to identify qualified HUBZone areas, and recent statutory changes have resulted in an increase in the number and types of HUBZone areas—changes that could diffuse the economic benefits of the program. Further, the map that SBA uses to help firms interested in participating in the program to determine if they are located in a HUBZone area is inaccurate. Specifically, the map incorrectly includes 50 metropolitan counties and excludes 27 nonmetropolitan counties. As a result, ineligible small businesses participated in the program, and eligible businesses have not been able to participate.

The mechanisms that SBA uses to certify and monitor firms provide limited assurance that only eligible firms participate in the program. Although internal control standards state that agencies should verify information they collect, SBA verifies the information reported by firms on their application or during recertification—its process for monitoring firms—in limited instances and does not follow its own policy of recertifying all firms every 3 years. GAO found that more than 4,600 firms that had been in the program for at least 3 years went unmonitored. Further, SBA lacks a formal policy on how quickly it needs to make a final determination on decertifying firms that may no longer be eligible for the program. Of the more than 3,600 firms proposed for decertification in fiscal years 2006 and 2007, more than 1,400 were not processed within 60 days—SBA's unwritten target. As a result of these weaknesses, there is an increased risk that ineligible firms have participated in the program and had opportunities to receive federal contracts.

SBA has taken limited steps to assess the effectiveness of the HUBZone program, and from 2003 to 2006 federal agencies did not meet the government-wide contracting goal for the HUBZone program. Federal agencies are required to identify results-oriented goals and measure performance toward the achievement of their goals. SBA tracks the number of firms certified or recertified, the annual value of contracts awarded to HUBZone firms, and the number of program examinations completed annually, but has not devoted resources to completing an evaluation of the program. Consequently, SBA lacks key information that could help it better manage and assess the results of the program. Finally, most federal agencies did not meet their HUBZone contracting goals during fiscal year 2006, the most recent year for which we had data. While the percentage of prime contracting dollars awarded to HUBZone firms increased in each fiscal year from 2003 to 2006, the 2006 awards fell short of the government-wide 3 percent goal by about one-third.

Madam Chairwoman and Members of the Committee:

I am pleased to be here today to discuss the Small Business Administration's (SBA) Historically Underutilized Business Zone (HUBZone) program. Created in 1997, the HUBZone program provides federal contracting assistance to small businesses located in economically distressed communities, or HUBZone areas, with the intent of stimulating economic development in those areas. In fiscal year 2007, federal agencies awarded contracts valued at about $8 billion to HUBZone firms. Firms that participate in the program must be located in a HUBZone and employ residents of HUBZones to facilitate the goal of bringing capital and employment opportunities to distressed areas. There are more than 14,000 HUBZone areas, and, as of February 2008, almost 13,000 firms participated in the program. Further, to support and encourage the development of small businesses in HUBZones, Congress has set a goal for federal agencies to award 3 percent of their annual contracting dollars to qualifying firms located in HUBZones.

My statement today is based on our June 2008 report that is being made public today, which discussed SBA's administration and oversight of the HUBZone program.[1] In my testimony, I will discuss (1) the criteria and process that SBA uses to identify and map HUBZone areas; (2) SBA mechanisms to ensure that only eligible small businesses participate in the HUBZone program; and (3) steps SBA has taken to assess the results of the program and the extent to which federal agencies have met their HUBZone contracting goals.

To assess the accuracy of the HUBZone map, we reviewed applicable statutes, regulations, and agency documents. We also interviewed SBA's mapping contractor and reviewed the contractor's policies and procedures. To assess the mechanisms that SBA uses to help ensure that only eligible businesses participate in the program, we reviewed policies and procedures established by SBA for certifying and monitoring HUBZone firms and internal control standards for federal agencies. We compared the actions that SBA took to its policies and procedures and selected internal control standards. In examining such compliance, we analyzed data from the HUBZone Certification Tracking System (the

[1]GAO, *Small Business Administration: Additional Actions Are Needed to Certify and Monitor HUBZone Businesses and Assess Program Results*, GAO-08-643 (Washington, D.C.: Jun. 17, 2008).

information system used to manage the HUBZone program) for fiscal years 2004 through 2007 to determine the extent of SBA monitoring. To determine the measures that SBA has in place to assess the results of the HUBZone program, we reviewed SBA's performance reports and other agency documents. To determine the extent to which federal agencies have met their HUBZone contracting goals, we analyzed data from SBA's "goaling" reports for fiscal years 2003 through 2006 (the most recent reports available). In addition, we visited a nongeneralizable sample of four HUBZone areas—Lawton, Oklahoma (to represent Indian Country); Lowndes County, Georgia (a nonmetropolitan area); and Los Angeles and Long Beach, California (two metropolitan areas)—to interview stakeholders about what, if any, benefits they believed the selected firms and communities received. For all the objectives, we interviewed SBA officials in headquarters and selected field offices. We assessed the reliability of the data we used and found them to be sufficiently reliable for our purposes. We conducted this performance audit—on which our recent report and this testimony are based—from August 2007 to June 2008 in accordance with 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 audit objectives.

In summary, we found that

- Because SBA relies on federal law to identify qualified HUBZone areas, recent statutory changes have resulted in an increase in the number and types of HUBZone areas—changes that could diffuse the economic benefits of the program. Further, the map that SBA uses to help firms interested in participating in the program to determine if they are located in a HUBZone area is inaccurate. Specifically, the map incorrectly includes 50 metropolitan counties as difficult development areas that do not meet this or any other criterion for inclusion in the HUBZone program. In addition, 27 nonmetropolitan counties that are eligible based on their unemployment rates were excluded because SBA has not updated its map since August 2006. As a result, ineligible small businesses participated in the program, some of which received federal contracts, and eligible businesses have not been able to participate.

- Furthermore, the mechanisms that SBA uses to certify and monitor HUBZone firms provide limited assurance that only eligible firms participate in the program. For certification and recertification, firms self-

report information on their applications. However, we found that SBA requested documentation or conducted site visits of firms to validate the self-reported data in only limited instances. Our analysis of the 125 applications submitted in September 2007 showed that SBA requested supporting documentation for 36 percent of the applications and conducted one site visit. While SBA's policies and procedures require program examinations—the one process that consistently includes reviews of supporting documentation—the agency conducts them on 5 percent of certified HUBZone firms each year. Further, SBA has a policy of recertifying firms every 3 years, yet more than 4,600 of the firms that have been in the program for at least 3 years (about 40 percent) have not been recertified. SBA also decertifies firms (removes them from the list of certified firms), after determining that they no longer meet eligibility criteria. However, in fiscal years 2006 and 2007, of the more than 3,600 firms proposed for decertification, more than 1,400 were not processed within SBA's informal goal of 60 days. As a result of a lack of controls (or limited application of controls) and weaknesses in the application and monitoring-related processes, SBA lacks assurances that only eligible firms participate in the program.

- Finally, SBA has taken limited steps to assess the effectiveness of the HUBZone program, and from 2003 to 2006 federal agencies did not meet the government-wide contracting goal for the HUBZone program. Federal agencies are required to identify results-oriented goals and measure performance toward the achievement of their goals. SBA tracks the number of firms certified or recertified, the annual value of contracts awarded to HUBZone firms, and the number of program examinations completed annually, but has not devoted resources to completing an evaluation of the program. Consequently, SBA lacks key information that could help it better manage and assess the results of the program. We also found that most federal agencies did not meet their HUBZone contracting goals during fiscal year 2006. While the percentage of prime contracting dollars awarded to HUBZone firms increased in each fiscal year from 2003 to 2006, the 2006 awards fell short of the government-wide 3 percent goal by about one-third.

To improve SBA's administration and oversight of the HUBZone program, we recommended in our recent report that SBA correct and update its HUBZone map, develop and implement guidance to ensure more routine verification of application data, eliminate its backlog of recertifications, formalize and adhere to a specific time frame for decertifying ineligible firms, and further assess the effectiveness of the program. SBA agreed with our recommendations and outlined steps that it plans to take to address each of them.

Background

The purpose of the HUBZone program, which was established by the HUBZone Act of 1997, is to stimulate economic development, through increased employment and capital investment, by providing federal contracting preferences to small businesses in economically distressed communities or HUBZone areas.[2] The types of areas in which HUBZones may be located are defined by law and consist of the following:

- *Qualified census tracts.* A qualified census tract has the meaning given the term by Congress for the low-income-housing tax credit program.[3] The list of qualified census tracts is maintained and updated by the Department of Housing and Urban Development (HUD). As currently defined, qualified census tracts have either 50 percent or more of their households with incomes below 60 percent of the area median gross income or have a poverty rate of at least 25 percent. The population of all census tracts that satisfy one or both of these criteria cannot exceed 20 percent of the area population.

- *Qualified nonmetropolitan counties.* Qualified nonmetropolitan counties are those that, based on decennial census data, are not located in a metropolitan statistical area and in which

  1. the median household income is less than 80 percent of the nonmetropolitan state median household income;

  2. the unemployment rate is not less than 140 percent of the average unemployment rate for either the nation or the state (whichever is lower); or

  3. a difficult development area is located.[4]

- *Qualified Indian reservations.* A HUBZone qualified Indian reservation has the same meaning as the term "Indian Country" as defined in another

[2]HUBZone Act of 1997, Pub. L. No. 105-135, Title VI, § 602(a), 111 Stat. 2592, 2627 (1997).

[3]The low-income-housing tax credit program aims to increase the availability of low-income housing by providing a tax credit to owners of newly constructed or substantially rehabilitated low-income rental housing.

[4]Difficult development areas have high construction, land, and utility costs relative to area median income, and HUD designates new difficult development areas annually using a process that compares these costs. Only those difficult development areas located in nonmetropolitan counties in Alaska, Hawaii, and the U.S. territories and possessions are eligible for the program.

federal statute, with some exceptions. These are all lands within the limits of any Indian reservation, all dependent Indian communities within U.S. borders, and all Indian allotments. In addition, portions of the State of Oklahoma qualify because they meet the Internal Revenue Service's definition of "former Indian reservations in Oklahoma."

- *Redesignated areas.* These are census tracts or nonmetropolitan counties that no longer meet the economic criteria but remain eligible until after the release of the 2010 decennial census data.

- *Base closure areas.* Areas within the external boundaries of former military bases that were closed by the Base Realignment and Closure Act (BRAC) qualify for HUBZone status for a 5-year period from the date of formal closure.

In order for a firm to be certified to participate in the HUBZone program, it must meet the following four criteria:

- the company must be small by SBA size standards;[5]

- the company must be at least 51 percent owned and controlled by U.S. citizens;[6]

- the company's principal office—the location where the greatest number of employees perform their work—must be located in a HUBZone;[7] and

- at least 35 percent of the company's full-time (or full-time equivalent) employees must reside in a HUBZone.

As of February 2008, 12,986 certified firms participated in the HUBZone program. More than 4,200 HUBZone firms obtained approximately $8.1 billion in federal contracts in fiscal year 2007. The annual federal

[5]SBA's size standards are almost always stated either as the average employment or average annual receipts of a business concern and vary by industry.

[6]Qualified HUBZone firms also can be owned and controlled by Alaskan Native Corporations, Indian tribal governments, community development corporations, and agricultural cooperatives.

[7]While a small business must have its principal office in a HUBZone area, it does not have to limit its work to that HUBZone. Certified HUBZone businesses can bid on and receive federal contracts for work to be performed anywhere; that is, HUBZone contracts are not limited to HUBZone areas.

contracting goal for HUBZone small businesses is 3 percent of all prime contract awards—contracts that are awarded directly by an agency.

SBA Relies on Federal Law to Identify HUBZone Areas but Its Map Is Inaccurate

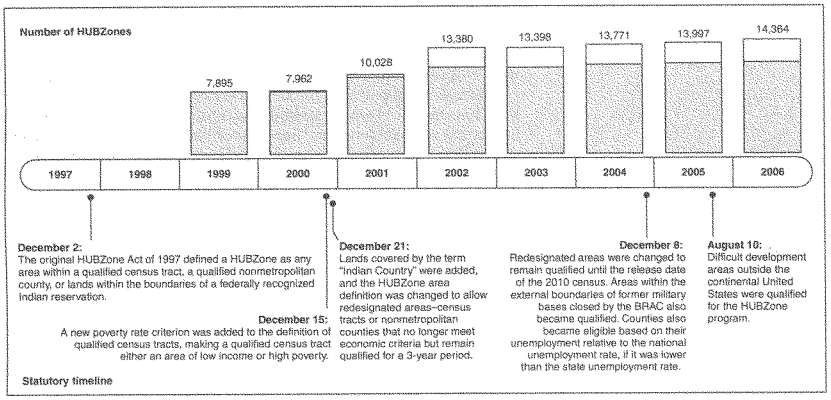
Our June 2008 report found that a series of statutory changes have resulted in an increase in the number and types of HUBZone areas. These changes could diffuse (or limit) the economic benefits of the program. Further, while SBA relies on federal law to identify qualified HUBZone areas, its HUBZone map is inaccurate.

Recent Legislation Increased the Number and Types of HUBZone Areas

In recent years, amendments to the HUBZone Act and other statutes have increased the number and types of HUBZone areas. The original HUBZone Act of 1997 defined a HUBZone as any area within a qualified census tract, a qualified nonmetropolitan county, or lands within the boundaries of a federally recognized Indian reservation. However, subsequent legislation revised the definitions of the original categories and expanded the HUBZone definition to include new types of qualified areas (see fig. 1). Subsequent to the various statutory changes, the number of HUBZone areas grew from 7,895 in calendar year 1999 to 14,364 in 2006. SBA's data show that, as of 2006, there were 12,218 qualified census tracts; 1,301 nonmetropolitan counties; 651 Indian Country areas; 82 BRAC areas; and 112 difficult development areas.[8]

[8]Because the boundaries of qualified HUBZone areas can overlap, some geographical areas qualify for multiple designations.

Figure 1: Statutory Changes to Definitions for HUBZone Areas and Effect on Number of HUBZones, 1997–2006



Source: GAO analysis of SBA data.

In expanding the types of HUBZone areas, the definition of economic distress has been broadened to include measures that were not in place in the initial statute. For example, a 2000 statute amended the HUBZone area definition to allow census tracts or nonmetroplitan counties that ceased to be qualified to remain qualified for a further 3-year period as "redesignated areas."[9] A 2004 statute permitted these same areas to remain qualified until the release date of the 2010 census data.[10] Further, in 2005, Congress expanded the definition of a qualified nonmetropolitan county to include

[9]HUBZones in Native America Act of 2000, Pub. L. No. 106-554, Title VI, Subtitle A, § 604, 114 Stat. 2763, 2763A-698 (2000).

[10]Small Business Reauthorization and Manufacturing Assistance Act of 2004, Pub. L. No. 108-447, Div. K, ch. 3, subtitle E, § 152(c), 118 Stat. 2809, 3457 (2004).

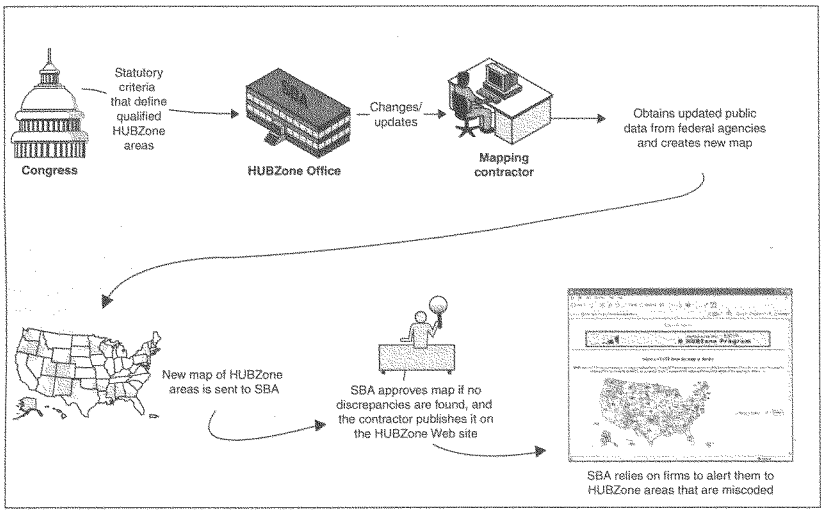
difficult development areas outside the continental U.S.—areas with high construction, land, and utility costs relative to area income—and such counties could include areas not normally considered economically distressed.[11] As a result, the expanded HUBZone criteria now allow for HUBZone areas that are less economically distressed than the areas initially designated. HUBZone program officials stated that the expansion can diffuse the impact or potential impact of the program on existing HUBZone areas. We recognize that establishing new HUBZone areas can potentially provide economic benefits for these areas by helping them attract firms that make investments and employ HUBZone residents. However, such an expansion could result in less targeting of areas of greatest economic distress.

SBA's Web Map Inaccurately Identifies Eligible Areas

SBA program staff employ no discretion in identifying HUBZone areas because they are defined by federal statute; however, they have not always designated these areas correctly on their Web map. To identify and map HUBZone areas, SBA relies on a mapping contractor and data from other executive agencies (see fig. 2). Essentially, the map is SBA's primary interface with small businesses to determine if they are located in a HUBZone and can apply for HUBZone certification.

[11]Pub. L. No. 109-59, § 10203, 119 Stat. 1144, 1933 (2005).

Figure 2: Process Used to Map HUBZone Areas



Sources: GAO analysis of SBA documents and interviews; Art Explosion (images).

During the course of our review, we identified two problems with SBA's HUBZone map. First, the map includes some areas that do not meet the statutory definition of a HUBZone area. As noted previously, counties containing difficult development areas are only eligible in their entirety for the HUBZone program if they are not located in a metropolitan statistical area. However, we found that SBA's HUBZone map includes 50 metropolitan counties as difficult development areas that do not meet this

or any other criterion for inclusion as a HUBZone area.[12] As a result of these errors, ineligible firms have obtained HUBZone certification and received federal contracts. As of December 2007, 344 certified HUBZone firms were located in ineligible areas in these 50 counties. Further, from October 2006 through March 2008, federal agencies obligated about $5 million through HUBZone set-aside contracts to 12 firms located in these ineligible areas.

Second, while SBA's policy is to have its contractor update the HUBZone map as needed, the map has not been updated since August 2006.[13] Since that time, additional data such as unemployment rates from the Bureau of Labor Statistics (BLS) have become available. Although SBA officials told us that they have been working to have the contractor update the mapping system, no subcontract was in place as of May 2008. While an analysis of the 2008 list of qualified census tracts showed that the number of tracts had not changed since the map was last updated, our analysis of 2007 BLS unemployment data indicated that 27 additional nonmetropolitan counties should have been identified on the map, allowing qualified firms in these areas to participate in the program. Because firms are not likely to receive information on the HUBZone status of areas from other sources, firms in the 27 areas would have believed from the map that they were ineligible to participate in the program and could not benefit from contracting incentives that certification provides.

In our June 2008 report, we recommended that SBA take immediate steps to correct and update the map and implement procedures to ensure that it is updated with the most recently available data on a more frequent basis. In response to our recommendation, SBA indicated that it plans to issue a new contract to administer the HUBZone map and anticipates that the maps will be updated and available no later than August 29, 2008. Further, SBA stated that, during the process of issuing the new contract, the HUBZone program would issue new internal procedures to ensure that the map is updated continually.

[12]Of the 50 counties, 47 were in Puerto Rico, 2 were in Alaska, and 1 in Hawaii. Puerto Rico consists of 78 municipios, which are the equivalent of counties; the 47 difficult development areas on the HUBZone map cover about half of Puerto Rico.

[13]SBA officials told us that, in September 2006, SBA began the process of having the contractor update the map. However, this update never occurred.

SBA Has Limited Controls to Ensure That Only Eligible Firms Participate in the HUBZone Program

Our June 2008 report also found that the policies and procedures upon which SBA relies to certify and monitor firms provide limited assurance that only eligible firms participate in the HUBZone program. While internal control standards for federal agencies state that agencies should document and verify information that they collect on their programs, SBA obtains supporting documentation from firms in limited instances. In addition, SBA does not follow its own policy of recertifying all firms every 3 years, and has not met its informal goal of 60 days for removing firms deemed ineligible from its list of certified firms.

SBA Largely Relies on Self-Reported Data for HUBZone Certifications and Recertifications, Increasing the Risk That Ineligible Firms Can Participate

Firms apply for HUBZone certification using an online application system, which according to HUBZone program officials employs automated logic steps to screen out ineligible firms based on the information entered on the application. For example, firms enter information such as their total number of employees and number of employees that reside in a HUBZone. Based on this information, the system then calculates whether the number of employees residing in a HUBZone equals 35 percent or more of total employees, the required level for HUBZone eligibility. HUBZone program staff then review the applications to determine if more information is required. While SBA's policy states that supporting documentation normally is not required, it notes that agency staff may request and consider such documentation, as necessary. No specific guidance or criteria are provided to program staff for this purpose; rather, the policy allows staff to determine what circumstances warrant a request for supporting documentation. In determining whether additional information is required, HUBZone program officials stated that they generally consult sources such as firms' or state governments' Web sites that contain information on firms incorporated in the state.[14] SBA ultimately approves the majority of applications submitted. For example, in fiscal year 2007, SBA approved about 78 percent of the applications submitted.

To ensure the continued eligibility of certified HUBZone firms, SBA requires firms to resubmit an application. That is, to be recertified, firms re-enter information in the online application system, and HUBZone program officials review it. In 2004, SBA changed the recertification

[14]For example, the Georgia Secretary of State's Web site contains a search feature that provides information such as the principal office address for firms incorporated in Georgia.

period from an annual recertification to every 3 years.[15] According to HUBZone program officials, they generally limit their reviews to comparing resubmitted information to the original application. The officials added that significant changes from the initial application can trigger a request for additional information or documentation. If concerns about eligibility are raised during the recertification process, SBA will propose decertification or removal from the list of eligible HUBZone firms. Firms that are proposed for decertification can challenge that proposed outcome through a due-process mechanism. SBA ultimately decertifies firms that do not challenge the proposed decertification and those that cannot provide additional evidence that they continue to meet the eligibility requirements. For example, SBA began 6,798 recertifications in fiscal years 2005, 2006, and 2007 and either had proposed to decertify or completed decertification of 5,201 of the firms (about 77 percent) as of January 22, 2008 (the date of the data set).[16] Although SBA does not systematically track the reasons why firms are decertified, HUBZone program officials noted that many firms do not respond to SBA's request for updated information.

Internal control standards for federal agencies and programs require that agencies collect and maintain documentation and verify information to support their programs. However, SBA verifies the information it receives from firms in limited instances. For example, our review of the 125 applications that were submitted in September 2007 shows that HUBZone program staff

- requested additional information but not supporting documentation for 10 (8 percent) of the applications;
- requested supporting documentation for 45 (36 percent) of the applications; and
- conducted one site visit.

[15]Until the online recertification system became available in 2005, the annual recertification process consisted of firms e-mailing HUBZone program officials a statement that the firms continued to meet the eligibility criteria.

[16]These are results of GAO analysis of data from the HUBZone Certification Tracking System.

According to HUBZone program officials, they did not more routinely verify the information because they generally relied on their automated processes and status protest process.[17] For instance, they said they did not request documentation to support each firm's application because the application system employs automated logic steps to screen out ineligible firms. For example, the application system calculates the percentage of a firm's employees that reside in a HUBZone and screens out firms that do not meet the 35 percent requirement. But the automated application system would not necessarily screen out applicants that submit false information to obtain a HUBZone certification.

Rather than obtaining supporting documentation during certification and recertification on a more regular basis, SBA waits until it conducts program examinations of a small percentage of firms to consistently request supporting documentation. Since fiscal year 2004, SBA's policy has been to conduct program examinations on 5 percent of firms each year.[18] From fiscal years 2004 through 2006, nearly two-thirds of firms SBA examined were decertified, and in fiscal year 2007, 430 of 715 firms (about 60 percent) were decertified or proposed for decertification.[19] The number of firms decertified includes firms that the agency determined were ineligible and were decertified, and firms that requested to be decertified. Because SBA limits its program examinations to 5 percent of firms each year, firms can be in the program for years without being examined. For example, we found that 2,637 of the 3,348 firms (approximately 79 percent) that had been in the program for 6 years or more had not been examined. In addition to performing program examinations on a limited number of firms, HUBZone program officials rarely conduct site visits during program examinations to verify a firm's information.

In our report, we recommended that SBA develop and implement guidance to more routinely and consistently obtain supporting documentation upon application and conduct more frequent site visits, as appropriate, to

[17]The HUBZone status protest process allows SBA, contracting officers, or any interested party to protest the qualified HUBZone status of any awardee or apparent awardee of a federal contract. An interested party is any firm that submits an offer for a specific HUBZone contract or submits an offer in full and open competition and whose opportunity for award will be affected by a price evaluation preference given to a qualified HUBZone firm.

[18]Before fiscal year 2004, program examinations were conducted on an as-needed basis.

[19]These are results of GAO analysis of data from the HUBZone Certification Tracking System (as of Jan. 22, 2008).

ensure that firms applying for certification are eligible. In response to this recommendation, SBA stated it was formulating procedures that would provide sharper guidance about when supporting documentation and site visits would be required, and plans to identify potential areas of concern during certification that would mandate additional documentation and site visits.

Because SBA Has a Backlog of Recertifications, Some Firms Went Unmonitored for Longer Periods

As noted previously, since 2004 SBA's policies have required the agency to recertify all HUBZone firms every 3 years. Recertification presents another opportunity for SBA to review information from firms and thus help monitor program activity. However, SBA has failed to recertify 4,655 of the 11,370 firms (more than 40 percent) that have been in the program for more than 3 years.[20] Of the 4,655 firms that should have been recertified, 689 have been in the program for more than 6 years. According to HUBZone program officials, the agency lacked sufficient staff to complete the recertifications. However, the agency hired a contractor in December 2007 to help conduct recertifications, using the same process that SBA staff currently use.[21] Although SBA has acquired these additional resources, the agency lacks specific timeframes for eliminating the backlog. As a result of the backlog, the periods during which some firms go unmonitored and reviewed for eligibility are longer than SBA policy allows, increasing the risk that ineligible firms may be participating in the program.

In our recent report, we recommended that SBA establish a specific time frame for eliminating the backlog of recertifications and take the necessary steps to ensure that recertifications are completed in a more timely fashion in the future. In its response to this recommendation, SBA noted that the HUBZone program had obtained additional staff and that the backlog of pending recertifications would be completed by September 30, 2008. Further, to ensure that recertifications will be handled in a more timely manner, SBA stated that the HUBZone program has made dedicated staffing changes and will issue explicit changes to procedures.

[20]These are results of GAO analysis of data from the HUBZone Certification Tracking System (as of Jan. 22, 2008).

[21]SBA officials generally limit their recertification reviews to the information provided by firms but can request documentation or conduct site visits.

SBA Lacks a Formal Policy on Timeframes for Decertifying Firms, Which Provides Ineligible Firms with an Opportunity to Obtain Contracts

While SBA policies for the HUBZone program include procedures for certifications, recertifications, and program examinations, they do not specify a timeframe for processing decertifications—the determinations subsequent to recertification reviews or examinations that firms are no longer eligible to participate in the HUBZone program. Although SBA does not have written guidance for the decertification timeframe, the HUBZone program office negotiated an informal (unwritten) goal of 60 days with the SBA Inspector General (IG) in 2006.[22] In recent years, SBA ultimately decertified the vast majority of firms proposed for decertification, but has not met its 60-day goal consistently (see table 1). From fiscal years 2004 through 2007, SBA failed to resolve proposed decertifications within its goal of 60 days for more than 3,200 firms. While SBA's timeliness has improved, in 2007, more than 400 (or about 33 percent) were not resolved in a timely manner. As a consequence of generally not meeting its 60-day goal, lags in the processing of decertifications have increased the risk of ineligible firms participating in the program.

Table 1: Summary of SBA's Efforts to Decertify Ineligible Firms for the HUBZone Program, Fiscal Years 2004–2007

	Year firms proposed for decertification			
	2004	2005	2006	2007[a]
Firms proposed for decertification[b]	559	1,390	2,428	1,227
Withdrawn by SBA	24	18	8	14
Firms actually decertified	314	1,082	2,032	890
Firms that retained certification	217	288	370	183
Cases that have not been resolved	4	2	18	140
Number of firms proposed for decertification but not resolved within 60 days	473	1,306	1,057	408

Source: GAO analysis of data from HUBZone Certification Tracking System (as of Jan. 22, 2008).

[a]SBA conducted 3,134 recertifications and program examinations, which are often precursors to proposals for decertification, in fiscal year 2007, which was 832 less than the previous year.

[b]Firms that are proposed for decertification have the ability to challenge that proposed outcome through a due-process mechanism. These data are based on the year that SBA proposed the firm for decertification.

[22]In May 2006, the SBA IG found that firms proposed for decertification as a result of 2004 program examinations were not processed timely and therefore recommended that the HUBZone program office set a maximum timeframe for decertifying firms and removing them from the SBA list once they no longer meet the eligibility criteria. See SBA Inspector General, *HUBZone Program Examination and Recertification Processes*, Report Number 6-23 (Washington, D.C.: May 23, 2006).

In our June 2008 report, we recommended that SBA formalize and adhere to a specific time frame for processing firms proposed for decertification in the future. In response, SBA noted that it would issue new procedures to clarify and formalize the decertification process and its timelines. SBA stated that the new decertification procedures would establish a 60 calendar day deadline to complete any proposed decertification.

SBA Has Not Implemented Plans to Assess the Effectiveness of the HUBZone Program and Most Agencies Have Not Met Contracting Goals

Our June 2008 report also found that SBA has taken limited steps to assess the effectiveness of the HUBZone program. SBA's three performance measures for the HUBZone program do not directly measure the effect of the program on communities. Moreover, federal agencies did not meet the government-wide contracting goal for the HUBZone program in fiscal years 2003 through 2006 (the most recent years for which goaling data are available).

SBA Has Limited Performance Measures and Has Not Implemented Plans to Evaluate the Effectiveness of the Program

While SBA has some measures in place to assess the performance of the HUBZone program, the agency has not implemented its plans to conduct an evaluation of the program's benefits. According to the Government Performance and Results Act of 1993, federal agencies are required to identify results-oriented goals and measure performance toward the achievement of their goals. We previously have reported on the attributes of effective performance measures, and reported that for performance measures to be useful in assessing program performance, they should be linked or aligned with program goals and cover the activities that an entity is expected to perform to support the intent of the program.[23]

According to SBA's fiscal year 2007 *Annual Performance Report,* the three performance measures for the HUBZone program were: (1) the number of small businesses assisted (which SBA defines as the number of applications approved and the number of recertifications processed), (2) the annual value of federal contracts awarded to HUBZone firms, and (3)

[23]See GAO-03-143 and GAO, *Small Business Administration: Additional Measures Needed to Assess 7(a) Loan Program's Performance,* GAO-07-769 (Washington, D.C.: July 13, 2007).

the number of program examinations completed. These measures provide some data on program activity and measure contract dollars awarded to HUBZone firms.[24] However, they do not directly measure the program's effect on firms (such as growth in employment or changes in capital investment) or directly measure the program's effect on the communities in which the firms are located (for instance, changes in median household income or poverty levels).

Similarly, the Office of Management and Budget (OMB) noted in its 2005 Program Assessment Rating Tool (PART) that SBA needed to develop baseline measures for some of its HUBZone performance measures and encouraged SBA to focus on more outcome-oriented measures that better evaluate the results of the program.[25] The PART assessment also documented plans that SBA had to conduct an analysis of the economic impact of the HUBZone program on a community-by-community basis using data from the 2000 and 2010 decennial census. However, SBA officials indicated that the agency has not devoted resources to implement either of these strategies for assessing the results of the program. Yet by not evaluating the HUBZone program's benefits, SBA lacks key information that could help it better manage the program and inform the Congress of its results.

As part of our work, we conducted site visits to four HUBZone areas (Lawton, Oklahoma; Lowndes County, Georgia; and Long Beach and Los Angeles, California) to better understand to what extent stakeholders perceived that the HUBZone program generated benefits. For all four HUBZone areas, the perceived benefits of the program varied, with some firms indicating they have been able to win contracts and expand their firms and others indicating they had not realized any benefits from the program. Officials representing economic development entities varied in their knowledge of the program, with some stating they lacked

[24]Our assessment of the databases that contain information on the agency's performance measures—the HUBZone Certification Tracking System and Federal Procurement Data System-Next Generation—concluded that these data were sufficiently reliable for the purposes of reporting on services provided to HUBZone firms and contracts awarded to HUBZone firms.

[25]OMB's PART evaluation rates programs on four critical elements—program purpose and design, strategic planning, program management, and program results/accountability. The answers to questions in each of the four sections result in a numeric score for each section from 0 to 100 (100 being the best). These scores are then combined to achieve an overall qualitative rating of Effective, Moderately Effective, Adequate, or Ineffective.

information on the program's effect that could help them inform small businesses of its potential benefits.

In our report, we recommended that SBA further develop measures and implement plans to assess the effectiveness of the HUBZone program. In its response to this recommendation, SBA stated that it would develop an assessment tool to measure the economic benefits that accrue to areas in the HUBZone program and that the HUBZone program would then issue periodic reports accompanied by the underlying data.

Most Federal Agencies Did Not Meet Their Contracting Goals for the HUBZone Program

Although contracting dollars awarded to HUBZone firms have increased since fiscal year 2003—when the statutory goal of awarding 3 percent of federally funded contract dollars to HUBZone firms went into effect—federal agencies collectively still have not met that goal.[25] According to data from SBA's goaling reports, for the four fiscal years from 2003 through 2006, the percentage of prime contracting dollars awarded to HUBZone firms increased, with the total for fiscal year 2006 at just above 2 percent (see table 2).

Table 2: HUBZone Percentage of Total Prime Contracting Dollars Eligible for Small Business Awards, Fiscal Years 2003–2006

Fiscal year	Total prime contracting dollars (in billions)	Prime contracting dollars awarded to HUBZone firms (in billions)	Governmentwide goal for percentage of small-business-eligible prime contracting dollars awarded to HUBZone firms	Percentage of total small-business-eligible prime contracting dollars awarded to HUBZone firms
2003	$277.5	$3.4	3%	1.23%
2004	$299.9	$4.8	3%	1.60%
2005	$320.3	$6.2	3%	1.93%
2006	$340.2	$7.2	3%	2.11%

Source: *Report on Annual Procurement Preference Goaling Achievements* (FY 2003) and *Small Business Goaling Reports* (FY 2004–2006).

Note: Fiscal year 2006 is the most recent year for which SBA has published a small business goaling report.

[25]The HUBZone Act established participation goals for certified firms starting with fiscal year 1999. The fiscal year 1999 goal was 1 percent of the year's total value of prime contract awards, and the fiscal year 2000 goal was 1.5 percent. The act increased the goal by one-half percent each year, reaching 3 percent in fiscal year 2003 and each fiscal year thereafter.

In fiscal year 2006, 8 of 24 federal agencies met their HUBZone goals.[27] Of the 8 agencies, 4 had goals higher than the 3 percent requirement and were able to meet the higher goals. Of the 16 agencies not meeting their HUBZone goal, 10 awarded less than 2 percent of their small business-eligible contracting dollars to HUBZone firms.

Madam Chairwoman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Contacts and Acknowledgments

For further information on this testimony, please contact William B. Shear at (202) 512-8678 or shearw@gao.gov. Individuals making key contributions to this testimony included Paige Smith (Assistant Director), Triana Bash, Tania Calhoun, Bruce Causseaux, Alison Gerry, Cindy Gilbert, Julia Kennon, Terence Lam, Tarek Mahmassani, John Mingus, Marc Molino, Barbara Roesmann, and Bill Woods.

[27]We limited our analysis to the 24 agencies that SBA assessed through its Small Business Procurement Scorecards, which provide an assessment of federal achievement in prime contracting to small businesses by the 24 Chief Financial Officers Act agencies.

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, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "E-mail Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, DC 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

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

PRINTED ON RECYCLED PAPER

United States Government Accountability Office

GAO

Testimony
Before the Committee on Small Business, House of Representatives

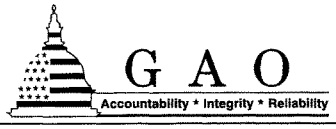
For Release on Delivery
Expected at 10:00 a.m. EST
Thursday, July 17, 2008

HUBZONE PROGRAM

SBA's Control Weaknesses Exposed the Government to Fraud and Abuse

Statement of Gregory D. Kutz, Managing Director
Forensic Audits and Special Investigations

Bruce A. Causseaux, Senior Level Specialist
Forensic Audits and Special Investigations



GAO-08-964T

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-08-964T, a testimony before the Committee on Small Business, House of Representatives

July 17, 2008

HUBZONE PROGRAM

SBA's Control Weaknesses Exposed the Government to Fraud and Abuse

Why GAO Did This Study

The Historically Underutilized Business Zone (HUBZone) program is intended to provide federal contracting opportunities to qualified small business firms in order to stimulate development in economically distressed areas. As manager of the HUBZone program, the Small Business Administration (SBA) is responsible for certifying whether firms meet HUBZone program requirements. To participate in the HUBZone program, small business firms must certify that their principal office (i.e., the location where the greatest number of employees work) is located in a HUBZone and that at least 35 percent of the firm's employees live in HUBZones.

Given the Committee's concern over fraud and abuse in the HUBZone program, GAO was asked to (1) proactively test whether SBA's controls over the HUBZone application process were operating effectively to limit program certification to eligible firms and (2) identify examples of selected firms that participate in the HUBZone program even though they do not meet eligibility requirements.

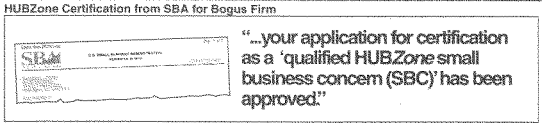
To perform its proactive testing, GAO created four bogus businesses with fictitious owners and employees and applied for HUBZone certification. GAO also selected 17 HUBZone firms based on certain criteria, such as receipt of HUBZone contracts, and investigated whether they met key program eligibility requirements.

To view the full product, including the scope and methodology, click on GAO-08-964T. For more information, contact Gregory Kutz at (202) 512-6722 or kutzg@gao.gov.

What GAO Found

GAO identified substantial vulnerabilities in SBA's application and monitoring process, clearly demonstrating that the HUBZone program is vulnerable to fraud and abuse. Considering the findings of a related report and testimony issued today, GAO's work shows that these vulnerabilities exist because SBA does not have an effective fraud-prevention program in place. Using fictitious employee information and fabricated documentation, GAO easily obtained HUBZone certification for four bogus firms. For example, to support one HUBZone application, GAO claimed that its principal office was the same address as a Starbucks coffee store that happened to be located in a HUBZone. If SBA had performed a simple Internet search on the address, it would have been alerted to this fact. Further, two of GAO's applications used leased mailboxes from retail postal services centers. A post office box clearly does not meet SBA's principal office requirement. See the graphic below for an example of a HUBZone certification letter GAO received for one of its bogus firms.

HUBZone Certification from SBA for Bogus Firm


"...your application for certification as a 'qualified HUB*Zone* small business concern (SBC)' has been approved."

Source: SBA.

We were also able to identify 10 firms from the Washington, D.C., metro area that were participating in the HUBZone program even though they clearly did not meet eligibility requirements. Since 2006, federal agencies have obligated a total of more than $105 million to these 10 firms for performance as the prime contractor on federal contracts. Of the 10 firms, 6 did not meet both principal office and employee residency requirements while 4 met the principal office requirements but significantly failed the employee residency requirement. For example, one firm that failed both principal office and employee residency requirements had initially qualified for the HUBZone program using the address of a small room above a dentist's office. GAO's site visit to this room found only a computer and filing cabinet. No employees were present, and the building owner told GAO investigators that nobody had worked there "for some time." During its investigation, GAO also found that some HUBZone firms used virtual office suites to fulfill SBA's principal office requirement. GAO investigated two of these virtual office suites and identified examples of firms that could not possibly meet principal office requirements given the nature of their leases. For example, one firm continued to certify it was a HUBZone firm even though its lease only provided mail forwarding services at the virtual office suite.

Madam Chairwoman and Members of the Committee:

Thank you for the opportunity to discuss our investigation of the Historically Underutilized Business Zone (HUBZone) program. Created in 1997 and managed by the Small Business Administration (SBA), the HUBZone program is intended to provide federal contracting opportunities to qualified small business firms in order to stimulate development in the economically distressed areas in which the firms are located. These areas, which are designated based on certain economic and census data, are known as HUBZones. To ensure HUBZone areas receive the economic benefit from the program, SBA is responsible for determining whether firms meet HUBZone program requirements and then later monitoring whether the firms maintain their eligibility. To participate in the HUBZone program, small business firms generally must satisfy three main requirements: (1) the firm must be owned and controlled by one or more U.S. citizens; (2) at least 35 percent of its full-time employees must live in a HUBZone; and (3) the principal office (i.e., the location where the greatest number of qualifying employees perform work) must be located in a HUBZone.[1]

Small business firms in the HUBZone program are eligible to bid on federal prime contracts and subcontracts available exclusively to program participants, in addition to benefiting from other contracting preferences. According to procurement data from the Federal Procurement Data System–Next Generation (FPDS-NG), in fiscal year 2007 federal agencies reported about $8 billion in obligations on prime contracts with HUBZone firms.[2] In awarding prime contracts and subcontracts, both federal contracting officials and prime contractor officials rely on SBA's controls to provide assurance that only eligible firms participate in the program.

When applying for HUBZone status, firms are required to verify that the information they submit to SBA is true and correct. If SBA approves an application and grants a firm HUBZone certification, that firm is then

[1]For service and construction firms, determination of principal office excludes employees who perform the majority of their work at job site locations to fulfill specific contract commitments. For this testimony, we define qualifying employees as those who do not work at job site locations to fulfill specific contract commitments.

[2]The FPDS-NG is the central repository for capturing information on federal procurement actions. Dollar amounts reported by federal agencies to FPDS-NG represent the net amount of funds obligated or deobligated as a result of procurement actions. Because we did not obtain disbursement data we were unable to identify the actual amounts received by firms.

required to notify SBA of any material changes affecting the firm's eligibility, such as changes in principal office location or number of employees residing in a HUBZone.[3] Further, to compete for government contracts, HUBZone firms must verify in the government's Online Representations and Certifications Application (ORCA)[4] that they are a HUBZone firm and that there have been "no material changes in ownership and control, principal office, or HUBZone employee percentage since it was certified by the SBA." There are criminal penalties for knowingly making false statements or misrepresentations in connection with the HUBZone program, including failure to correct "continuing representations" that are no longer true.[5]

Although the HUBZone program can have positive economic outcomes for small business firms and economically distressed communities, in January 2003 the SBA Office of Inspector General (OIG) reported that SBA's internal controls were inadequate to ensure that only eligible firms were allowed to participate in the HUBZone program.[6] Given your concern over program fraud and abuse, you requested that we perform an investigation to (1) proactively test whether SBA's controls over the HUBZone application process were operating effectively to limit program certification to eligible firms and (2) identify examples of selected firms that participate in the HUBZone program even though they do not meet eligibility requirements.

To proactively test whether SBA's controls over the HUBZone application process were operating effectively, we set up four bogus firms and submitted applications to SBA. Our applications contained fictitious employee information and bogus principal office addresses. We used publicly available guidance provided by SBA in preparing our applications.

[3]13 C.F.R. §126.501.

[4]ORCA was established as part of the Business Partner Network, an element of the Integrated Acquisition Environment, which is implemented under the auspices of White House Office of Management and Budget, Office of Federal Procurement Policy, and the Chief Acquisition Officers Council. ORCA is "the primary Government repository for contractor submitted representations and certifications required for the conduct of business with the Government."

[5]13 C.F.R. § 126.900.

[6]SBA OIG, *Audit of the Eligibility of 15 HUBZone Companies and a Review of the HUBZone Empowerment Contracting Program's Internal Controls*, 3-05 (Jan. 22, 2003).

When necessary, we fabricated documents to support our applications using commercially available hardware and software.

To identify examples of firms that participate in the HUBZone program even though they do not meet eligibility requirements, we first obtained and analyzed a list of HUBZone firms from the SBA's Certification Tracking System as of January 2008. We then obtained federal procurement data from FPDS-NG for fiscal years 2006 and 2007. We analyzed these data to identify HUBZone firms with a principal office located in the Washington, D.C., metropolitan area for which federal agencies reported obligations on HUBZone prime contracts totaling more than $450,000 between fiscal years 2006 and 2007. Based on this process, we selected 16 firms for further investigation. We selected an additional firm for investigation based on a referral to GAO's FraudNet hotline. For the 17 selected firms, we then used investigative methods, such as interviewing firm managers and reviewing firm payroll documents, to gather information about the firms and to determine whether they met HUBZone requirements. We also reviewed information about each firm in ORCA. While performing our proactive testing and investigative work, we found other HUBZone firms using virtual office suites[7] to fulfill SBA's principal office requirement. We investigated two of these virtual office suites to identify additional examples of firms that participate in the HUBZone program even though they do not meet eligibility requirements.

Our work was not designed to identify all fraudulent activity in the HUBZone program or estimate its full extent. In addition, our work was not designed to determine whether the selected firms we investigated committed fraud when applying for HUBZone status or receiving a HUBZone contract award. We conducted our investigation from January 2008 through June 2008 in accordance with quality standards for investigations as set forth by the President's Council on Integrity and Efficiency. Additional details on our scope and methodology are included in appendix I.

Summary

We identified substantial vulnerabilities in SBA's application and monitoring process, clearly demonstrating that the HUBZone program is

[7]Virtual offices are located nationwide and provide a range of services for individuals and firms, including part-time use of office space or conference rooms, telephone answering services, and mail forwarding.

vulnerable to fraud and abuse. Considering the findings of a related report and testimony we are issuing today,[8] our work shows that these vulnerabilities exist because SBA does not have an effective fraud prevention program in place. Using fictitious employee information and bogus documentation, we easily obtained HUBZone certification for four bogus firms. For example, to support one HUBZone application, we claimed that our principal office was the same address as a Starbucks coffee store that happened to be located in a HUBZone. If SBA had performed a simple Internet search on the address, it would have been alerted to this fact. Further, two of our applications used retail postal service center addresses where we leased mailboxes for less than $24 per month. A post office box clearly does not meet SBA's principal office requirement. To meet employee residency requirements on all four applications, we represented that we had employees working for us who lived in HUBZones. In the one instance where SBA asked for supporting documentation to verify the address of a fictitious employee, we easily created a fake identification card. Without basic fraud prevention controls in place for the HUBZone application process, SBA is at great risk of certifying ineligible firms that have applied using false information—just as we did with our four bogus firms.

We were also able to identify 10 firms from the Washington, D.C., metro area that were participating in the HUBZone program even though they clearly did not meet eligibility requirements.[9] Since 2006, federal agencies have obligated a total of more than $105 million to these 10 firms for performance as the prime contractor on federal contracts. Of the 10 firms, 6 did not meet both the principal office and employee residency requirements while 4 met the principal office requirement but significantly failed the employee residency requirement. For example, one firm that failed both principal office and employee residency requirements had initially qualified for the HUBZone program using the address of a small

[8]GAO, *Small Business Administration: Additional Actions Are Needed to Certify and Monitor HUBZone Businesses and Assess Program Results*, GAO-08-643 (Washington, D.C.: June 17, 2008) and *Small Business Administration: Additional Actions Are Needed to Certify and Monitor HUBZone Businesses and Assess Program Results*, GAO-08-975T (Washington, D.C.: July 17, 2008).

[9]As noted previously, we selected 17 total firms for investigation. Of the 17 firms, 6 did not meet both the principal office requirement and HUBZone residency requirement and 4 more significantly did not meet the HUBZone residency requirement. These 10 firms are discussed in the body of this report. With percentages ranging between 30 percent and 33 percent, another 4 firms nearly met the HUBZone residency requirement. The remaining 3 firms appeared to meet both requirements at the time of our investigation.

room above a dentist's office. Our site visit to this room found only a computer and filing cabinet. No employees were present, and the building owner told our investigators that nobody had worked there "for some time." According to its Web site, this firm identified an address in McLean, Virginia, as its headquarters. A site visit to this building, which was not located in a HUBZone, revealed that all of the firm's officers in addition to about half of the qualifying employees worked there. The fact that this firm continued to represent in ORCA, on its Web site, and to our investigators that it is a HUBZone firm is indicative of fraud. During our investigation, we also found that some HUBZone firms used virtual office suites to fulfill SBA's principal office requirement. We investigated two of these virtual office suites and identified examples of firms that could not possibly meet principal office requirements given the nature of their leases. For example, one firm continued to certify it was a HUBZone firm even though its lease only provided mail forwarding services at the virtual office suite.

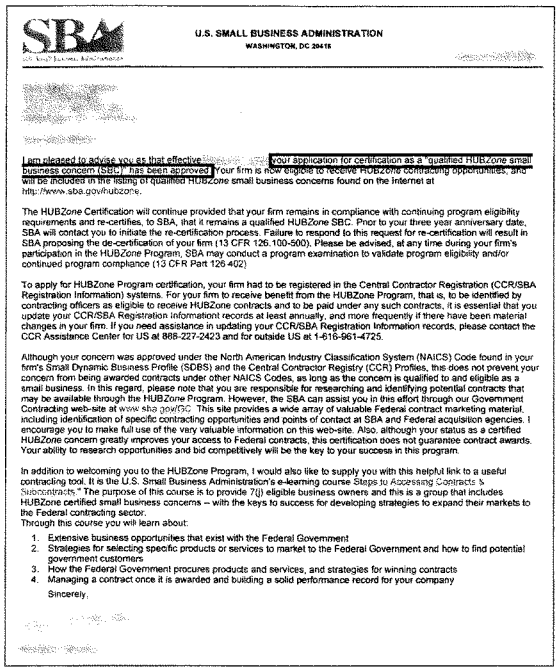
We briefed SBA officials on the results of our work. They were concerned about the vulnerabilities to fraud and abuse demonstrated by our work and expressed interest in improving fraud prevention controls over the HUBZone program.

Ineffective Program Eligibility Controls Enabled GAO to Obtain HUBZone Certification for Bogus Firms

Our proactive testing found ineffective HUBZone program eligibility controls, exposing the federal government to fraud and abuse. In a related report and testimony[10] released concurrently with this testimony, we reported that SBA generally did not verify the data entered by firms in its online application system. We found that SBA was therefore vulnerable to certifying firms based on fraudulent application information. Our use of bogus firms, fictitious employees, and fabricated explanations and documents to obtain HUBZone certification demonstrated the ease with which HUBZone certification could be obtained by providing fraudulent information to SBA's online application system. In all four instances, we successfully obtained HUBZone certification from SBA for the bogus firms represented by our applications. See figure 1 for an example of one of the acceptance letters we received.

[10]GAO-08-643 and GAO-08-975T.

Figure 1: HUBZone Certification Letter from SBA for One of Four Bogus Firms



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

I am pleased to advise you as that effective [redacted] your application for certification as a "qualified HUB*Zone* small business concern (SBC)" has been approved. Your firm is now eligible to receive HUB*Zone* contracting opportunities, and will be included in the listing of qualified HUB*Zone* small business concerns found on the Internet at http://www.sba.gov/hubzone.

The HUB*Zone* Certification will continue provided that your firm remains in compliance with continuing program eligibility requirements and re-certifies, to SBA, that it remains a qualified HUB*Zone* SBC. Prior to your three year anniversary date, SBA will contact you to initiate the re-certification process. Failure to respond to this request for re-certification will result in SBA proposing the de-certification of your firm (13 CFR 126.100-500). Please be advised, at any time during your firm's participation in the HUB*Zone* Program, SBA may conduct a program examination to validate program eligibility and/or continued program compliance (13 CFR Part 126.402)

To apply for HUBZone Program certification, your firm had to be registered in the Central Contractor Registration (CCR/SBA Registration Information) systems. For your firm to receive benefit from the HUBZone Program, that is, to be identified by contracting officers as eligible to receive HUBZone contracts and to be paid under any such contracts, it is essential that you update your CCR/SBA Registration Information records at least annually, and more frequently if there have been material changes in your firm. If you need assistance in updating your CCR/SBA Registration Information records, please contact the CCR Assistance Center for US at 888-227-2423 and for outside US at 1-616-961-4725.

Although your concern was approved under the North American Industry Classification System (NAICS) Code found in your firm's Small Dynamic Business Profile (SDBS) and the Central Contractor Registry (CCR) Profiles, this does not prevent your concern from being awarded contracts under other NAICS Codes, as long as the concern is qualified to and eligible as a small business. In this regard, please note that you are responsible for researching and identifying potential contracts that may be available through the HUB*Zone* Program. However, the SBA can assist you in this effort through our Government Contracting web-site at www.sba.gov/GC. This site provides a wide array of valuable Federal contract marketing material, including identification of specific contracting opportunities and points of contact at SBA and Federal acquisition agencies. I encourage you to make full use of the very valuable information on this web-site. Also, although your status as a certified HUB*Zone* concern greatly improves your access to Federal contracts, this certification does not guarantee contract awards. Your ability to research opportunities and bid competitively will be the key to your success in this program.

In addition to welcoming you to the HUBZone Program, I would also like to supply you with this helpful link to a useful contracting tool. It is the U.S. Small Business Administration's e-learning course Steps to Accessing Contracts & Subcontracts." The purpose of this course is to provide 7(j) eligible business owners and this is a group that includes HUBZone certified small business concerns – with the keys to success for developing strategies to expand their markets to the Federal contracting sector.
Through this course you will learn about:

1. Extensive business opportunities that exist with the Federal Government
2. Strategies for selecting specific products or services to market to the Federal Government and how to find potential government customers
3. How the Federal Government procures products and services, and strategies for winning contracts
4. Managing a contract once it is awarded and building a solid performance record for your company

Sincerely,

"...your application for certification as a 'qualified HUB*Zone* small business concern (SBC)' has been approved."

Source: SBA.

Although SBA requested documentation to support one of our applications, the agency failed to recognize the information we provided in all four applications represented bogus firms that actually failed to meet

HUBZone requirements. For instance, the principal office addresses we used included a virtual office suite from which we leased part-time access to office space and mail delivery services for $250 a month, two different retail postal service centers from which we leased mailboxes for less than $24 a month, and a Starbucks coffee store. An Internet search on any of the addresses we provided would have raised "red flags" and should have led to further investigation by SBA, such as a site visit, to determine whether the principal office address met program eligibility requirements. Because HUBZone certification provides an opening to billions of dollars in federal contracts, approval of ineligible firms for participation in the program exposes the federal government to contracting fraud and abuse, and moreover, can result in the exclusion of legitimate HUBZone firms from obtaining government contracts. We provide specific details regarding each application below.

- **Fictitious Application One:** Our investigators submitted this fictitious application and received HUBZone certification 3 weeks later. To support the application, we leased, at a cost of $250 a month, virtual office services from an office suite located in a HUBZone and gave this address as our principal office location. Specifically, the terms of the lease allowed us to schedule use of an office space up to 16 hours per month and to have mail delivered to the suite. Our HUBZone application also indicated that our bogus firm employed two individuals with one of the employees residing in a HUBZone. Two business days after submitting the application, an SBA official emailed us requesting a copy of the lease for our principal office location and proof of residency for our employee. We created the documentation using publicly available hardware and software and faxed copies to SBA to comply with the request. SBA then requested additional supporting documentation related to utilities and cancelled checks. After we fabricated this documentation and provided it to SBA, no further documentation was requested before SBA certified our bogus firm.

- **Fictitious Application Two:** Four weeks after our investigators submitted this fictitious application, SBA certified the bogus firm to participate in the HUBZone program. For this bogus firm, our "principal office" was a mailbox located in a HUBZone that our investigators leased from a retail postal service provider for less than $24 a month. The application noted that our bogus firm had nine employees, four of which lived in a HUBZone area. SBA requested a clarification regarding a discrepancy in the application information, but no further contact was made before we received our HUBZone certification.

- **Fictitious Application Three:** Our investigators completed this fictitious application and received HUBZone certification 2 weeks later. For the

principal office address, our investigators used a Starbucks coffee store located in a HUBZone. In addition, our investigators indicated that our bogus firm employed two individuals with one of the employees residing in a HUBZone area. SBA did not request any supporting documentation or explanations for this bogus firm prior to granting HUBZone certification.

- **Fictitious Application Four:** Within 5 weeks of submitting this fictitious application, SBA certified our bogus firm. As with fictitious application two, our investigators used the address for a mailbox leased from a retail postal service provider located in a HUBZone for the principal office. Our monthly rental cost for the "principal office" was less than $10 per month. Our application indicated that two of the three employees that worked for the bogus firm lived in a HUBZone. SBA requested a clarification regarding a small discrepancy in the application information, but no further contact was made before receiving the HUBZone certification.

Selected HUBZone Firms Do Not Meet Program Eligibility Requirements

We were also able to identify 10 firms from the Washington, D.C., metro area that were participating in the HUBZone program even though they clearly did not meet eligibility requirements.[11] Since 2006, federal agencies have obligated a total of more than $105 million to these firms for performance as the prime contractor on federal contracts. Of the 10 firms, 6 did not meet both the principal office and employee residency requirements while 4 met the principal office requirement but significantly failed the employee residency requirement. We also found other HUBZone firms that use virtual office suites to fulfill SBA's principal office requirement. We investigated two of these virtual office suites and identified examples of firms that could not possibly meet principal office requirements given the nature of their leases.

According to HUBZone regulations, persons or firms are subject to criminal penalties for knowingly making false statements or misrepresentations in connection with the HUBZone program including failure to correct "continuing representations" that are no longer true. During the application process, applicants are not only reminded of the program requirements, but are required to agree to the statement that

[11]As noted previously, we selected 17 total firms for investigation. Of the 17 firms, 6 did not meet the principal office requirement and HUBZone residency requirement and 4 significantly did not meet the HUBZone residency requirement. These 10 firms are discussed in the body of this report. With percentages ranging between 30 percent and 33 percent, another 4 firms nearly met the HUBZone residency requirement. The remaining 3 firms appeared to meet both requirements at the time of our investigation.

anyone failing to correct "continuing representations" shall be subject to fines, imprisonment, and penalties. Further, the Federal Acquisition Regulation (FAR) requires all prospective contractors to update ORCA—the government's Online Representations and Certifications Application—which includes certifying whether the firm is currently a HUBZone firm and that there have been "no material changes in ownership and control, principal office, or HUBZone employee percentage since it was certified by the SBA."[12] However, we found that all 10 of these case-study firms continued to represent themselves to SBA, ORCA, GAO, and the general public as eligible to participate in the HUBZone program. Because the 10 case study examples clearly are not eligible, we consider each firm's continued representation indicative of fraud. We referred the 10 firms to SBA OIG for further investigation.

Case Studies of HUBZone Firms That Do Not Meet Program Eligibility Requirements

We determined that 10 case study examples from the Washington, D.C., metropolitan area failed to meet the program's requirements. Specifically, we found that 6 out of the 10 failed both HUBZone requirements to operate a principal office in a HUBZone and to ensure that 35 percent or more of employees resided in a HUBZone. Our review of payroll records also found that the remaining four firms failed to meet the 35 percent HUBZone employee residency requirement by at least 15 percent. In addition, all 10 of the case study examples continued to represent themselves to SBA, ORCA, GAO, and the general public as HUBZone program–eligible. One HUBZone firm self-certified in ORCA that it met HUBZone requirements in March 2008 despite the fact that we had spoken with its owner about 3 weeks before about her firm's noncompliance with both the principal office and HUBZone residency requirements. Table 1 highlights the 10 case-study firms we investigated.

[12] 48 C.F.R. § 4.1201.

Table 1: HUBZone Firms Making Fraudulent or Inaccurate Representations

Case	Primary product or service	Fiscal year 2006-07 obligations on HUBZone contracts[a] (reporting agencies)	Case details
1	Information Technology (IT), engineering, logistics, technical support services, and business management services	$3.9 million (Departments of the Army and Air Force)	• Multiple site visits to listed principal office revealed that no employees were working at the location and the only business equipment we found was a computer and filing cabinet. • Firm maintained its actual principal office in McLean, Virginia, which is not in a HUBZone, where most of firm's qualifying employees, including the management staff, worked. • According to payroll records, only 21 percent of the firm's employees lived in a HUBZone as of December 2007. • Firm last self-certified and represented that it met the HUBZone requirements in ORCA in July 2007.
2	General construction	$4.1 million (Department of the Air Force)	• Site visit to the firm's listed principal office during normal business hours revealed it was one-half of a residential duplex building with no employees present. • Vice president of firm admitted to certifying the firm met HUBZone requirements even though no employees worked at their principal office location. • According to payroll records, only 12 percent of the firm's employees lived in a HUBZone as of December 2007. • Although the firm admitted to failing to meet the HUBZone requirement, as of June 2008 the firm's Web site has a large lettered statement that the firm is HUBZone-certified. • The firm self-certified that it met the HUBZone requirements in ORCA in September 2007.
3	Design and installation of fire alarm systems	$463,000 (Department of Veterans Affairs)	• President admitted that his firm "technically" did not meet HUBZone requirements. • Site visit to the firm's listed principal office during normal business hours revealed that it was a virtual office. • Firm operated its actual principal office in McLean, Virginia, not in a HUBZone, where most of firm's qualifying employees, including the management staff, worked. • According to payroll records, only 8 percent of the firm's employees lived in a HUBZone area as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in May 2007.

Case	Primary product or service	Fiscal year 2006-07 obligations on HUBZone contracts[a] (reporting agencies)	Case details
4	Engineering and construction management services	$6.1 million (Department of the Army and the Smithsonian Institution)	• Site visit to the listed principal office during normal business hours found no employees present, the door locked, and mail stuffed under the door. • Firm operated its actual principal office in Beltsville, Maryland, which is not in a HUBZone, an indication that its daily operation is conducted out of this non-HUBZone office • According to payroll records, only 30 percent of the firm's employees lived in a HUBZone as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in May 2008, 7 weeks after we spoke to officials.
5	IT consulting	$1.8 million (Department of the Army)	• Site visit to the firm's listed principal office found the firm's president and one employee • According to the president, between 80 to 90 full-time employees worked at a non-HUBZone location in Lanham, Maryland. A site visit confirmed the existence of this location, indicating that the listed principal office does not meet HUBZone requirements. • According to payroll records, only 29 percent of the firm's employees lived in a HUBZone area as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in May 2007.
6	Mechanical engineering	n.a.[b]	• Federal agencies obligated more than $27 million on government contracts that were not HUBZone contracts for the firm. • Multiple site visits revealed no employees present at the principal office in Washington, D.C. • Firm operated from an office in Hyattsville, Maryland, not in a HUBZone, where most qualifying employees worked. • President stated that she believed SBA defined "principal office" as "where the principal" (e.g., president) worked. • President also stated that she typically worked at the principal office, but that investigators happened to find her at the non-HUBZone office location. • According to payroll records, only 4 of 78 employees (about 5 percent) lived in a HUBZone as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in March 2008, less than a month after we spoke to officials.
7	Acquisition and project management	$3.2 million (Defense Information Systems Agency)	• Firm met principal office requirement. • Payroll documents indicate less than 6 percent of the firm's employees lived in a HUBZone as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in May 2008.

Case	Primary product or service	Fiscal year 2006-07 obligations on HUBZone contracts[a] (reporting agencies)	Case details
8	Construction management	$4.9 million (Public Buildings Service and others)	• Firm met principal office requirement. • Payroll documents showed only about 17 percent of the firm's employees lived in a HUBZone as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in September 2007.
9	IT products and services	$712,000 (Department of the Army)	• Firm met principal office requirement. • Payroll documents showed that the firm's only employee did not live in a HUBZone as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in October 2007.
10	IT and logistics management	$515,000 (Department of Health and Human Services)	• Firm met principal office requirement. • Payroll documents show only about 15 percent of the firm's employees lived in a HUBZone as of December 2007. • Firm self-certified that it met the HUBZone requirements in ORCA in March 2008

Source: GAO analysis of data from FPDS-NG, ORCA, and firms.

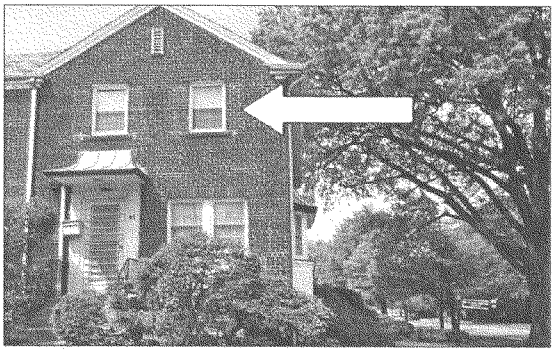
[a]Obligations on prime contracts with HUBZone firms according to procurement data from FPDS-NG.

[b]n.a. = not applicable. While federal agencies did not report to FPDS-NG any obligations on HUBZone contracts for this firm during fiscal years 2006 and 2007, the nature of the allegation was as such to warrant our investigation.

Case 1: Our investigation clearly showed that this firm represented itself as HUBZone-eligible even though it did not meet HUBZone requirements at the time of our investigation. This firm, which provided business management, engineering, information technology, logistics, and technical support services, self-certified in July 2007 in ORCA that it was a HUBZone firm and that there had been "no material changes in ownership and control, principal office, or HUBZone employee percentage since it was certified by the SBA." We also interviewed the president in March 2008 and she claimed that her firm met the HUBZone requirements. However, the firm failed the principal office requirement. Our site visits to the address identified by the firm as its principal office found that it was a small room that had been rented on the upper floor of a dentist's office where no more than two people could work comfortably. No employees were present, and the only business equipment in the rented room was a computer and filing cabinet. The building owner stated that the president of the firm used to conduct some business from the office, but that nobody had worked there "for some time." Moreover, the president indicated that instead of paying rent at the HUBZone location, she provided accounting services to the owner at a no-cost exchange for use of the space. See figure 2 for a picture

of the building the firm claimed as its principal office (arrow indicates where the office is located).

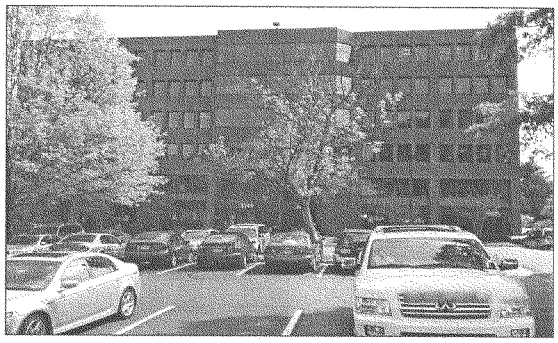
Figure 2: Principal Office for Case Study 1 Firm



Source: GAO.

Further investigation revealed that the firm listed its real principal office (called the firm's "headquarters" on its Web site) at an address in McLean, Virginia. In addition to not being a HUBZone, McLean, Virginia, is in one of the wealthiest jurisdictions in the United States. Our site visit to this second location revealed that the majority of the firm's officers in addition to about half of the qualifying employees worked there and indicated this location was the firm's actual principal office. When we interviewed the president, she claimed that the McLean, Virginia, office was maintained "only for appearance." See figure 3 for a picture of the McLean, Virginia, building where the firm rented office space.

Figure 3: Headquarters for Case Study 1 Firm



Source: GAO.

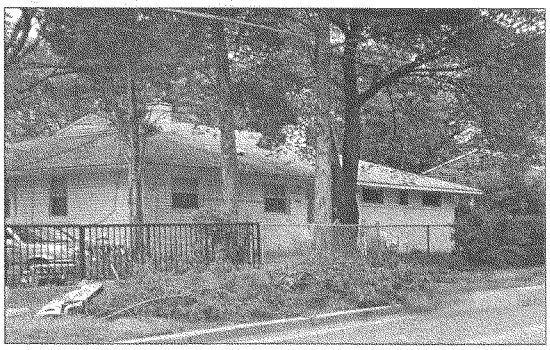
Based on our review of payroll documents we received directly from the firm, we also determined the firm failed the 35 percent HUBZone residency requirement. The payroll documents indicated that only 15 of the firm's 72 employees (21 percent) lived in a HUBZone as of December 2007. We also found that in January 2007 during SBA's HUBZone recertification process the president self-certified that 38 percent of the firm's employees lived in a HUBZone. However, the payroll documents received directly from firm showed only 24 percent of the firm's employees lived in a HUBZone at that time.

In 2006 the Department of the Army, National Guard Bureau, awarded a HUBZone set-aside contract with a $40 million ceiling to this firm based on its HUBZone status. Although only $3.9 million have been obligated to date on the contract, because the firm remains HUBZone-certified, it can continue to receive payments up to the $40 million ceiling based on its HUBZone status until 2011. We referred this firm to SBA OIG for further investigation.

Case 2: Our investigation determined that this firm, a general contractor specializing in roofing and sheet metal, continued to represent itself as HUBZone-eligible even though it did not meet HUBZone requirements.

While he self-certified to the firm's HUBZone status in ORCA in September 2007, the vice president admitted during our interview in April 2008 that the firm did not meet HUBZone requirements. Nonetheless, after our interview, the firm continued actively to represent that it was a HUBZone firm—including a message in large letters on its Web site and business cards declaring that the firm was "HUBZone certified." The firm's vice-president self-certified during the SBA's HUBZone certification process in March 2007 that, as shown in figure 4, the firm's principal office was one-half of a residential duplex in Landover, Maryland.

Figure 4: Principal Office for Case Study 2 Firm



Source: GAO.

We visited this location during normal business hours and found no employees present. Our investigative work also found that the vice president owned another firm, which did not participate in the HUBZone program. A visit to this firm, which was located in Capitol Heights, Maryland—not in a HUBZone—revealed that both it and the HUBZone firm operated out of the same location.

Further, payroll documents we received from the HUBZone firm indicated that it had 34 employees but that only 4 employees (or 12 percent) lived in a HUBZone as of December 2007. Based on our analysis of FPDS-NG data,

between fiscal years 2006 and 2007 federal agencies obligated about $12.2 million for payment to the firm. Of this, about $4 million in HUBZone contracts were obligated by the Department of the Air Force. Because this firm clearly did not meet either principal office or employee HUBZone requirements at the time of our investigation but continued to represent itself as HUBZone-certified we referred this firm to SBA OIG for further investigation.

Case 3: Our investigation demonstrated that this firm continued to represent itself as HUBZone-eligible while failing to meet HUBZone requirements. This firm, which specializes in the design and installation of fire alarm systems, self-certified in May 2007 in ORCA that it was a HUBZone firm and that there had been "no material changes in ownership and control, principal office, or HUBZone employee percentage since it was certified by the SBA." However, when we interviewed the president in April 2008, he acknowledged that the firm "technically" did not meet the principal office requirement. For its HUBZone certification in April 2006, an address in a HUBZone in Rockville, Maryland, was identified as its principal office location. We visited this location during normal business hours and found the address was for an office suite that provided virtual office services. According to the lease between the HUBZone firm and the office suite's management, the firm did not rent office space, but paid $325 a month to use a conference room on a scheduled basis for up to 4 hours each month. Absent additional services provided by the virtual office suite, it would be impossible for this firm to meet the principal office requirement under this lease arrangement. Moreover, the president of the firm told us that no employees typically worked at the virtual office. Additional investigative work revealed that the firm's Web site listed a second address for the firm in McLean, Virginia, which as noted above is not in a HUBZone. Our site visit determined this location to be where the firm's president and all qualifying employees worked. In addition, the payroll documents we received from the firm revealed that the percentage of employees living in a HUBZone during calendar year 2007 ranged from a low of 6 percent to a high of 15 percent—far below the required 35 percent.

Based on our analysis of FPDS-NG data, between fiscal years 2006 and 2007 federal agencies obligated about $3.3 million for payment to the firm. Of this, over $460,000 in HUBZone contracts were obligated by the Department of Veterans Affairs. Further, in addition to admitting the firm did not meet the principal office requirement, the president was also very candid about having received subcontracting opportunities from large prime contracting firms based solely on the firm's HUBZone certification.

According to the president, the prime contractors listed the HUBZone firm as part of their "team" to satisfy their HUBZone subcontracting goals. However, he contended that these teaming arrangements only occasionally resulted in the prime contractor purchasing equipment from his firm. Because it continued to represent itself as HUBZone-eligible, we referred it to SBA OIG for further investigation.

Some HUBZone Firms Using Virtual Office Services Do Not Meet Program Requirements

Virtual offices are located nationwide and provide a range of services for individuals and firms, including part-time use of office space or conference rooms, telephone answering services, and mail forwarding. During our proactive testing discussed above, we leased virtual office services from an office suite located in a HUBZone and fraudulently submitted this address to SBA as our principal office location. The terms of the lease allowed us to schedule use of an office space for up to 16 hours per month, but did not provide permanent office space. Even though we never used the virtual office space we rented, we still obtained HUBZone certification from SBA. Our subsequent investigation of two virtual office suites located in HUBZones—one of which we used to obtain our certification—found that other firms had retained HUBZone certification using virtual office services. Based on our review of lease agreements, we found that, absent additional services provided by the virtual office suites, some of these firms could not possibly meet principal office requirements. For example:

- One HUBZone firm that claimed its principal office was a virtual office address had a lease agreement providing only mail-forwarding services. The mail was forwarded to a different address not located in a HUBZone. Absent additional services provided by the virtual office suite, it would be impossible for this firm to perform any work at the virtual office location with only a mail-forwarding agreement.

- Five HUBZone firms that claimed their principal office was a virtual office address leased less than 10 hours of conference room usage per month at the same time they maintained at least one other office outside of a HUBZone. Absent additional services provided by the virtual office suite, it would be impossible for these firms to meet principal office requirements with only 10 hours of conference room time per month, leading us to conclude that the majority of work at these companies was performed in the other office locations.

- Five other firms claimed their principal office was a virtual office address but leased office space for less than 20 hours a month. These firms

simultaneously maintained at least one other office outside of a HUBZone. Absent additional services provided by the virtual office suite, it would be impossible for these firms to meet principal office requirements with only 20 hours of rented office time per month, leading us to conclude that the majority of work at these companies was performed in the other office locations.

The virtual office arrangements we investigated clearly violate the requirements of the HUBZone program and, in some cases, exemplify fraudulent representations.

Corrective Action Briefing

We briefed SBA officials on the results of our investigation on July 9, 2008. They were concerned about the vulnerabilities to fraud and abuse we identified. SBA officials expressed interest in pursuing action, including suspension or debarment, against our 10 case study firms and any firm that may falsely represent their eligibility for the HUBZone program. They were also open to suggestions to improve fraud prevention controls over the HUBZone application process, such as performing steps to identify addresses of virtual office suites and mailboxes rented from postal retail centers.

Madam Chairwoman and Members of the Committee, this concludes my statement. I would be pleased to answer any questions that you or other Members of the Committee may have at this time.

Contacts and Acknowledgments

For further 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 testimony.

Appendix I: Objective, Scope, and Methodology

To proactively test whether the Small Business Administration's (SBA) controls over the Historically Underutilized Business Zone (HUBZone) application process were operating effectively, we applied for HUBZone certification using bogus firms, fictitious employees, fabricated explanations, and counterfeit documents to determine whether SBA would certify firms based on fraudulent information. We used publicly available guidance provided by SBA to create four applications. We did the minimal work required to establish the bogus small business firms represented by our applications, such as obtaining a Data Universal Numbering System (DUNS) number from Dun & Bradstreet and registering with the Central Contractor Registration database. We then applied for HUBZone certification with our four firms using SBA's online HUBZone application system. Importantly, the principal office addresses we provided to SBA, although technically located in HUBZones, were locations that would appear suspicious if investigated by SBA. When necessary (e.g., at the request of SBA application reviewers), we supplemented our applications with fabricated explanations and counterfeit supporting documentation created with publicly available computer software and hardware and other material.

To identify examples of firms that participate in the HUBZone program even though they do not meet eligibility requirements, we first obtained and analyzed a listing of HUBZone firms from the SBA's Certification Tracking System as of January 2008 and federal procurement data from the Federal Procurement Data System–Next Generation (FPDS-NG) for fiscal years 2006 and 2007. We then performed various steps, including corresponding with SBA officials and testing the data elements used for our work electronically, to assess the reliability of the data. We concluded that data were sufficiently reliable for the purposes of our investigation. To develop our case studies, we limited our investigation to certified HUBZone firms with a principal office located in the Washington, D.C., metropolitan area and for which federal agencies reported obligations on HUBZone preference contracts—HUBZone sole source, HUBZone set-aside, and HUBZone price preference—totaling more than $450,000 for fiscal years 2006 and 2007. We selected 16 for further investigation based on indications that they either failed to operate a principal office in a HUBZone or ensure that at least 35 percent of employees resided in a

HUBZone, or both. We also investigated one firm referred through GAO's FraudNet Hotline.[1]

For the selected 17 firms, we then used investigative methods, such as interviewing firm managers and reviewing firm payroll documents, to gather information about the firms and to determine whether the firms met HUBZone requirements. We also reviewed information about each firm in the Online Representations and Certifications Application system (ORCA).[2] During our investigation, we also identified a couple of addresses for virtual office suites in the Washington, D.C., metropolitan area where several different HUBZone firms claimed to have their principal office.[3] We investigated two of these virtual office suites to determine whether HUBZone firms at these locations met program eligibility requirements. For the selected virtual office suites, we obtained and reviewed the lease agreements between the HUBZone firms and the virtual office suite management and verified any of the HUBZone firms' other business addresses.

[1]While federal agencies did not report to FPDS any obligations on HUBZone contracts for this firm during fiscal years 2006 and 2007 the nature of the allegation was as such to warrant our investigation.

[2]ORCA was established as part of the Business Partner Network, an element of the Integrated Acquisition Environment, which is implemented under the auspices of White House Office of Management and Budget, Office of Federal Procurement Policy, and the Chief Acquisition Officers Council. ORCA is "the primary Government repository for contractor submitted representations and certifications required for the conduct of business with the Government."

[3]Virtual offices are located nationwide and provide a range of services for individuals and firms, including part-time use of office space or conference rooms, telephone answering services, and mail forwarding.

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, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "E-mail Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, DC 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

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

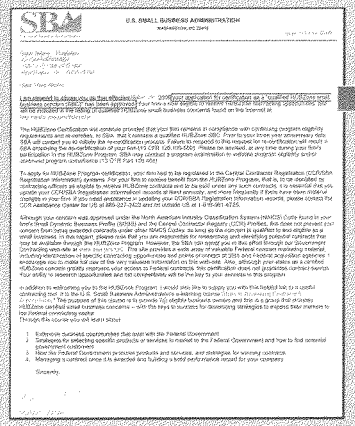
Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

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

PRINTED ON RECYCLED PAPER

Excerpt From HUBZone Acceptance Letter For Bogus Company



SBA

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

Dear Mr. Hughes:

I am pleased to advise you that effective [illegible] 2006 your application for certification as a "qualified HUBZone small business concern (SBC)" has been approved! Your firm is now eligible to receive HUBZone contracting opportunities that are reserved in the listing of qualified HUBZone small business concerns found on this Internet site:

http://www.dsbs.sba.gov/dsbs/

The HUBZone Certification was conferred provided that your firm remains in compliance with continuing program eligibility requirements and requirements, to SBA, that it remains a qualified HUBZone SBC. Prior to your three year anniversary date, SBA will contact you to initiate the re-certification process. Failure to respond to the required re-certification will result in SBA initiating the de-certification of your firm (13 CFR 126.115/126.116). Please be advised, at any time during your firm's participation in the HUBZone Program, SBA may conduct a program examination to validate program eligibility and/or continued program compliance (13 CFR Part 126.400)

To apply for HUBZone Program certification, your firm had to be registered in the Central Contractor Registration (CCR/SBA Registration Information) systems. For your firm to receive benefit from the HUBZone Program, that is, to be identified to contracting officers as eligible to receive HUBZone contracts and to be paid under any such contracts, it is essential that you update your CCR/SBA Registration information records at least annually, and more frequently if there have been material changes in your firm's data. If you need assistance with the CCR/SBA Registration information records, please contact the CCR Assistance Center for US at 888-227-2423 and for outside US at 1-616-961-4725.

Although your company was approved under the North American Industry Classification System (NAICS) Code found in your firm's Small Business Business Profile (SBBP) and the Central Contractor Registry (CCR) Profiles, this does not prevent your company from being awarded contracts under other NAICS Codes, as long as the company is qualified to and eligible as a small business. In this regard, please note that you are responsible for researching and identifying potential contracts that may be available through the HUBZone Program. However, the SBA can assist you in this effort through our Government Contracting website at www.sba.gov/gc. This site provides a wide array of valuable Federal contract marketing material, including identification of specific contracting opportunities and points of contact (POC) and Federal procurement agencies to encourage you to make full use of the very valuable information on this website. Also, although your status as a certified HUBZone small business concern is valid for three years, it is important that you continue to maintain your certified status. Your ability to identify opportunities and bid on contracts will be the key to your success in this program.

In addition to notifying you by the HUBZone Program, I would also like to supply you with the helpful link to a useful contracting tool. It is the U.S. Small Business Administration's e-learning course (Click to Business) [illegible] Contracting. The purpose of this course is to provide 50 eligible business owners and firms a group that includes HUBZone certified small business concerns – with the keys to success for developing strategies to expand their markets to the Federal contracting sector.

Through this course you will learn how:

1. Enhance business opportunities that exist with the Federal Government
2. Strategies for selecting specific products or services to market to the Federal Government and how to find potential government customers
3. How the Federal Government procures products and services, and strategies for winning contracts
4. Managing a contract once it's awarded and building a solid performance record for your company

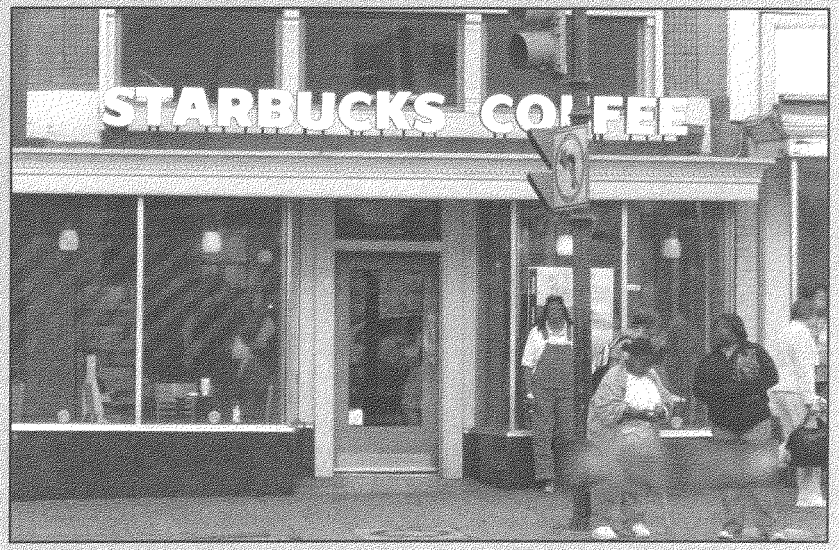
Sincerely,

"...your application for certification as a 'qualified HUB*Zone* small business concern (SBC)' has been approved."

Source: GAO.

GAO

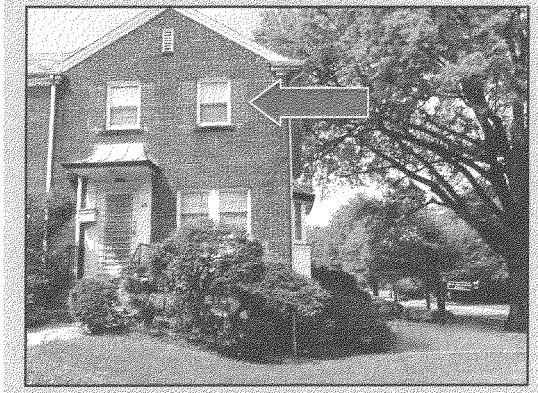
Principal Office For Bogus HUBZone Company



Source: GAO.

GAO

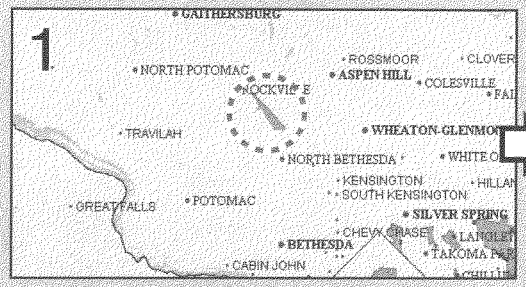
Supposed Principal Office Versus Real Principal Office For Case Study

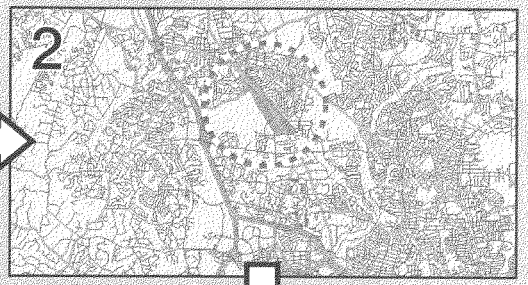


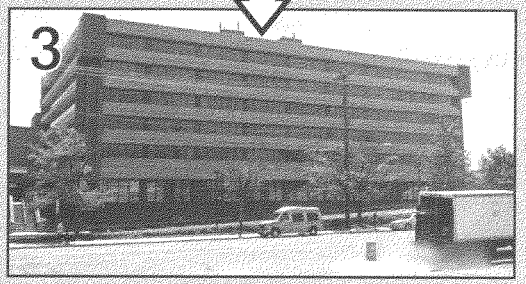
Source: GAO.

GAO

10 of 17 HUBZone Companies Located In Rockville, Maryland Use The Same Office Suite For Principal Office







1. SBA map of Montgomery County, MD and surrounding area
2. HUBZone area in Rockville, MD and surrounding area
3. Principal office location for 10 of 17 HUBZone companies in Rockville, MD

Source: SBA, GAO.

AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

FOR IMMEDIATE RELEASE
Thursday
July 17, 2008

Contact: Kelley Keeler Short
(703) 837-5310
keelerk@agc.org
Marco Giamberardino
(703) 837-5325
giamberardinom@agc.org

GAO REPORT VALIDATES AGC CONCERNS OVER HUBZONE PROGRAM

Washington, D.C. — The Associated General Contractors of America (AGC) today endorsed the findings of a report released by the Government Accountability Office (GAO), which found that the Historically Underutilized Business Zone (HUBZone) program is highly susceptible to fraud and "widespread abuse."

"The GAO report confirms the claims contractors have been making for years – that the Small Business Administration (SBA) has failed to execute its oversight authority over the HUBZone program," said AGC's chief executive officer Stephen E. Sandherr. "The HUBZone program has been a huge administrative failure, which has cost the program its potential as a legitimate contracting vehicle, the opportunity for growth for these disadvantaged communities and billions of lost taxpayer dollars."

AGC has long expressed significant concerns about the effectiveness and fairness of the HUBZone program as it is applied to the construction industry and has advocated that significant improvements be enacted to reform the program. The program does not realize its goal of increasing employment and reinvesting in economically disadvantaged areas.

It does not require the SBA to measure the successes and failures of the program and it does not fairly reward firms in a manner consistent with the intent of the program. Consequently, this undermines not only the intent of the program, but hurts small businesses, HUBZones communities, and costs the American taxpayers billions of dollars.

"For years the HUBZone program has failed to meet its goals of increasing employment opportunities, investment and economic development in low income and/or high unemployment areas," added Sandherr. "We thank Chairwoman Nydia Velazquez (D-NY) for her foresight in recognizing the problems facing the HUBZone program."

For several years, AGC has recommended several changes to improve the HUBZone program:

- **Limit the Program to Construction Projects in or Near a HUBZone.** The SBA should apply the HUBZone program only to contracts for the construction of federal projects within a 150-mile radius of the HUBZone contractor's principal place of business. Only those projects can offer employment to a significant number of HUBZone residents, and only those projects can promise to make a lasting change in their economic circumstance.
- **Require HUBZone Contractors Ensure that HUBZone Residents Receive at Least 30% of the Payroll Needed to Perform**

All HUBZone Contracts. Current regulations require HUBZone contractors to self-perform only 15% of their general construction contracts. 13 CFR 126.700 (a)(2). Using payroll as the correct measure will avoid pass through purchases of materials and supplies that encourage brokering by legal HUBZones entities that nonetheless are not actually building construction projects. This change would also help ensure that HUBZone contractors are really in the market to construct the projects on which they bid.

- **Require Annual Reports on Employment and Income in the Nation's HUBZones.** With the aid and assistance of the Departments of Labor and Commerce, the SBA can and should publish a report on employment and income in each of the nation's HUBZones at least once each year.

- **Require SBA to Routinely Investigate Alleged Abuses of the Program.** Some construction contractors have found the SBA indifferent to their complaints that individual firms are abusing the HUBZone program, or violating its terms or conditions. The SBA regulations should therefore require the agency's local offices to investigate such complaints and publicly report their findings and decisions in a public writing within 10 days.

- **Change the 10% Price Preference to 5%.** Congress should authorize and require a smaller price preference for the construction industry, where prices rarely vary by as much as 10%. Such a bid preference would still exceed the profit margin on the vast majority of federal construction contracts. While Congress may want to give HUBZone contractors some kind of advantage, it should not go so far as to guarantee federal contracts for any firm.

- **Authorize All Contractors Who Stand Ready, Willing, and Able to Build to Protest.** To help prevent fraud or other abuse of the HUBZone program, the regulations should also permit contractors to protest a sole source acquisition on the grounds that the HUBZone contractor does not actually qualify for the program.

- **Require Certification During Periods of Peak Employment or Require Payroll Records.** Current regulations permit construction contractors to seek and obtain certification for the HUBZone program at any time. The SBA should either limit certification to the months of peak employment or require construction firms – companies that experience large fluctuations in employment throughout the course of any given year – to provide certified payroll records, at the end of each year. This would establish that HUBZone residents truly worked at least 35% percent of all the hours worked in that year.

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7,500 of America's leading general contractors, and over 12,500 specialty-contracting firms. More than 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. Visit the AGC Web site at www.agc.org.

###