



## Office of Inspector General U.S. Small Business Administration

May 2004 Update

### *Agency Management*

Spring Semiannual Report (SAR) Submitted to the Administrator. The OIG's spring 2004 SAR to Congress was submitted to the Administrator for transmittal to Congress, as required by the Inspector General Act of 1978. The SAR summarizes the results of OIG audit, investigation, inspection, and other activities during the period October 1, 2003, through March 31, 2004. Accomplishments during this period included \$6,136,000 in potential investigative recoveries and fines, \$13,536,000 in management avoidances, \$1,012,000 in disallowed costs agreed to by management, \$535,000 in funds potentially put to better use, 17 indictments, and 13 convictions.

OIG Issues New Management Challenge. On May 24, 2004, the OIG issued a new management challenge on the Small Business Investment Company (SBIC) program under the report title ***The SBIC Program: At Risk for Significant Losses***. One of the most important challenges facing the SBA today is that the current structure and oversight practices of the SBIC program place too much risk on taxpayer money. This report provides a concise statement of the problems that have been identified in past General Accounting Office and OIG reports, and in the Program Assessment Rating Tool (PART) assessment recently released by the Office of Management and Budget.

SBIC program officials estimate that, given the rapidly mounting losses in the portfolio, the cumulative cost of the program to the Federal Government will be almost \$2 billion on an outstanding portfolio of \$5 billion. Problem areas related to program structure and oversight include: 1) SBA's "profits" are not proportional to the investment that the agency makes in SBICs;

2) insufficient incentives exist to encourage SBICs to pay back principal debt to SBA as quickly as possible; 3) SBA's policy of allowing extensive time for financially troubled SBICs to attempt rehabilitation has allowed SBIC assets to decrease and has reduced SBA's potential for recovery; and 4) capially-impaired participating securities SBICs that have been transferred to liquidation are not being liquidated. In addition, the subsidy model underestimates the cost of the program, with the technical assumptions more optimistic than actual performance.

According to program officials, actions are being taken that will strengthen the assessment and management of financial and regulatory risks inherent in the program. To improve the program's ability to limit risk and prevent major avoidable program losses, officials should pursue legislative reforms and act in a timely manner in dealing with and liquidating capially-impaired SBICs.

In accordance with the Reports Consolidation Act of 2000, this challenge will be incorporated with other Agency challenges in our Report on the Most Serious Management Challenges Facing the Small Business Administration in Fiscal Year (FY) 2005. The complete FY 2005 report will be included in SBA's annual Performance and Accountability Report this fall.

Agency Completes Seven Final Actions on Audit of SBA's FY 2003 Financial Statements – Management Letter. The following seven final actions have been completed: 1) the Agency has agreed to strengthen reporting internal control to ensure that accounting transactions are posted in the fiscal year in which the economic event occurs; 2) the Agency has agreed to work with the Office of Administration (OA) and the Office of Field Operations (OFO) to strengthen internal control over accountable property; 3) the Office of Financial Assistance has implemented a certification process and an end of year assurance process over

SBA's collateral purchase (COLPUR) inventory. A report of outstanding COLPUR items was distributed to field offices for their certification of the asset value. The end of year Federal Manager's Financial Integrity Act assurance letters were modified to include a statement on COLPUR management; 4) the Agency has agreed to correct the mathematical error in converting quarterly to monthly probabilities in its Secondary Market Guarantee model; 5) the Agency has included an appropriate timeline for performance data measures gathering, summarization, quality assurance, and auditor review in the FY 2004 Management Discussion and Analysis plan; 6) the Agency developed and implemented new Centrally Billed Account (CBA) procedures (these procedures include the requirement for the segregation of duties and timely processing of CBA obligations); and 7) the Agency has agreed to develop procedures to ensure that travel authorizations (obligations) are fully recorded in Oracle, thus utilizing automated funds control at all times, including periods of continuing resolution.

Agency Completes Final Action on Audit of SBA's FY 2003 Financial Statements. In the audit, the OIG recommended that the Office of the Chief Financial Officer (OCFO) calculate and pay all interest due to immediate pay vendors for late payments in prior years. The report also recommended that SBA begin paying Prompt Payment Act interest to these vendors on future late payments. As a result, OCFO is working with the Office of Procurement and Grants Management to improve controls over requests to set up vendors for immediate pay. The OCFO will require contractual proof for each immediate pay request to prevent Prompt Pay Act violations.

## ***Business Loan Programs***

New Jersey Man Pleads Guilty to Conspiracy to Make False Statements. On May 17, 2004, a Forked River, New Jersey, man pled guilty to one count of **conspiracy to make false statements**. He was indicted in Newark, New Jersey, on February 9, 2004, on one count of **conspiracy to make false statements**, one count of **conspiracy to defraud the United States**, and one count of **false statements**. The guilty plea relates to a SBA guaranteed loan that was obtained by the owner of an automotive repair business that purchased land from

his company in 1999. The investigation revealed that the owner of the automotive repair business did not make the capital injection and conspired with the land owner to represent fraudulently to the lender that the injection had been made. They entered into an \$80,000 mortgage agreement, which they concealed from the lender, in lieu of the capital injection. The mortgage was not filed until months after the loan was disbursed. The owner of the automotive repair business defaulted on the loan, and the SBA paid the guarantee. The case was referred to the OIG by the lender.

Former Oregon Loan Broker and Financial Consultant Pleads Guilty to Bank Fraud. On May 14, 2004, a former loan broker and owner of a financial consulting business in Beaverton, Oregon, pled guilty to one count of **bank fraud** in the U.S. District of Oregon. He was previously charged with six counts of **bank fraud** on March 10, 2004. In exchange for his plea, the other five **bank fraud** counts of his indictment were dropped. The Grand Jury indictment alleged he engaged in a scheme to defraud a financial institution of more than \$500,000. The broker allegedly submitted false loan applications containing the names and personal identity information of six people, fictitious business information, and forged signatures to the financial institution. The broker used the proceeds of these loans for his personal purposes, including to pay debts and to gamble. The Federal Bureau of Investigation (FBI) and SBA OIG conducted a search warrant on his residence. During the search, agents found the original applications for some of the above-charged loans, original cancelled checks from some of the fraudulently-opened accounts, and mortgage loan files for several of the six people. During the search, he confessed to falsifying the applications charged in the March 10, 2004, indictment. The SBA OIG conducted this investigation jointly with the FBI.

Chicago Graphic Artist Arrested. A Chicago area graphic artist was arrested and charged, via a complaint filed on May 11, 2004, by the Cook County State's Attorney, in Chicago, Illinois, and subsequently indicted on May 20, 2004, on one count of **felony manufacture of a fraudulent identification document**, and one count of **felony forgery with intent to defraud**, in connection with assistance he provided in an attempted \$594,000 loan fraud through the SBA's 504 loan program. At the request of a SBA loan applicant, he agreed to create a counterfeit U.S. Certificate of Naturalization, showing that the applicant was a U.S. citizen. Less than 1 month after becoming a U.S.

citizen, using graphics equipment and software at his business, he scanned his personal naturalization certificate and an aged-color photo of the borrower, and carefully altered the data and dates to fabricate the counterfeit document. The borrower, an illegal alien, later presented the counterfeit certificate along with \$2,500 cash (of an agreed upon \$5,000 bribe) to an SBA official to influence an official act. As was previously reported, the borrower and his spouse were each indicted in Federal Court for conspiracy and attempted loan fraud.

Arizona Telecommunications Owner Signs Settlement Agreement. On May 11, 2004, the owner of a Phoenix, Arizona, telecommunications company and the Civil Division, United States Attorney's Office for the District of Arizona, signed a negotiated **settlement agreement** in the amount of \$22,000. The agreement was the result of an investigation conducted by the OIG that focused on the submission of **false statements and false claims** by an Arizona financial institution during the financing of his business through the SBA 504 program. The \$22,000 was placed in the General Fund of the United States Treasury by the Arizona District of the United States Attorney's Office.

Former Ohio Jewelry Store President Pleads Guilty. The former president of a jewelry store in Cincinnati, Ohio, pled guilty on May 28, 2004, to one count of **bank fraud** and one count of **bankruptcy fraud**. The plea agreement was pursuant to a two count **Information** previously filed against the president. On December 28, 1999, a financial institution and SBA approved a \$99,500, 80 percent SBA guaranteed loan to the president and his wife. The purpose of the loan was to purchase equipment, inventory, and for working capital. The investigation disclosed that during the loan application process, the president failed to disclose the existence of a \$923,718 civil judgment filed against him and a company he previously owned. Additionally, he concealed his extensive criminal history. On July 18, 2002, the president and his wife filed for bankruptcy protection. In the bankruptcy petition, the president failed to disclose his other company, and concealed that company's active business checking account. This case was initiated based on a referral from the financial institution. The SBA OIG is conducting this investigation jointly with the FBI.

Agency Completes Final Action on Audit of Central Servicing Agent for CDC Loan Program. In the audit, the OIG recommended that the Associate Deputy Administrator for Capital Access monitor contract compliance directly or modify the contract to require that a contractor obtain independent evaluation of contract compliance. As a result of the audit, the contractor has agreed to submit to SBA a Statement on Auditing Standards No. 70 audit in addition to the opinion audit that they already provide.

## *Disaster Loan Program*

New York President/Owner and Managing Partner Sentenced. The president and owner of a business in New York, New York, and his managing partner, were sentenced on May 13, 2004. The president/owner received 51 months of incarceration, 3 years of supervised release, and ordered to pay \$373,000 in restitution. The managing partner received 33 months of incarceration, 3 years of supervised release and ordered to pay \$245,000 in restitution. The president/owner and the managing partner were convicted by jury on October 3, 2003, on all 21 counts including **conspiracy, mail fraud, wire fraud, and making false statements**. In the wake of the September 11, 2001, terrorist attacks in New York City, they applied for and received a \$228,200 SBA disaster loan. They claimed that: 1) their company had been located in 2 World Trade Center, Suite 2112, and that they were subleasing office space from their parent company (which was legitimately located in 2 World Trade Center); 2) they lost approximately \$94,000 worth of machinery, office equipment, supplies, furniture, and fixtures; and 3) they lost all financial backing from their parent company; and 4) they lost their entire customer base. The investigation revealed that their business was not located in 2 World Trade Center on September 11, 2001. In fact, they were salaried employees of another company at the time. The case was referred to the SBA OIG by the Niagara Disaster Office.

## *Government Contracting and Business Development Programs*

OIG Issues Audit Report on Small Business Set-Aside Contract. On May 18, 2004, the OIG issued a final audit report on a small business set-aside contract. The audit objective was to determine whether the small

business qualified for a small business set-aside contract with the U.S. Air Force. The small business was ineligible to receive the small business set-aside contract as a small business non-manufacturing reseller, since it supplied a product considered to be from a large business. According to 13 CFR, in order for a company to be a small business non-manufacturing reseller, it must, among other things, supply the end items of a small business manufacturer or processor made in the United States. The small business supplied the product of a manufacturer that, in this case, was considered to be a large business because of the manufacturer's affiliation with a large business.

We made two recommendations to the Associate Deputy Administrator for Government Contracting and Business Development (ADA/GC&BD) to:  
1) advise the procuring agency that the contract should not be counted as a small business award; and 2) provide guidance to SBA Size Determination officials to increase awareness of the need to include consideration of affiliation issues. The ADA/GC&BD agreed with both recommendations.

This monthly update is produced by the SBA OIG,  
Harold Damelin, Inspector General.

The OIG has established an e-mail address ([oig@sba.gov](mailto:oig@sba.gov)) that we encourage the public to use to communicate with our office. We welcome your comments concerning this update or other OIG publications. To obtain copies of such documents please contact:

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