

# **SBA**

SOP 10 09

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# **SBA Internal Examinations Guidelines**

**(NOTE: This SOP is generally for internal use only. Any requests for disclosure must be made under the Freedom of Information Act (FOIA).)**

Office of SBIC Examinations  
Office of Investment

U.S. Small Business Administration



**SMALL BUSINESS ADMINISTRATION  
STANDARD OPERATING PROCEDURE**

SUBJECT: SBIC Internal Examinations Guidelines	S.O.P.		REV
	SECTION 10	NO. 09	

**INTRODUCTION**

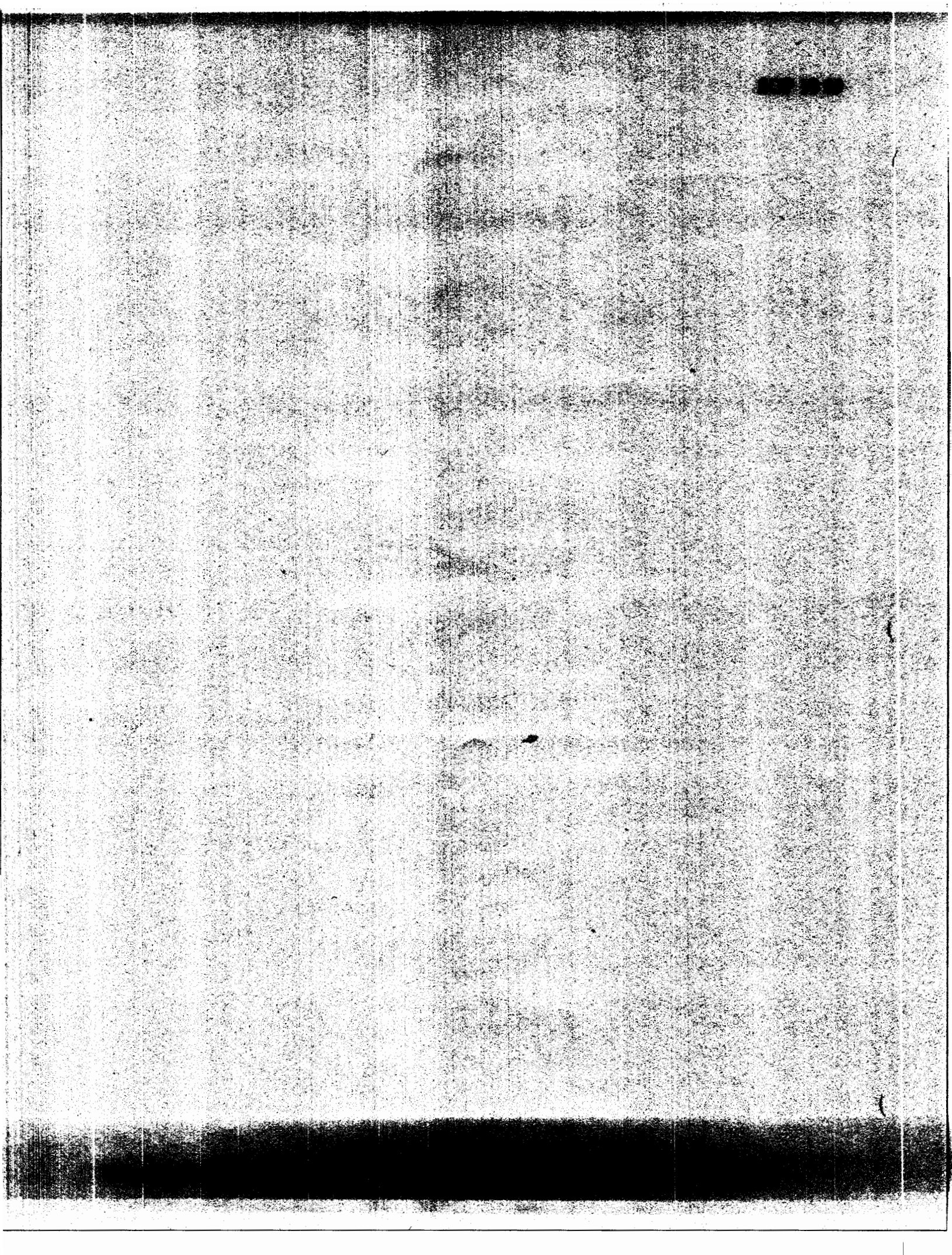
1. Purpose. To provide current instructions and guidelines for the examination of Small Business Investment Companies.
2. Personnel Concerned. All personnel in Headquarters and field offices who are involved in the examination of Small Business Investment Companies.
3. Directives Canceled. None
4. Originator. Office of SBIC Examinations,  
Investment Division

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## Chapter 1

### How Do I Prepare for An Examination?

#### 1. Why Is Preparation So Important?

- a. Thorough preparation is vital to the examination process. The amount of work necessary to prepare for an examination of an SBIC depends on the licensee's:
  - (1) Organizational structure;
  - (2) Size;
  - (3) Type of leverage;
  - (4) Investment policy;
  - (5) Level of investment activity; and
  - (6) Number of years in the program.
- b. You must complete several steps when preparing for an examination:
  - (1) Notify the licensee of the examination;
  - (2) Review existing documentation on the licensee;
  - (3) Talk to the financial analyst in SBIC Operations;
  - (4) Select the financings to be reviewed;
  - (5) Obtain credit reports for selected financings; and
  - (6) Send confirmations to selected portfolio concerns.

#### 2. How Do I Notify the Licensee of the Examination?

- a. Telephone an appropriate SBIC official to establish the examination as-of-date, as well as the dates you will be working on-site.
- b. You should notify the licensee in writing at least 30 days in advance of the date you will be making the on-site visit. Send a copy of your letter to the appropriate Area Chief in the Office of SBIC Operations.

- c. Your notification letter must inform the licensee's management of the examination dates, and request any required information. For example, if the licensee's latest *Annual Financial Report (SBA Form 468)* is not in your files, you should request a copy of it in your letter. If appropriate, request Securities and Exchange Commission reports and financial statements of the parent company or general partner.
- d. In your notification letter, instruct the licensee's management to prepare and have available specific information for the examination period, including:
  - (1) Books of account;
  - (2) Bank account reconciliations;
  - (3) Bank statements, canceled checks, wire transfer authorizations;
  - (4) List of all cash and idle fund accounts, including account numbers and the names and addresses of financial institutions;
  - (5) Minutes of all board of directors meetings;
  - (6) Documentation on the valuations of all portfolio concerns;
  - (7) Current financial statements on all portfolio concerns;
  - (8) All legal documents and correspondence relating to the portfolio concerns;
  - (9) Stock certificate book, or partnership agreement and amendments;
  - (10) Correspondence files; and
  - (11) Amendments to Proposal to Operate (SBA Forms 415C).
- e. In your notification letter, request that the licensee send you, within 10 working days:
  - (1) Working trial balance;
  - (2) Schedule of financings, including a list of all new or additional financings made since the last examination cut-off date, together with a list of officers, directors, and shareholders or partners of these portfolio companies;
  - (3) Schedule of the licensee's portfolio, showing outstanding balances;
  - (4) Schedule of delinquencies;

- (5) An executed *Disclosure Statement*;
- (6) Schedule of financings paid-off, written off, and sold since the last examination;  
and
- (7) Schedule of distributions made on Participating Securities (if applicable) since the prior examination, including the date, type, and amount.

### 3. How Do I Review Existing Documentation?

- a. Review all available information concerning the licensee, including:
  - (1) Prior examination reports and related workpapers;
  - (2) Actions taken by the Agency and the licensee on prior examinations;
  - (3) License application and any amendments to the application;
  - (4) Correspondence between the licensee and Office of SBIC Operations; and
  - (5) Reports submitted to the Agency—such as the financial reports, program evaluation reports, and the independent accountant's audit report.
- b. Compare the *Schedule of Officers, Directors and Stockholders*, or the *Schedule of Partners* from the prior examination report with information shown on the licensee's latest SBA *Form 468* report, and note any changes in management or ownership.
- c. If appropriate, review IG investigation reports to obtain any information pertinent to the examination. Also, if appropriate, review SEC reports and financial statements of the parent company or general partner.

### 4. What Discussions Should I Have With the Financial Analyst?

- a. Phone the appropriate financial analyst in the Office of SBIC Operations to discuss the upcoming examination. The purpose of the call is to:
  - (1) Inform the analyst of the examination dates;
  - (2) Learn of any special areas or issues to address during the examination;
  - (3) Identify specific financings to focus on; and
  - (4) Make sure you have all pertinent correspondence involving the licensee.



- b. In addition to your phone call, send a fax to the analyst (or preferably e-mail if you have that capability), requesting any issues or concerns he/she want you to address. You must send this fax (or e-mail) to the analyst at least 14-30 days prior to starting your site work. The analyst, in turn, must fax (or e-mail) a reply back to you (including a no comment reply) at least 1 week before you begin your site work. Use the analyst's information to help develop the scope of the examination.

## **5. How Do I Select Financings to be Reviewed?**

- a. After reviewing the existing documentation and talking with the financial analyst, select the financings to be reviewed during the examination. In most cases, you should review all financings made since the last examination.
- b. Whenever you decide to use a sample, discuss the selection criteria with your manager. In general, the sample size should represent at least 50 percent of the dollar value of the licensee's total financings, and include a combination of loan, debt security and equity financings. When selecting a sample, consider such factors as:
  - (1) Dollar amount and type of financings;
  - (2) Type of business financed;
  - (3) Past examination findings; and
  - (4) Input from Office of SBIC Operations' analysts.
- a. You may increase the sample size to include additional financings as a result of information you obtain during the examination.

## **6. How Do I Use Credit Reports to Review Selected Financings?**

- a. Unless your field manager decides otherwise, obtain a Dun & Bradstreet credit report (and direct confirmation) for each small business that has received financing during the examination period. While these reports have limitations, they are useful in determining:
  - (1) Name, address, SIC Code, and history of the business;
  - (2) Financings that represent bona fide assets of the licensee;
  - (3) Financings to businesses that may not meet Agency size standards;
  - (4) Credit ratings of the business;

- (5) Financial condition of the business;
  - (6) Affiliations between companies financed by the licensee; and
  - (7) Indications of any self-dealing transactions.
- b. You must obtain follow-up credit reports whenever:
- (1) Changes have taken place in the financial condition or ownership of a portfolio concern; or
  - (2) Additional financings have been made to a portfolio concern.

## 7. What Other Preliminary Steps Should I Complete?

Before traveling to the licensee's location for the on-site phase of the examination, make sure you complete the following steps:

- a. Analyze the unaudited trial balance provided by the SBIC for indications of financial problems, unusual account balances, and potential regulatory violations.
- b. Review the *Disclosure Statement* provided by the SBIC for indications of regulatory violations and other potential problems, especially:
  - (1) Conflicts of interest;
  - (2) Hypothecation of the licensee's assets;
  - (3) Encumbrances of the licensee's capital stock;
  - (4) Control of portfolio concerns; and
  - (5) Serious litigation involving the licensee.
- c. Review the commitments shown on the *Disclosure Statement*, and note items to document during the examination, such as the form, terms and fees charged in the commitment. Compare the level of commitments claimed by the licensee with those shown in the licensee's latest SBA *Form 468*.
- d. Review the latest SBA *Form 468* to identify other significant factors:
  - (1) Potential overline financings;

- (2) Delinquent financings;
  - (3) Financing participations bought or sold;
  - (4) Unrealized appreciation/depreciation of portfolio assets; and
  - (5) Portfolio concerns at the same address, or at the licensee's address.
- e. Compare the latest SBA *Form 468* with the licensee's current trial balance and analyze any variances.
- f. After completing your preliminary review, meet with your Examinations Manager to discuss:
- (1) Scope and objectives of the on-site examination;
  - (2) Length of time to be spent on-site;
  - (3) Estimated travel costs; and
  - (4) Need for additional staff.

## Chapter 2

### How Do I Conduct the On-Site Phase of the Examination?

#### 1. How Do I Conduct an Entrance Conference?

- a. The on-site phase of the examination begins with an entrance conference. Meet with licensee officials to give an overview of the examination process and inform them of what information, documentation and facilities you will need to conduct the examination.
- b. During the entrance conference, be sure to discuss:
  - (1) Information and documentation you've reviewed that needs clarification;
  - (2) Unresolved findings from the prior examination; and
  - (3) Recent amendments to the licensee's operating plan.
- c. Explain to the licensee official that the Examination's Headquarters office will mail an invoice of the examination fee when the examination is completed. Explain that the fee is based on the licensee's assets as of the date of its latest certified financial statement, and is computed using the rate table in Title 13, Code of Federal Regulations, Part 107.692.
- d. Do not assess a fee for a special examination, unless your field manager directs you to do so. We normally do not assess a fee for a special examination because these examinations are limited in scope and made to obtain specific information for Agency officials.
- e. SBA may assess an additional fee if the examination is delayed or prolonged due to a lack of cooperation on the part of the licensee or the poor condition of the licensee's records. For example, if a licensee's records are not kept current, the resulting delay could be considered cause for such an assessment. The Associate Administrator for Investment, after consulting with the Director of SBIC Examinations, has the authority to assess the licensee an additional fee based on delays caused by the licensee.

#### 2. What Should Be My Overall Approach to the Examination?

- a. The examination process is a flexible one, and depends heavily on the examiner's judgment. The specific review procedures you use during the examination will depend on several factors, such as the licensee's:

- (1) Classification (debenture, participating security, 301(d), non-leveraged);
  - (2) Financial condition;
  - (3) Amount and form of SBA leverage;
  - (4) Prior regulatory history; and
  - (5) Period of time since the last examination.
- b. With approval from your field manager, you may expand the scope of the examination on the basis of information you gather as the review proceeds. At a minimum, your examination must include a review of:
- (1) Corporate minutes and ownership records;
  - (2) Correspondence files;
  - (3) Partnership agreements and amendments (if applicable);
  - (4) Licensee policies, practices, and procedures;
  - (5) Books of account and supporting documentation;
  - (6) Selected assets and liabilities (including confirmations);
  - (7) Financing files for selected portfolio concerns; and
  - (8) Valuation procedures and practices.

### **3. What Major Findings Should I Focus On?**

Whether a particular transaction justifies a finding depends on the language of the Act or regulations in effect at the time of the transaction. If a particular transaction violates the regulations in effect at the time, a finding should be made even though a later change in the law that became effective after the transaction) might have permitted such a transaction.

To more efficiently use examination resources, as well as focus attention on serious regulatory issues, the Investment Division has identified nine major findings that are of special concern. The following sections describe these major findings (also referred to as *Category 1* findings) and the typical examination coverage involved for each one.

a. Activities Not Contemplated by the Act (§107.500; §107.700; §107.110)

The Small Business Investment Act of 1958, as amended, contemplates that small businesses will be assisted in specific ways. The principal issues of concern in this area, as specified in the Act, are:

- (1) Financing a big business;
- (2) Financing provided by a Specialized SBIC (SSBIC) to a small business that is not owned, controlled, and managed by disadvantaged persons; and
- (3) A licensee conducting operations of any business other than that for which it was licensed.

In reviewing this area, you should analyze the licensee's financing records and other documentation, including background information on the small business being financed and the owners of the small business. In making your evaluation, you need a working knowledge of the Small Business Investment Act and pertinent Agency regulations.

b. Prohibited Conflicts of Interest (§107.730; §107.885)

Licensees and those persons operating licensees must not self deal to the prejudice of a small business, the licensee itself, the owners of the licensee, or SBA. A finding in this area usually involves licensees providing financing to associates (as defined in the regulations) or otherwise providing the licensee's assets for the use of associates either directly or indirectly, without SBA permission. In addition, licensees with outstanding leverage or Earmarked Assets may not sell (or transfer) to associates, title to assets without permission from SBA.

Review the terms of financings provided to portfolio concerns, and records pertaining to their principals, owners, and directors. Also review the disposition of assets not now on the licensee's books, but shown on the books during the prior examination. As part of your review, obtain credit reports on the entities receiving financing, as well as written confirmations from the portfolio concerns. Give serious consideration to visiting any small business that appears to be involved in a conflict of interest situation.

c. Prohibited Control of a Small Business (§107.865)

Licensees, either directly or through associates, are generally prohibited from operating a business enterprise or functioning as a holding company that exercises control over a financed small business. Temporary control is permitted under certain conditions to protect the interests of the licensee and SBA, but licensees must provide certain information in writing to SBA, within 30 days of assuming control, to justify the action.

Review the terms of financings made to portfolio concerns, including the post-financing ownership, stock voting rights, shareholders' agreements, and board membership or partner rights. Use the *Disclosure Statement*, which you obtained from the licensee, in making your review. Phone or visit the small business when control is a potential issue.

d. Short-Term Financings (§107.830; §107.835; §107.845)

Licensees must provide only long-term financing to small businesses, unless it meets one of the exceptions described §107.835, such as short-term financings made for changes in ownership, those made to protect prior investments, or bridge financings needed in anticipation of long-term debt or equity financing. Regular SBICs must provide financing for a minimum of 5 years, and SSBICs for a minimum of 4 years.

Review the terms of the financing provided, including equity financings, to determine whether the terms of the financing, or any prepayment or redemption provisions, result in a prohibited short-term financing.

e. Overline Investments (§107.740)

Licensees with leverage are prohibited from concentrating their assets in any one small business, or any affiliated group of small businesses. Regular SBICs are generally restricted to having 20 percent of their regulatory capital in any small business, and SSBICs are restricted to investing no more than 30 percent of regulatory capital.

Compare the licensee's total outstanding financing and commitments to each small business with its appropriate overline limit. In addition, determine affiliations of small businesses receiving financing, and compare the total financing for all affiliates with the licensee's overline limit. In making overline calculations, you should include contingent liabilities of the licensee on investments sold on a recourse basis, any amount of a financing previously written off, and total financing and expenditures on assets acquired in the liquidation of a small business.

f. Relending, Foreign, Passive or Other Prohibited Investments, Including Prohibited Real Estate Financings (§107.720)

Certain types of investments are prohibited. These prohibitions generally apply to financings in which the proceeds go to other than a domestic operating small business engaged in regular and continuing business, and to financings in which the proceeds are used to indirectly benefit associates of the licensee.

Determine the general nature of the small business receiving the financing, as well as how the proceeds of the financing were used. The nature of the business is determined by reviewing the licensee's financing files, and is confirmed by a D&B credit report and a visit to the small business. During the visit, discuss the use of proceeds with the small business owner. In most cases, you should also review the small business's bank records

and other documentation to confirm the use of proceeds. If the small concern's use of proceeds differs from the conditions of the financing, you should determine whether the licensee has approved this change.

g. Excessive Cost of Money (§107.855; See also §§107.860; 107.830(d)(3); and 107.900)

Licensees are restricted in the cost of money they can charge on loans and debt securities. The cost of money includes stated interest rates, discounts, and fees charged. Licensees also may charge only reasonable prepayment penalties. The regulations describe which fees and charges are included, as well as excluded, from calculating the cost of money.

Determine the rate of interest and any discount or fee charged on financings provided to portfolio concerns by examining the note and any other financing agreements. Also, review the terms of equity financings to determine whether the financing is, in fact, a loan disguised as an equity financing. Evaluate equity redemptions to determine whether the terms have resulted in an excessive cost of money.

h. Inappropriate Distributions, Including Improper Dividends and Excessive Expenditures (§107.520; §107.585; §§107.1520-107.1580; §107.50)

Licensees are restricted in the types and amounts of capital and earnings distributions they may make. Management fees, operating expenses, and earnings distributions are restricted for leveraged licensees. All licensees are subject to restrictions on reducing paid-in capital.

Analyze capital accounts (paid-in and earned) for changes since the prior examination. In addition, compare earnings distributions with restrictions imposed by the regulations.

i. Impairment and Valuation Issues (§§107.1830-107.1850; §107.503; §107.650)

For those licensees having leverage, capital impairment occurs when a licensee's losses reach a threshold as defined in the regulations. Such impairment is directly affected by both operating and investment losses, as well as unrealized losses on portfolio assets. Licensees are required to have a portfolio valuation policy approved by their boards of directors, or general partners, and by SBA. Most licensees have adopted SBA's "Model Valuation Policy." Licensees with leverage are required to value their portfolios at the end of the second quarter and at the end of the fiscal year, and to provide valuation reports to SBA within specified time periods. Licensees without leverage must value their portfolios only at the end of the fiscal year.

Review capital accounts, and the unrealized appreciation and depreciation of the portfolio, and calculate any capital impairment based on regulatory requirements. Determine if portfolio valuations, as shown in valuation reports, have been completed in accordance with the approved valuation policy and reported to SBA.



j. Other Matters in Prior Examinations Not Resolved and New Regulatory Issues Involving Similar Prior Matters

Regulatory issues other than the nine listed above, as well as potential violations of the regulations, are reported in examination reports as *Other Matters* rather than as *Findings*. These matters become findings, however, when they had been reported in the previous examination and remain unresolved by the licensee, or when they are new instances of the same regulatory issues previously reported as *Other Matters*. The one exception to this policy concerns potential or possible violations, which never elevate to level of a finding, unless the issue actually occurs.

Determine whether all previously reported *Other Matters* have been resolved to the satisfaction of SBA's Office of SBIC Operations. Report as *Findings* those issues that remain unresolved, or are new instances of the same previously reported issue.

4. **What Financial Records Should I Review?**

a. Purpose and Scope of Financial Review

The financial part of the examination is necessarily limited in scope and duration. To the extent possible, you should rely on the Independent Public Accountant's audited financial statements. The primary objectives of your financial review are to:

- (1) Verify that the licensee's funds qualify as private capital;
- (2) Document changes in private capital;
- (3) Determine whether private capital requirements have been met or maintained.
- (4) Verify the accuracy of reported financings;
- (5) Document the timely payment of funds due SBA;
- (6) Determine whether internal controls adequately safeguard the SBIC's assets;
- (7) Confirm and reconcile the licensee's cash and invested idle funds deposits;
- (8) Review selected revenue and expense accounts; and
- (9) Determine whether the SBIC's operations are consistent with the regulations.

b. Review Licensee's Capital Accounts and Changes in Ownership

Review the licensee's capital accounts, and document any changes in its Regulatory or Leverageable Capital as described in §107.585.

During the first examination, you should confirm that the initial capital with which the licensee began operations matches the amount shown in its license application. In later examinations, you should confirm any reported increases in private capital.

During the first examination, be sure to request confirmations of ownership from all owners (or partners) of the licensee, and from new owners or partners as changes occur. When the licensee has numerous owners, confirm the interests of only those owners who are officers or directors, or who own at least 10 percent of the licensee.

During every examination, request confirmations from the licensee's owners for any unfunded commitments to contributed capital.

c. Review Cash Disbursements and Receipts

Review the licensee's cash disbursement journals and bank statements to identify those disbursements relating to the financings selected for review. For each disbursement, record the date, payee, endorsement, check number, amount, purpose, and authorization. For any questionable disbursements, review additional documentation.

Review cash disbursements unrelated to financings to determine whether the licensee:

- (1) Made financings not shown on the schedule it sent to you;
- (2) Made its required payments due to SBA; and
- (3) Made payments which appear to be unusual based on payee, amount, purpose, or other factors.

Verify the disbursements you've identified in the above step to the source documents (canceled checks or wire transfer documents, and bank statements if necessary).

Review the cash receipts journals and bank statements to identify:

- (1) Receipt of additional private capital due or claimed by the SBIC;
- (2) Receipts and deposits of SBA leverage in a timely manner;
- (3) Prepayments that indicate possible Cost of Money violations; and
- (4) Payments that may indicate other irregularities.

Obtain and compare the licensee's bank reconciliations with the bank statements, book balances and the trial balance provided to you. Resolve any discrepancies.

d. Review Idle Funds

Review documentation relating to idle funds deposits and compare the balances with the amounts shown on the trial balance. Resolve any discrepancies.

Make any needed copies of bank statements and idle funds documentation. Mail confirmation requests to all financial institutions and custodians to verify the existence and amounts of these assets. Keep copies of all confirmation forms to use for follow up if a response is not received.

For all leveraged licensees, or those applying for leverage, determine whether all cash accounts are Federally insured and whether all idle funds are held in investments approved under §107.530.

Analyze whether an SBIC with low cash and idle funds balances can meet its financial and regulatory obligations to SBA. Also determine whether such a licensee will be able to meet the amortization schedule for its SBA leverage.

e. Inactivity

For all licensees, determine whether the licensee's cash and idle funds amount to more than 20 percent of its total assets (at cost) for the most recent fiscal year end. If the amount exceeds 20 percent, perform the inactivity calculations required under §107.590.

f. Review Delinquencies

Obtain a breakdown of accrued interest receivable from the licensee. Compare this information with the licensee's latest SBA *Form 468* and the *List of Delinquencies* provided by the licensee. Note instances in which interest continues to be accrued on investments delinquent more than 120 days.

Based on your review, determine the number and extent of delinquencies and whether the delinquencies, if any, are adversely affecting the licensee's financial condition. Record your analysis and conclusions, and consider the impact that significant delinquencies may have on the licensee's valuation of its portfolio.

g. Review Management Expenses

Review the licensee's expense accounts for compliance with its approved level of management expenses as described in §§107.140; 107.250 and 107.520.

#### h. Other Financial Review Steps

Review the SBIC's liability accounts for any secured third party debt not approved by SBA (§107.550).

Analyze and reconcile the licensee's undistributed realized earnings (deficit) and perform one or more capital impairment calculations depending on the issuance dates of the licensee's leverage. Use §§107.1830 through 107.1850 for leverage issued after April 25, 1994, or §107.203(d) of the prior version of the regulations for leverage issued before that date. If the licensee has any wholly-owned subsidiaries, examine their financial records.

If the SBIC is a limited partnership, examine the financial records of the Entity General Partner under §107.160(b)(2).

Prepare an unaudited comparative balance sheet for the as-of dates of the current and prior examinations, using the trial balances provided by the licensee. Reconcile and explain any significant deviations between amounts shown on the two balance sheets.

Review any other general ledger accounts which, based on their nature, description, or amount, appear unusual. Whenever you find discrepancies, inconsistencies, errors or omissions that you cannot resolve to your satisfaction, get in touch with the IPA for more information, or the phone field manager for guidance.

### 5. **What Non-Financial Records Should I Review?**

- a. Ascertain the licensee's identification as an SBIC and inspect its SBIC license (§§107.501 and 107.508).
- b. Review the SBA-approved contract of the licensee's Investment Advisor/Manager for material changes (§107.510).
- c. Determine whether the licensee has a personal computer with a modem, and is able to use this equipment to prepare reports (using SBA-approved software) and transmit them by modem to SBA, as required by §107.504. Also determine whether the licensee has electronically filed a *Portfolio Financing Report* (SBA Form 1031) for all financings made after May 1, 1996, and whether the licensee's files contain fax confirmations from SBA showing receipt of these SBA Form 1031s.
- d. Review and document the following SBIC records required under §107.600:
  - (1) All minutes of meetings of directors, stockholders, executive committees, partners, or other officials;

- (2) All documents evidencing ownership of the licensee, including ownership ledgers, and transfer registers;
  - (3) All correspondence files (for the examination period) involving the licensee and SBA, and the licensee and its IPA, attorneys, and portfolio concerns;
  - (4) Annual and quarterly financial reports issued to the licensee's partners or shareholders, as well as any prospectus, letter, or other publication;
  - (5) Any report, application, or document filed with the SEC;
  - (6) Litigation reports required to be filed with SBA; and
  - (7) Any other reports that SBA required the licensee to file.
- e. Decide whether your review of non-financial records disclosed facts that indicate possible violations of the following regulatory requirements:
- (1) Management and Ownership diversity under §107.150(d);
  - (2) Special rules for limited partnerships under §§107.160(b)(1) and (c)(2);
  - (3) Changes in ownership or control as described in §§107.400 through 107.430;
  - (4) Changes in the structure of the SBIC under §107.470;
  - (5) Transfer of the SBIC license under §107.475;
  - (6) False filings and nonperformance of agreements with SBA under §107.507;
  - (7) Filing of financial statements with SBA Form 468 under §107.630; and
  - (8) Reporting changes not subject to prior SBA approval under §107.680.

## 6. How Do I Review the Licensee's Portfolio Investments?

The purpose of this phase of the examination is to determine whether the licensee is providing long-term financings to eligible small businesses for legitimate purposes.

Unless your field manager decides otherwise, you should review all financings made since the last examination. When your review is based on a sample of financings, consider expanding the sample based on information you obtain during the examination, such as when you discover major regulatory violations.

a. Review Financings

Review the licensee's financing documents and prepare a *Loan and Investment Information Schedule (SBA Form 861)* for each financing that shows:

- (1) Name, address, and type of business of the portfolio concern;
- (2) Information on disbursements of financing proceeds, including the date, check number, amount and payee (if other than the small business); and
- (3) Information on the portfolio concern's financial condition, collateral, management and owners (including ownership/control of corporate owners or entity partners).

When preparing the *SBA Form 861*, be sure to:

- (1) Use the Dun & Bradstreet report obtained prior to the on-site examination for background on the portfolio concern;
- (2) Request and review the *Certification of the Use of Proceeds* and *SBA Forms 480, 652 and 1031*, as required under §107.610;
- (3) Review all final financing closing documents, legal binders and closing statements required by §107.691 and summarize needed information;
- (4) Review the financial statements of the small business prior to financing, and compare them with the *Size Status Declaration—SBA Form 480*;
- (5) Review the latest updated financial information on each portfolio investment, as required by §107.620, and summarize it; and
- (6) Review the correspondence files between the licensee and the portfolio concern regarding the financing.

b. Eligibility for Financing

Based on the information you've summarized in the above examination step, determine if the small business is eligible for SBIC financing under the following regulations:

- (1) Size standards criteria, as described in §§107.700 and 107.760;
- (2) Relenders or reinvestors; passive businesses; real estate businesses and project financings under §§107.720 and 107.500;
- (3) Conflicts of interest under §§107.730 and 107.885; and

- (4) Activities not contemplated by the Act under §§107.500; 107.507; 107.800(a) and 107.860(b).

c. Limitations on Financing Terms

Determine if the terms of the financing violate any of the following regulations:

- (1) Restrictions on control of a small business under §107.865;
- (2) Minimum financing term under §§107.830; 107.835; 107.845 and 107.850(a);
- (3) Portfolio diversification (Overline limitation) under §§107.740; 107.825(d) and 107.880(c); and
- (4) Interest rate ceiling and limitations on fees charged to small businesses (Cost of Money) under §§107.855; 107.830(d)(3); 107.850(b) and 107.860.

Determine if financings for a change in the ownership of a portfolio concern meet the requirements of §107.750.

Determine if financings in the form of Equity Securities meet the requirements of §107.800.

Determine whether there are any restrictions on the redemption of equity securities, as detailed in §107.850.

Determine if financings in the form of Debt Securities meet the requirements of §107.815.

Determine whether the terms of the financing include management services and related fees to the portfolio concern, and whether the licensee has complied with the requirements under §107.900.

Determine if financings made in the form of Guarantees meet the requirements of §107.820.

Review any securities purchased by the SBIC from or through an underwriter for compliance with §§107.825(a); (b) and (c).

Review any SBIC securities purchased from, or exchanged with, another SBIC or from SBA under §107.825(d). Determine whether licensee has contingent liabilities based on put rights or any other guarantees.

Determine if the licensee has met the requirement to finance "smaller businesses" under §107.710.

d. Licensee Commitments

You should pay particular attention to the licensee's commitments to finance small businesses when the licensee is using these commitments to qualify for SBA funding.

Obtain the commitment letter for each commitment, verify the terms of the commitment, and ensure that the letter was signed by the small business owner.

Compare the commitments shown on the *Disclosure Statement* with those shown on the SBA *Form 468* filed during the examination period, as well as with those shown on the *Disclosure Statement* from the prior examination. Multiple commitments to the same small business, and commitments which have been outstanding for more than 3 months, should be scrutinized to verify their legitimacy.

e. Valuation of Portfolio Investments

An SBIC's portfolio of loans and investments usually represents the bulk of its assets. A realistic and timely valuation of these assets is needed because the performance of these loans and investments affects the licensee's viability as a going concern. The licensee therefore must have procedures in place to ensure that its portfolio is properly valued, with sufficient documentation to support each valuation.

Other segments of your examination may reveal indicators of valuation problems—for example, capital impairment, delinquent loans, operating losses and significant amounts of unrealized appreciation. The purpose of this phase of the examination is not to arrive at a specific valuation for each of the licensee's assets, but rather, to determine whether the licensee has a written valuation policy approved by SBA, and whether that policy is being implemented and adequately documented.

Review the licensee's latest valuation of its portfolio investments under §§107.503 and 107.650. Determine if the SBIC has fairly valued its portfolio investments in accordance with SBA-approved guidelines, and has recorded its unrealized appreciation and depreciation, based on your analysis of:

- (1) Requirements of the written SBA-approved valuation policy;
- (2) IPA's workpapers showing the latest review of valuations;
- (3) Licensee's latest delinquency listing;
- (4) Updated financial statements for each portfolio concern;



- (5) Current collateral appraisals (if available);
- (6) Valuations of portfolio co-investments with other SBIC's; and
- (7) Minutes of meetings that discussed portfolio valuations.

You should not talk to prospective purchasers of small businesses when the licensee's valuation is based on a proposed sale price. Instead, indicate that the valuation is based on a proposed sale, and that you were unable to verify the terms of the proposed sale.

## 7. **How Do I Review Licensees Using Participating Securities?**

Participating Securities issued by SBICs are redeemable, preferred, equity-type securities in the form of Limited Partnership Interests, Preferred Stock, or Debentures with interest payable only to the extent of earnings. Participating Securities now exist only in the form of preferred limited partnership interests.

When you send a notification letter to a licensee that has issued Participating Securities, request a schedule of any distributions made on these securities during the examination period. The schedule should include the date, type and amount of each distribution, and be made part of the permanent workpaper File E.

### a. Eligibility for Participating Securities

As explained in §107.1500, there are special eligibility requirements for Participating Securities, including:

- (1) Minimal capital level (under §107.220);
- (2) Liquidity requirements (under §107.1505);
- (3) Non-SBA borrowing limits (under §107.570); and
- (4) Equity Capital Investment (under §107.1500(b)).

Confirm, in writing, the licensee's private capital with each investor. Confirm the actual cash invested to date and the balance of any remaining capital commitment.

Calculate the SBIC's Liquidity Ratio under §107.1505. Liquidity impairment exists if the ratio calculated is less than 1.20, as detailed in §107.1505(b). Give special attention to those elements of the calculation that are based on estimates.

Determine if the SBIC has any non-SBA debt not in compliance with §107.570.

Determine if the SBIC has invested in the level of Equity Capital Investments as required under §107.1500(b)(4).

b. New General Ledger Account Definitions

For licensees using Participating Securities, you should be aware of the following new general ledger account definitions:

- (1) **Accumulation Account:** a memo account whose balance represents accumulated unearned prioritized payments and adjustments.
- (2) **Distribution Account:** a liability account whose balance represents earned prioritized payments and adjustments not yet distributed.
- (3) **Earned Payments Account:** a memo account that holds the cumulative total of all additions to the Distribution Account.
- (4) **Profit Participation Account:** a liability account whose balance represents SBA's unpaid share of the SBIC earmarked profits. The balance must be distributed within 120 days of the fiscal year end subject to liquidity requirements.

c. Payments To Be Made on Participating Securities

SBICs that issue Participating Securities agree to pay:

- (1) Prioritized payments under §107.1520;
- (2) Adjustments to prioritized payments under §107.1520;
- (3) SBA Profit Participation under §107.1530;
- (4) Required and optional distributions under §§107.1540 through 107.1580, and
- (5) Mandatory redemption of Participating Securities under §107.1500(e).

Review the licensee's computation of Earmarked Profits under §107.1510. Their determination is used to calculate the licensee's obligation to make prioritized payments and adjustments under §107.1520 and profit participation under §107.1530. The calculation is made at the SBIC's fiscal year end, as well as for any interim period in which the SBIC makes a distribution.

Review the licensee's computation of prioritized payments and adjustments under §107.1520. The prioritized payment for a full year equals its redemption price times its trust certificate rate. Shorter periods of time are pro-rated.

Review the licensee's annual calculation of profit for prioritized payment purposes under §107.1520(d). The SBIC is obligated to make the prioritized payment only if it has a profit. If sufficient profits exist, the prioritized payments are considered earned. Such earned prioritized payments and any adjustments on them under §107.1520(f) that are also earned, are liabilities of the SBIC and should be booked to the Distribution account of the general ledger. In addition to the required annual calculation, the licensee may also choose to calculate its profit for an interim period (one or more fiscal quarters) in order to make an interim distribution.

Determine if the adjustments on prioritized payments have been computed at fiscal year end under the formula detailed in §107.1520(f).

Determine if the calculated prioritized payments and the adjustments on prioritized payments have been booked to the Accumulation account if they are unearned, or to the Distribution account if they are earned.

Review the SBIC's computation of SBA's Profit Participation under §107.1530. The calculations of Earmarked Profits under §107.1510 and Prioritized Payments and Adjustments under §107.1520 must be made before the licensee computes its profit participation. If there is no profit, there is no profit participation for that period.

If sufficient profits exist, the unpaid profit participation calculated above is booked to the Profit Participation Account, a liability account. SBA receives Profit Participations as a portion of its share of distributions made under §§107.1550, 107.1560, or 107.1570(a). The licensee must reserve funds equal to the amount of Profit Participation due SBA, and may not reinvest or use these funds in any way. These reserves are not required to be held in a segregated account.

Review any distributions of Prioritized Payments and Adjustments made during the examination period under §107.1540. If the liquidity ratio requirements are met, prioritized payments and adjustments booked to the Distribution account are required to be distributed annually on the first or second payment date after the fiscal year end. If this required distribution is not made in full, the SBIC is required to follow the procedures described in §107.1540(b).

Review permitted Tax Distributions by the licensee to private investors and SBA. Section 107.1550 allows an SBIC that is a Limited Partnership, S Corporation, or an equivalent pass-through entity for tax purposes, to make annual tax distributions in which SBA receives a share. SBA's share is calculated on its profit participation rate and is applied to any profit participation owed the SBA.

Review the SBIC's Required Distributions under §107.1560. The SBIC must make distributions if it has outstanding Participating Securities or Earmarked Assets and it satisfies the conditions set out in §107.1560(a). The amount to be distributed is determined by the calculation of Retained Earnings Available for Distribution (READ)

under §107.1560(b), and it is required to be distributed on either the first or second payment date after the fiscal year end.

Review any Optional Distributions made by the SBIC under §107.1570. If the SBIC has outstanding Participating Securities or Earmarked Assets, it may make two types of optional distributions:

- (1) Interim distributions, based on READ, as explained in §107.1570(a); and
- (2) Annual or interim distributions, not based on READ, under §107.1570(b).

If In Kind Distributions of publicly traded and marketable securities were made under §107.1580, review the special rules for any distribution made under §§107.1560 and 107.1570. Prior SBA approval is required for In Kind Distributions of any earmarked asset which is not publicly traded and marketable.

d. Other Special Rules

For licensees having outstanding leverage or Earmarked Assets, review the following:

- (1) Frequency of portfolio valuations under §107.503(d);
- (2) Management expenses under §107.520;
- (3) Restrictions on third party debt under §§107.550 and 107.570(a) and (b);
- (4) Voluntary decreases in capital allowed under §107.585 (except for Participating Securities issuers, which can reduce their capital only under §§107.1560 and 107.1570);
- (5) Exceptions to receiving prior written SBA approval to finance small businesses with associates under §107.730(d); and
- (6) Maximum amount of Participating Securities outstanding under §107.1170.

**8. What Adjustments Do I Make for Section 301(d) Licensees?**

- a. Review the licensee's eligibility profile certifications as shown on the *Financing Eligibility Statement (SBA Form 1941)* for all current financings as required by §107.610(c).
- b. Review the level of the licensee's financings to disadvantaged businesses that are relenders or reinvestors under §107.720(a)(2), and determine whether the total of

these financings outstanding at the fiscal year end exceed the licensee's regulatory capital.

- c. Calculate the total outstanding financings and commitments to portfolio concerns under Portfolio Diversification (Overline Limitation) at 30 percent of regulatory capital for a 301(d) SBIC, as explained in §107.740(a)(2).
- d. Review the term of the licensee's financings, which under §107.830(b) may be for a minimum period of 4 years for 301(d) SBICs. Additional short term-financings are allowed for various purposes, including to assist a small business in performing set-aside programs for minority or disadvantaged contractors under §107.835.
- e. Determine whether a licensee with a fourth tier of leverage is maintaining Venture Capital Financings (at cost) equal to at least 30 percent of the SBIC's Total Funds Available for Investment under §107.1160(c)(2).
- f. Determine whether a licensee with a second tier of Preferred Securities is maintaining at least the same dollar amount of Venture Capital Financings (at cost) under §107.1160(d)(2).
- g. Determine whether the licensee has paid its dividends or distributions due to SBA under §§107.1400 and 107.1440, and has booked an appropriate liability to record the cumulative amount that remains unpaid on its 4 percent preferred stock.
- h. In calculating capital impairment for a 301(d) licensee, be aware that a condition of capital impairment occurs only when the impairment percentage exceeds 75 percent.

## 9. What Adjustments Do I Make for Unleveraged SBICs?

### a. Regulation Exemptions

For licensees having no outstanding leverage or Earmarked Assets, §107.1000 exempts these SBICs from the following regulations:

- (1) Overline limitation in §107.740;
- (2) Idle funds investment restrictions in §107.530;
- (3) Third party debt restrictions in §107.550;
- (4) Expense restrictions for maintaining or improving assets acquired in liquidation of portfolio concerns under §107.880; and

- (5) Record keeping requirements and fee limitations under §107.825(b) and (c), respectively, for securities purchased through or from an underwriter.

b. Exemptions from Prior SBA Approval

Agency regulations also exempt unleveraged licensees from having to obtain SBA's prior approval for:

- (1) Decreases in Regulatory Capital of more than 2 percent under §107.585, but not below the minimum required by the Act or the regulations;
- (2) Disposition of any Asset to an associate under §107.885;
- (3) Contracts to employ an Investment Adviser/Manager under §107.510;
- (4) Initial management expenses under §107.140, and increases in these expenses under §107.520;
- (5) Options obtained from a portfolio concern by licensee management or employees under §107.815(b); and
- (6) SBA's post approval of new directors and officers, other than the Chief Operating Officer. (Licensees still must notify SBA, within 30 days, of new officers and directors.)

c. Discretion of Examinations Manager To Eliminate Certain Steps

Our policy is to conduct limited-scope examinations of unleveraged SBICs. These examinations should focus on major regulatory violations and the workpapers necessary to support their existence. For examinations of unleveraged licensees, the Examinations Manager has the discretion to eliminate the following steps from the examination process:

- (1) Confirmations of cash and idle funds;
- (2) Visit and inventory of safe deposit box;
- (3) Verification of securities held by third parties;
- (4) Review of control procedures over cash disbursements;
- (5) Analysis of private capital;
- (6) Review of capital stock certificate book;

- (7) Analysis of the financial condition of the SBIC;
- (8) Analysis of trial balance accounts;
- (9) Analysis of provisions for losses;
- (10) Analysis of accrued interest receivable;
- (11) Reconciliation and analysis of retained earnings;
- (12) Review of valuation procedures and specific valuations;
- (13) Review of IPA workpapers;
- (14) Review of SEC reports;
- (15) Conducting visits to portfolio concerns; and
- (16) Reviews for violations regarding idle funds or overlines.

With unleveraged licensees, you should review no more than ten new financings to different portfolio concerns. Obtain Dun & Bradstreet reports only for financings selected for review. Also, use the licensee's Schedule of Portfolio Financings, instead of updating the Workpaper B File summary sheets.

#### **10. When Do I Visit the Independent Public Accountant?**

For leveraged and unleveraged licensees, you should use your discretion in deciding whether or not to visit the Independent Public Accountant (IPA). These visits may be helpful, for example, when developing findings concerning valuations of specific portfolio concerns. As authorized in §107.691, you may review the workpapers that support the IPA's opinion in the financial statements. Document your interview by completing *Comments on IPA Annual Report* (Workpaper G-5). Whenever you find instances of what you believe to be substandard IPA work, refer the matter to the Assistant Inspector General for Auditing for a quality review and possible referral to the state licensing board.

## 11. How Do I Conduct Visits to Portfolio Concerns?

### a. Criteria for Leveraged and Unleveraged Licensees

For licensees having SBA leverage, you should schedule as much time as is reasonable and practical to visiting portfolio concerns. These visits are especially useful in confirming the existence of the firms and verifying the use of financing proceeds.

Unless you suspect major regulatory problems, or the licensee has indicated an interest in applying for funding, do **not** visit portfolio concerns of licensees that have no leverage. However, whenever a licensee is first examined, or has applied for its first tier of leverage, you should visit a significant portion of the licensee's existing portfolio.

### b. Focus on Use of Proceeds

Your examination of a leveraged licensee should include at least one visit to verify the use of proceeds by reviewing the small business's books and records. Always review financings made for working capital to make sure that the proceeds were used for legitimate business purposes. Be alert to the possibility that the amount of working capital advanced to the small concern may be excessive in relation to comparably-sized concerns in the same business, and that the proceeds may have been used to pay debts not owed by the small business. As a general rule, you should review the portfolio concern's bank statements and deposits, its canceled checks, the Cash Disbursement Ledger, and any vendor invoices. You should also make a physical inspection of each item purchased with the proceeds.

### c. Additional Field Visits

The extent to which you make additional visits will be based on the combined judgment of you and your manager, and should consider the results of your initial visit, as well as any unusual circumstances. For example, you should visit a portfolio concern whenever issues arise during your examination that indicate the company may be involved in a serious regulatory violation. You should also consider additional visits whenever you find:

- (1) D&B reports indicating that no business exists at the reported address;
- (2) Portfolio concerns having a PO Box address; and
- (3) Portfolio concerns at the same address, especially the licensee's location.

Be alert to licensee practices that form a reasonable basis for making additional field visits. For example, you should consider increasing the number of field visits whenever you examine:

- (1) Licensees that are closely-held and have minimal capitalization;



- (2) Licensees having inadequate documentation to support their financings;
- (3) Licensees having a high number of delinquent or charged-off loans;
- (4) Licensees whose files do not contain periodic financial statements (at least annually) from portfolio concerns; and
- (5) Licensees having a portfolio of small businesses that have been non-responsive to requests for information from the licensee.

Decisions not to visit companies that meet the criteria discussed in this section require the concurrence of both the field manager and the Director of SBIC Examinations.

In summary, you should consider making a field visit whenever you develop a regulatory finding or determine that there are significant unanswered questions about a particular financing. Telephone the small business owner, instead of making a field visit, *only when a visit is clearly unnecessary, or other factors (such as time and cost) preclude you from making the visit.* With questionable financings, you should always lean in favor of making a field visit, and not on making a telephone call.

Whenever a field visit involves a significant amount of time or travel funds, you should obtain prior approval from your field manager. This is especially true when you believe that the scope of the examination should be significantly expanded to include additional visits.

d. Examination Steps During Field Visits

During your visit to a small business, be sure to:

- (1) Confirm details of the financing received from the licensee;
- (2) Confirm the use of financing proceeds;
- (3) Verify the officers, directors, owners or partners;
- (4) Determine if any associate relationships exist;
- (5) Document any possible conflicts of interest;
- (6) Determine whether the licensee or its associates provide management services to the small business, and the nature of any such charges; and
- (7) Obtain copies of any relevant records.

e. Prior Notification of Field Visits

You are under no obligation to notify the licensee that a particular visit will be made; nor are you obliged to explain the reason for making a visit. You may coordinate arrangements for the visit with a licensee official if, in your opinion, his/her involvement will not jeopardize the integrity of the information you seek. You should not encourage licensee officials to accompany you on these visits; however, you cannot prevent them from being present during the visit.

In general, whenever you anticipate reviewing the books and records of a small business, you should request both the licensee official and the small business owner to make certain that specific documents be made available to you during the site visit.

f. Access To Records

Title 13, Code of Federal Regulations, Part 107.620(c), gives you access to the books and records of portfolio concerns receiving financing from licensees. This regulation requires licensees to:

- (1) Obtain any information that we request to verify certifications made by portfolio concerns, including those concerning the use of proceeds; and
- (2) Ensure that financing documents contain provisions giving us access to the portfolio concern's books and records.

If the small business owner denies or restricts your access to the portfolio concern's records, or is uncooperative with your request for access, promptly report the matter to your Examinations Manager. In these situations, consider having a licensee official call the owner in an effort to obtain cooperation. Under no circumstances should you try to intimidate or threaten officials of the licensee or small business into complying with your requests for information. Document problems in obtaining information from a portfolio concern in the *Other Matters* section of your examination report.

g. Document Results of Field Visits

Document the results of each field visit in a memorandum. The length of the memorandum will depend on the results of the visit. At a minimum, the memorandum should include sufficient information to adequately address the questions that prompted your visit, including a record of discussions held with officials of the small business. Include the memorandum in the "B" section of the workpapers, along with other documentation you obtained during the visit.

**12. What Issues Require An Immediate Telephone Call to My Manager?**

During the onsite phase of your examination, you will normally phone your examinations manager, at some point, to report on your progress. On certain sensitive matters, you should immediately phone your manager for guidance. These matters include, but are not limited to:

- a. Indications of fraud or other criminal acts;
- b. Need for timely action to protect SBA's financial interests; or
- c. Conditions either precluding or handicapping the examination.

**13. How Do I Conduct an Exit Conference?**

- a. After you finish the on-site examination, you must meet with licensee officials for an exit conference. During this meeting, present the results of your examination, obtain comments from the licensee on each finding, and clarify any misunderstandings relating to the facts. You must hold the exit conference in person, not by telephone. Document the meeting in a *Memorandum of Interview*.
- b. Never accept verbal representations of licensee officials as proof that a finding does not exist, or that past findings have been resolved. Always require the licensee official to give you documentation to show that a finding either does not exist, or has been resolved to the satisfaction of the Office of SBIC Operations.
- c. During the exit conference, explain the process in which examination findings are handled by the Office of SBIC Operations. Emphasize that it is the responsibility of the Office of SBIC Operations to determine whether a finding is, in fact, a violation and the appropriate corrective action needed to correct the finding. You must take special care not to discuss possible corrective actions that should be taken by the licensee.
- d. You should allow licensee officials, whenever they request it, the opportunity to respond to your examination findings in writing. When they make such a request, explain that you must have their written comments within 2 weeks, and that you will not delay processing of the examination report by waiting longer than 2 weeks for their comments to arrive.
- e. At no point during the exit conference (or any other time during the examination), should you give the licensee official a written statement of the finding. Our written explanation of the finding is included in the examination report—after the examinations manager has reviewed the issue and consideration given to the licensee's verbal and written comments.

**14. When Should I Give an Oral Briefing to the Financial Analyst?**

After finishing the on-site phase of the examination, phone the financial analyst handling the licensee and give him/her a briefing on the results of your examination. You don't have to make this call from the licensee's office, but you should make it no later than the day you return to your field office. Be sure to cover any findings you've developed, as well as any other important issues.

**15. When Should I Make Return Visits to Licensees?**

- a. As part of their monitoring duties, financial analysts in the Office of SBIC Operations visit their portfolio of assigned licensees to determine whether corrective action has been taken to resolve examination findings.
- b. There may be instances when you must assist the analyst by returning to the licensee to confirm, through documentation, that corrective action has, in fact, been taken. Your field manager, after discussing the situation with the responsible Area Chief in the Office of SBIC Operations, will decide whether you should make a return visit.

**16. How Do I Prepare Examination Workpapers?**

- a. Workpapers are a standard part of the examination process. They provide a systematic record of the work done in making an examination, and a structured way of organizing information obtained and developed in support of an examination's findings. Workpapers should include your source of information, your initials, and the date you prepared them. Your workpapers must be:
  - (1) Accurate;
  - (2) Complete;
  - (3) Well-Organized;
  - (4) Neat and Legible; and
  - (5) Self-explanatory.
- b. Permanent and Current Workpapers

During an examination, you prepare two types of workpapers—permanent and current. You must update the permanent workpapers because they contain basic background

information of continuing use from one examination to the next. You must prepare a distinct set of current workpapers each time you examine a licensee because these files contain information that pertains only to the current examination.

c. Location of Workpapers

In general, you should maintain your workpapers in your field office. You must obtain approval from your Examinations Manager before moving workpapers to another location.

## Chapter 3

### How Do I Write an Examination Report?

#### 1. What Is the Purpose of an Examination Report?

When you write an examination report, you communicate the results of your examination to Investment Division officials responsible for taking action involving the licensee. Your report must be clear, concise, factual, accurate, objective, and in sufficient depth to allow these officials to understand the reported matters and take appropriate action. To ensure fairness, your reports must include pertinent comments and explanations of the licensee.

#### 2. What is the Standard Report Format?

a. Examination reports include a report cover and follow a standard report format. The standard format always includes the following sections:

- (1) Table of Contents;
- (2) Summary;
- (3) Introduction;
- (4) Background;
- (5) Objectives and Scope;
- (6) Status of Prior Findings;
- (7) Findings;
- (8) Other Matters; and
- (9) Exhibits.

#### b. Report Cover

Examination reports use a green and black cover that includes:

- (1) Name of the SBIC;
- (2) SBIC's Location (City and State);

(3) License Number;

(4) Report Issue Date

c. Table of Contents

The *Table of Contents* lists all the sections of the report, including the captions of the individual findings, and the pages on which each section and caption begins. The *Table of Contents* is page-numbered with lower case Roman Numerals, such as i and ii.

The top heading (**Table of Contents**) should be in bold lettering, centered, not underlined, and with only the first letters of Table and Contents capitalized.

The page column should be headed with the word *Page* underlined and only the first letter capitalized.

The major headings (*Summary, Introduction, Status of Prior Findings, etc.*) should be aligned to the left margin and have only the first letter of each word capitalized.

d. Summary

The *Summary* begins on page 1 and is a synopsis of the report. The heading (**Summary**) should be centered at the top of the page in bold letters, have only the first letter capitalized, and not be underlined. There should be a two-line gap before the beginning of the first paragraph. All paragraphs should be in block style, with first line of each paragraph not indented. The *Summary* should generally be limited to one page and include:

- (1) An introductory paragraph with short statements giving background information on the licensee you examined and your objectives and scope;
- (2) A paragraph or two that summarize the findings and other matters; and
- (3) A paragraph covering your discussion of the findings with the SBIC's management, including a reference to their comments elsewhere in the report.

e. Introduction

The *Introduction* section begins on a separate page immediately following the *Summary* and consists of two standard subsections: *Background* and *Objectives and Scope*. The heading (**Introduction**) should be centered at the top of the page, have only the first letter capitalized, and be in bold letters. There should be a one line gap before the beginning of the first subsection (*Background*).

Both of the subsections (**Background and Objectives and Scope**) should be in bold letters and underlined, with only the first letters of each word capitalized. A one-line gap should be used between each subsection heading and the beginning of the first paragraph in that section. At the end of each section, there should be a one-line gap before the next subsection heading. Paragraphs should be in block style, with the first line of each paragraph not indented.

The wording used in the *Introduction* should be in the format and style historically used in prior reports. In writing the *Introduction*, you must accurately detail the actual examination steps you took. Include the time frame for the on-site phase of the examination and state when the on-site phase of the examination was completed.

f. Status of Prior Findings

The *Status of Prior Findings* section begins on a separate page following the *Introduction* and follows the same format. You must detail the prior examination's findings and state whether these have been corrected. If a prior finding is to be resolved over a time period set by SBA, this should be explained, and the finding should not be reported again unless the period for corrective action has expired.

g. Findings

Findings are factual situations found during an examination that you believe may indicate major violations of the Small Business Investment Act or the SBIC regulations. The types of apparent violations to include in your report as findings are:

- (1) Activities Not Contemplated by the Act  
§107.500; §107.700; §107.110;
- (2) Prohibited Conflicts of Interest  
§107.730; §107.885;
- (3) Prohibited Control of a Small Business  
§107.865;
- (4) Short-Term Financings  
§107.830; §107.835; §107.845;
- (5) Overline Investments  
§107.740;
- (6) Relending, Foreign, Passive or Other Prohibited Investments,  
Including Prohibited Real Estate Financings §107.720;



- (7) Excessive Cost of Money  
§107.855 (See also §§107.860; 107.830(d)(3); and 107.900);
- (8) Inappropriate Distributions, Including Improper Dividends and Excessive Expenditures  
§107.585; §§107.1520-107.1580; §107.50;
- (9) Impairment and Valuation Issues  
§§107.1830-107.1850; §107.503; §107.650; and
- (10) Other Matters From Prior Examinations That Remain Unresolved.

The *Findings* section begins on a separate page immediately following the *Status of Prior Findings* section, using the same format as the other sections. Each finding subsection (including the description and regulatory cite), should be in bold letters, with only the first letters of each finding number and description capitalized. The entire *Finding* caption, including finding number, description and regulatory cite should be underlined. There should be a one-line gap between the heading of each finding and the beginning of the first paragraph in that section. At the end of each finding, there should be a two-line gap before the heading of the next finding. Paragraphs should be in block style, with the first line of each paragraph not indented.

Each finding begins with a heading that cites the regulation being discussed. The first paragraph summarizes the finding. The second paragraph cites the specific section of the regulations at issue and an explanation of that regulation. Subsequent paragraphs explain the details of the finding.

Each finding must include a discussion under the caption, *Licensee's Comments*. In this section, include any comments or explanations that licensee officials have about the finding, specifically whether they agree or disagree with it. If necessary, give licensee officials up to 2 weeks to comment in writing on the findings. The written responses must be made an exhibit to the report. After the licensee's comments, include your rebuttal (if necessary) under the caption, *Evaluation of Licensee's Comments*.

The captions *Licensee's Comments* and *Evaluation of Licensee Comments* must be aligned to the left margin, italicized, and have the initial letter of each word capitalized, except for the word *of*. Both captions should be underlined. Place a one-line gap between each caption and the beginning of the first paragraph. A one-line gap must be used to separate the end of the *Licensee's Comments* section from the beginning of the *Evaluation of the Licensee's Comments* section. paragraphs must be in block style, with the first line of each paragraph not indented.

#### h. Other Matters

Use the *Other Matters* section of the examination report to present:

- (1) Apparent violations that are of a less serious regulatory nature than those included in the *Findings* section;
- (2) Any possible or potential violations;
- (3) Information disclosed during field visits; and
- (4) Any other issues you believe are important.

The *Other Matters* section begins on a separate page immediately following the *Findings* section. The heading (**Other Matters**) should be centered at the top of the page, have only the first letter of each word capitalized, and be in bold letters. There should be a two-line gap before the beginning of the first paragraph.

Information in this section should be presented as briefly as possible to get the point across. To ensure clarity, use sub-sections, such as *Regulatory Issues*, *Field Visits*, and *Other Issues*. Each issue presented as an *Other Matter* should be numbered.

When you made a field visit for the purpose of supporting a report finding, or the visit itself produces a new finding, incorporate the results of the visits into the *Findings* section of your report. However, when your field visits do not develop facts to support a finding, summarize the results of the visits in the *Other Matters* section of the report, without making reference to the companies' names.

You should also use the *Other Matters* section to describe situations in which the small business owner either does not produce records in a timely manner, or refuses to produce the records. In these cases, you should note that the records were requested, and that sufficient time was given to produce the records, but that the owner did not comply (or refused to comply) with the request. In general, we consider 5 days from the date of our request to be sufficient time for the small business owner to produce the requested records.

#### i. Exhibits and Attachments

Exhibits to the examination reports will include:

- |           |  |
|-----------|--|
| Exhibit 1 | Comparative Balance Sheet  |
| Exhibit 2 | Schedule of Officers, Directors and Stockholders, or<br>Schedule of Partners |
| Exhibit 3 | Written Comments Provided by Licensee  |

j. Transmittal Memorandum

You must prepare a transmittal memorandum that forwards the examination report from your field manager to the Director of SBIC Operations. Transmittal memoranda are internal documents for use by officials in the Investment Division, and should never be provided to licensee officials.

In the transmittal memorandum, include the names of any small businesses you visited during the examination. Also include, if appropriate, any recommendations for action (such as a transfer to the Office of Liquidation or denial of a funding request), and any concerns you have about the licensee's management or operations.

In the transmittal letter, you must specify and address any issues raised by the Office of SBIC Operations' financial analyst.

When the analyst responded to your inquiry, but did not provide you with issues to address during the examination, include the following wording in the transmittal letter:

“Prior to the examination, we contacted the financial analyst to inquire whether the Office of SBIC Operations had any concerns or outstanding issues to be addressed during the examination. The analyst advised us that he (she) had no specific issues to be addressed at this time.”

When the analyst did not respond to your inquiry, include the following wording in the transmittal letter:

“Prior to the examination, we contacted the financial analyst to inquire whether the Office of SBIC Operations had any concerns or outstanding issues to be addressed during the examination. The analyst did not reply to our inquiry (ies).”

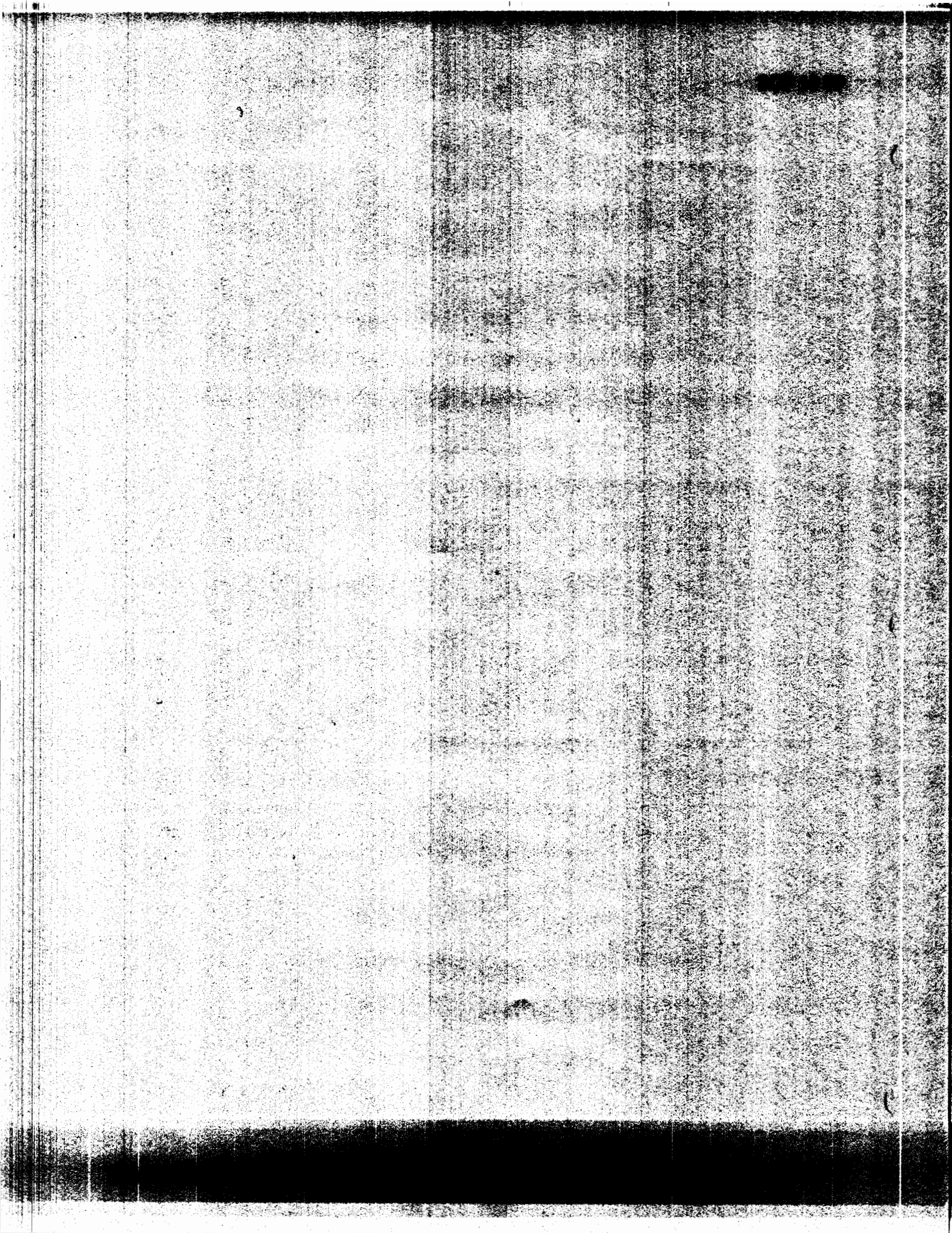
k. Memorandum Reports

Use a brief memorandum report to document examinations that have no findings. A memorandum report does not include a report cover, but does include a *Comparative Balance Sheet* and a *Schedule of Officers, Directors and Stockholders*, or a *Schedule of Partners* as attachments. The memorandum report should be addressed from the Examinations Manager to the appropriate official receiving the report, usually the Director of SBIC Operations.

l. Report Distribution

Your field manager reviews, approves and issues examination reports. You should assist the manager in making sure that the report is issued in a timely manner and that copies of the report are sent to the appropriate Investment Division officials for action. In most

cases, you will send reports to either the Director of SBIC Operations or the Director of SBIC Liquidation.



## Chapter 4

### How Do I Recommend an OIG Referral?

#### 1. What Situations Require an OIG Referral?

During your examinations, you may find situations or transactions that appear to indicate fraud, illegal expenditures or other illegal acts. Normally, you will not have enough time to adequately pursue these issues within the time frame of a regular examination. In these cases, you should obtain whatever information is readily available to assist the Office of Inspector General (OIG) in making an informed decision about whether to investigate the matter.

#### 2. How Should I Make a Referral?

- a. Whenever you find or suspect illegal activity on the part of a licensee, you must report the matter to the Investigations Division of the Office of Inspector General. Referrals should be made in writing, unless the urgency of the matter, such as a bribe or gratuity, demands an immediate telephone call. In such cases, prepare a written report following the call.
- b. No one has the authority to hinder, obstruct, or prevent a referral from being made to the Office of Inspector General. Any examiner or examinations manager who believes that a referral is being hindered, obstructed, or prevented should immediately report this situation to the Assistant Inspector General for Investigations.

#### 3. How Do I Prepare a Referral Memorandum?

- a. When making an OIG referral, draft a memorandum from the Director of SBIC Examinations to SBA's Assistant Inspector General for Investigations. After your field manager reviews the memorandum, send it to the Director of SBIC Examinations for signature. Fully explain why you suspect an illegal activity and include all pertinent documentation to support the referral. When appropriate, you should include your examination report as an attachment to the referral memorandum.
- b. If you are uncertain about whether to make a referral, prepare a referral memorandum for review by your field manager, the Director of SBIC Examinations, and the Associate Administrator for Investment.



**4. How Do I Distribute Referrals?**

Whenever a referral is made to the Office of Inspector General, the Director of SBIC Examinations will promptly send copies of the referral to:

- a. Associate Administrator for Investment;
- b. Deputy Associate Administrator for Investment;
- c. Director of SBIC Operations; and
- d. Director of SBIC Liquidation.

**5. How Do I Report Bribes and Gratuities?**

- a. A bribe or gratuity is a violation of Federal law (Title 18, United State Code, Section 201). You must immediately report a bribe or gratuity to the Office of Inspector General.
- b. Bribery is defined as the giving, offering, or promising of something of value to influence a public official in the conduct of business. A gratuity is defined as the giving, offering, or promising of something of value for any official act performed or to be performed. A gratuity does not have to influence an official act.
- c. Never delay reporting a bribe or gratuity by waiting to prepare a formal written report. Attempted bribery is of such a serious nature that it must not await a formal written report. In such cases, you should immediately report the matter to an OIG Special Agent, Regional Inspector General for Investigations, or directly to the Assistant Inspector General for Investigations.

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**Report**

Reserved



