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# SMALL BUSINESS ADMINISTRATION

# Undercover Tests Show HUBZone Program Remains Vulnerable to Fraud and Abuse

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GAO-10-920T

Madam Chairwoman and Members of the Committee:

Thank you for the opportunity to discuss the results of our investigation of the Small Business Administration's (SBA) Historically Underutilized Business Zone (HUBZone) program. In fiscal year 2009, federal agencies obligated nearly $3 billion in sole source or set-aside contracts to firms participating in the HUBZone program. Created in 1997, the program provides federal contracting assistance to small businesses located in HUBZones—economically distressed areas with low income levels or high unemployment rates. Qualified businesses in these areas are eligible to bid on federal prime contracts and subcontracts available exclusively to program participants, in addition to benefiting from other contracting preferences. The SBA must certify that a small business meets the following criteria to qualify for the program: the firm must be owned and controlled by one or more U.S. citizens; at least 35 percent of full-time employees must live in a HUBZone; and the principal office, where most qualifying employees work, must be in a HUBZone. According to the SBA's Dynamic Small Business Web site, as of July 2010, 9,300 firms were participating in the program.

Over the last 2 years, we have reported on fraud and abuse and other concerns with the HUBZone program.[1] In July 2008, we testified that the SBA's lack of an effective fraud prevention program meant its application process could not provide reasonable assurance that only eligible firms were being certified to participate in the program. Using fictitious employee and owner information and fabricated documentation, we easily obtained HUBZone certification for four bogus firms. We also identified 10 firms from the Washington, D.C., metro area that participated in the program even though they did not meet eligibility criteria. In March 2009, we reported on 19 additional HUBZone firms from Alabama, California, and Texas that were not eligible for the program.

[1] GAO, *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). 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). GAO, *HUBZone Program: SBA's Control Weaknesses Exposed the Government to Fraud and Abuse*, GAO-08-964T (Washington, D.C.: July 17, 2008). GAO, *HUBZone Program: Fraud and Abuse Identified in Four Metropolitan Areas*, GAO-09-440 (Washington, D.C.: Mar. 25, 2009). GAO, HUBZone Program: Fraud and Abuse Identified in Four Metropolitan Areas, GAO-09-519T (Washington, D.C.: Mar. 25, 2009).

My statement today summarizes our most recent report, which we are releasing today, regarding the HUBZone program.[2] Our report and my statement responds to your request that we (1) perform additional proactive testing of the SBA's HUBZone certification process and (2) determine what actions, if any, the SBA has taken against the 29 case study firms we identified in our prior work. In conducting our work, we proactively tested SBA's application process by applying for HUBZone certification for four bogus businesses with fictitious owners and employees. For all four bogus businesses, we used publicly available resources to fabricate documents. To determine what actions, if any, the SBA has taken against the 29 case study firms, we made inquiries with SBA officials. We also analyzed data from the Federal Procurement Data System-Next Generation. We did not attempt to project the extent of fraud and abuse in the program nor systematically assess HUBZone program controls. Our work was done in accordance with quality standards for investigations as set forth by the Council of the Inspectors General on Integrity and Efficiency.

## SBA's HUBZone Certification Process Remains Vulnerable to Fraud and Abuse

The SBA continues to struggle with reducing fraud risks in its HUBZone certification process, although SBA has taken steps to bolster SBA's controls. In our previous investigations, we found that many of the firms in the 29 cases fraudulently used "virtual offices" and fake business locations as their principal offices to qualify for HUBZone status. Our testing revealed that the SBA still does not adequately authenticate self-reported information—especially principal office locations—to ensure program eligibility. Specifically, the agency certified three of our four bogus firms based on fraudulent information. We used fabricated explanations, fraudulent documentation, and borrowed addresses or principal offices, including the Alamo, a public storage facility in Florida, and a city hall in Texas. The SBA lost application materials for our fourth firm on multiple occasions, forcing us to abandon our application. The SBA's failure to verify principal office locations—even through a simple Internet search—leaves the program vulnerable to firms misrepresenting their eligibility, preventing program benefits from going to intended targets.

[2] GAO, *Small Business Administration: Undercover Tests Show HUBZone Program Remains Vulnerable to Fraud and Abuse*, GAO-10-759 (Washington, D.C.: June 25, 2010).

As we stated in our March 2009 report, SBA began to take actions intended to strengthen the program's internal controls.[3] However, we were still able to obtain certification for our bogus firms, and the certification process became considerably longer. The SBA took at least 7 months to process each of the three applications that it certified from our bogus companies. In our previous test, the SBA certified our firms in as little as 2 weeks, though this occurred with minimal requests for documentary evidence. SBA's increased processing times failed to prevent our bogus firms from becoming certified.

In response to our proactive testing, SBA officials stated that it was unreasonable to expect them to have identified our fictitious firms because of the bogus documentation that we included in our applications. For example, SBA officials stated that the submission of false affidavits would subject an applicant to prosecution. However, while the threat of prosecution is an important deterrent, it does not help to identify firms that attempt to commit fraud, as our testing shows. SBA officials also stated that competitors may identify fraudulent firms and likely protest if those firms were awarded a HUBZone contract. While competitors may identify some ineligible firms that were awarded contracts, SBA is responsible for ensuring that only eligible firms participate in the HUBZone program.

We indicated that if the SBA had conducted site visits at the addresses of the firms represented in our applications, those applications would have been identified as fraudulent. SBA officials stated that because of resource constraints, they primarily conduct site visits on certified firms that receive large prime HUBZone contracts. However, we believe that such reviews are too late in the process. We also suggested that the SBA conduct Internet searches on the addresses of applicant firms to help validate principal office locations. Such searches would have minimal impact on resources.

[3] In the March 2009 report, we reported that SBA officials stated that they have begun a process of reengineering the HUBZone program. SBA officials stated that this process is intended to make improvements to the program that are necessary for making the program more effective while also minimizing fraud and abuse.

## SBA Has Taken Some Actions on the 29 HUBZone Firms Previously Investigated by GAO

As of March 2010, the SBA has reviewed the status of all 29 firms we referred to it from our prior HUBZone investigations. Of the 29 firms, 16 were decertified by the SBA, 8 voluntarily withdrew from the HUBZone program, and 5 were found by the agency to be in compliance with program requirements and remain certified. We did not attempt to verify SBA's work. Although SBA indicated that firms sometimes come in and out of compliance while in the program, we maintain that the five firms SBA determined to meet HUBZone program requirements were out of compliance at the time of our initial review. In addition, we found that five decertified firms continued to market themselves, through their Web sites, as HUBZone certified even after the SBA removed them from the HUBZone program.

Since our March 2009 report, the 29 firms we identified have received more than $66 million in federal obligations for new contracts. Not all of these obligations are necessarily improper, and some do not relate to HUBZone contracts. For example, one firm continued to benefit from another SBA program even though it misrepresented its eligibility for the HUBZone program and was decertified by the SBA. This firm, a construction firm that was a part of our recent investigation into fraud and abuse in the SBA's 8(a) Business Development Program, [4] also had been 8(a) certified while in the HUBZone program.[5] During that investigation, we found that the firm misrepresented its status as a qualified 8(a) firm because it was being controlled by individuals who did not qualify for the program. Because SBA did not promptly suspend or debar the firm, this firm received nearly $600,000 in additional noncompetitive 8(a) contracts since our last report and nearly $10 million in additional contracts from the federal government. According to SBA officials, the agency has recently proposed debarment for this firm and, as a result, the firm is generally ineligible for additional federal government contracts at this time.

Madam Chairwoman, 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.

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

[5] This firm is represented as GAO case 2 in Table 1 GAO-10-759.

## Contact and Staff Acknowledgments

For further information regarding this testimony, please contact Greg Kutz at (202) 512-6722 or kutzg@gao.gov. In addition, contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals who made key contributions to this testimony are Andy O'Connell, Assistant Director; Matthew Valenta, Assistant Director; Lerone Reid, Analyst-In-Charge; Eric Eskew, Agent-In-Charge; Jason Kelly; Barbara Lewis; Jeff McDermott; and Timothy Walker.

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