Office of Inspector General
Small Business Administration

September 1999 Update

Business Loans

Texas Clothing Manufacturer Indicted for Making Material False Statements. The owner of a clothing manufacturer in Dallas, Texas, was indicted on one count each of **making material false statements, misuse of a Social Security number (SSN),** and **misappropriation of SBA collateral** in connection with a $675,000 SBA-guaranteed loan from a participating nonbank lender. Using an alias, she sought the loan to open a second business in Prattville, Alabama. In the loan application, she allegedly represented the second company as employing 75 people with a 1995 profit of over $2 million. Actually, she was its sole employee and worked out of a 700 square foot apartment. She also allegedly gave a false SSN and a false name on the loan application as part of an effort to conceal the fact that her previous business had defaulted on an SBA loan. She also allegedly submitted fictitious tax returns and supporting IRS documentation, falsified financial statements, false lessors' agreements, and false invoices to secure the loan. To substantiate some documents, she allegedly established several telephone numbers in the names of fictitious companies and had voice-mail taking messages for the bogus companies. This loan was disbursed in August 1996. The business owner then failed to purchase the equipment pledged as collateral and allegedly used most of the loan proceeds for personal purchases including two homes, cars, furniture, and other unauthorized items. She went into immediate default on this loan, with a loss to the nonbank lender and SBA of $689,983. This investigation was based on a referral from the lender through SBA's Alabama District Office.

Virginia Insurance Agent Sentenced for Mail Fraud. A Vienna, Virginia, field agent for a life insurance company was charged with and pled guilty to one count of **mail fraud**. He was sentenced to serve 18 months in prison and 3 years on supervised release. He was also ordered to pay the insurance company $261,758 in restitution. A joint investigation by SBA/OIG, the Postal Inspection Service, and FBI showed that, from 1992 through 1998, the agent fraudulently misappropriated approximately $261,758 from the insurance company and its policyholders. OIG initiated its investigation following a May 1998 referral from SBA's Washington District Office. The insurance company had forwarded a copy of a letter authorizing them to release a collateral lien SBA held on an insurance policy that belonged to one of the agent's clients, a former SBA loan applicant. The letter was purportedly from SBA's Washington District Director, who actually had retired more than 1 year before the date on the letter. The investigation proved that the bogus letter was prepared and sent by the agent as part of his scheme to defraud the insurance company and the policyholder.

Glendale, California, Business Owner Sentenced for Making False Statements to Federally Insured Lender. The continuing investigation of the Inglewood, California, loan brokerage firm recently produced the sentencing of an eleventh defendant. The former owner of an automotive repair business in Glendale, California, was sentenced on September 8, 1999, to serve 5 months imprisonment, 5 months on home detention, and 3 years of supervised release. He was also ordered to pay $4,050 in fines. He previously pled guilty to one count of **making false statements to a federally insured lender**. He submitted altered Federal income tax returns for 1987-89 in support of his application for a $1 million SBA-guaranteed loan.

Music Company President in Springfield, Missouri Sentenced for Making False Statements to SBA. The former president of a retail musical instruments company in Springfield, Missouri, was sentenced on August 16, 1999, to serve 1 year on probation. He previously pled guilty to one count of **making false statements to SBA**. He admitted misrepresenting on his SBA Application for a Business Loan that certain outstanding loans from the participating lender, were current, when they were actually past due. The retail store received a $155,000 SBA-guaranteed loan in 1995, but defaulted after only two payments. As a result of a joint investigation by OIG and FBI, the participating lender previously agreed to pay $260,286, in settlement of a related civil fraud complaint. Two loan officers involved in the company application previously signed pre-trial diversion agreements and are no longer employed by the lender. This investigation was initiated based on a referral from SBA's Springfield, Missouri, Branch Office.

Beauty Supply Owner in Philadelphia, Pennsylvania, Sentenced for Making Material False Statements. The owner of a beauty supply store in Philadelphia, Pennsylvania, was sentenced on July 14, 1999, to serve 3 years on probation and 250 hours of community service and ordered to pay $2,800 in fines. He previously pled guilty to two counts of **making material false statements** in an unsuccessful 1994 attempt to obtain a $60,000 SBA-guaranteed bank loan. He had failed to disclose a 1978 Delaware State criminal conviction in applying for the loan. He also admitted submitting copies of Federal tax returns for 1991 and 1993 that he knew had been altered to show higher gross receipts and net profits than those actually filed with the IRS. The loan commitment was canceled when the tax return discrepancies were discovered, and further investigation revealed his criminal history. OIG's investigation was based upon a referral from SBA's Philadelphia District Office.

President of Washington Credit Exchange Pleads Guilty to Making False Statements on Loan Application. The president of a credit exchange in Kennewick, Washington, pled guilty to one count of **making false statements to SBA**. In return, a bank fraud count on which she had also been indicted was dismissed. She was sentenced to serve 3 years on probation with the first 4 months to be served as home detention with electronic monitoring. She was also ordered to pay restitution of $54,604 (65 percent to SBA and 35 percent to the participating bank). *(Updated from March 1999 Semiannual Report.)*

Audits of Early Defaulted Loans. A program of auditing early defaulted loans is yielding dollar recoveries for SBA. In this period, **a lender was collecting payments on a note**

receivable held as collateral on a defaulted loan, but was not forwarding SBA its guarantee share (62.5 percent) as required by the lender agreement. As a result of the audit, the lender started making payments to SBA. SBA should now continue to receive $4,881 a month through the year 2006, a potential recovery of $419,971, or 75 percent of the amount SBA paid out to honor the guarantee on the loan.

An "early default" is a loan which goes into liquidation within 3 years of origination. This sometimes indicates there was error or fraud on the part of the lender or borrower. The Auditing Division is auditing a sample of early defaulted loans each year.

<u>President of Construction Company in Des Moines, Washington, Sentenced for Making False Statements on a Loan Application</u>. The former president of a construction/management company in Des Moines, Washington, pled guilty to one count of **making false statements on a loan application**. He was sentenced to serve 1 year and 1 day in prison and 5 years on supervised release. He was also ordered to pay $480,150 in restitution and an additional $37,506 obligation to the Internal Revenue Service. *(Updated from March 1999 Semiannual Report.)*

<u>Missouri Child Care Center Operator Indicted for Making False Statements to SBA</u>. The president of an educational center in Kansas City, Missouri, was indicted on seven counts of **making false statements to SBA** in connection with a $387,000 guaranteed PLP loan she received from a nonbank lender. The businesswoman received this loan in January 1998 to purchase a building and expand her child care operation. According to the indictment, she failed to disclose on her application and related documents that she owed delinquent taxes and had a prior arrest for passing a bad check. She also allegedly made numerous false statements to document her required $111,000 cash injection and falsely reported that she purchased 50 new computers funded partially by proceeds of the loan. She made no regular payments on the loan, and the lender has foreclosed on the real property and is in the process of evicting the occupants. SBA/OIG initiated this investigation based on information received from the Treasury Department's Inspector General for Tax Administration and conducted it jointly with that office.

<u>Inspection Finds SBA Needs to Improve Oversight of CDC Program</u>. OIG issued an inspection report on the CDC Program that examines the oversight and operations of the Section 504 Loan Program. The report contains recommendations for strengthening internal controls and improving the effectiveness and timeliness of program delivery. More specifically, it focuses on CDC reporting requirements, CDC contractual agreements with service providers, Section 504 fees charged to borrowers, compliance with program rules, and performance measurement.

Overall, OIG believes that SBA's oversight of the CDCs needs tightening to be effective. **OIG found that some SBA district offices were not diligent in reviewing CDC annual reports, preparing summary assessments, and forwarding the reports and assessments to Headquarters**. To correct this problem and improve oversight, **OIG recommends that SBA (1) ensure that the district offices obtain, review, and forward all CDC annual reports and assessments to Headquarters in a timely manner, and (2) provide the field offices with appropriate guidance on reviewing the reports.**

CDCs are allowed to contract for certain services, such as marketing, packaging, processing and servicing, with SBA's prior approval. **Some district offices did not have a prior approval process in place, nor did they review CDC contracts on an annual basis, as required**. We found that at least three non-profit CDCs contracted out virtually all CDC functions to for-profit companies whose owners were directly involved in the management of the CDC. Further, most or all CDC compensation was passed to these for-profit companies. Not only does this arrangement allow CDCs to circumvent the rules barring for-profit CDCs, it also violates regulations that forbid self-dealing. To correct such problems, **OIG recommends that SBA (1) provide district offices with standard procedures for reviewing CDC contracts, (2) hold those offices accountable for conducting annual reviews, (3) require CDCs to provide copies of all contractual agreements in their annual reports, (4) clarify its policy on contracting out the majority of services to for-profit companies, and (5) exercise closer oversight to prevent program violations.**

OIG attempted to use the information provided in CDC annual reports to determine if CDCs were charging borrowers the appropriate processing fees. Although **we identified five CDCs that were charging excessive fees, most of the annual reports did not contain sufficient detail to allow the Agency to verify specific Section 504 revenues. We also found that some CDCs' financial statements did not comply with Generally Accepted Accounting Principles (GAAP), as required**. CDCs are not compelled to undergo an audit by a Certified Public Accountant (CPA); their expense may make such audits inappropriate for smaller CDCs. As a result of these findings, **OIG recommends that SBA (1) require CDCs to list separately each Section 504-related revenue and expense in their financial statements, (2) review all Section 504 revenues to identify CDCs that may be charging borrowers excessive fees, (3) issue guidance to all district offices and CDCs clarifying what fees can be charged to borrowers, and (4) develop a means for certifying compliance with GAAP requirements by CDCs that do not have their financial statements audited by a CPA.**

OIG also conducted a survey of CDC directors that **identified significant variation in closing fees charged by CDCs and substantial dissatisfaction with the time district offices took to approve loans submitted under the Accredited Lender Program (ALP)**. The survey also revealed that 21 percent of the CDCs had not received a site visit from their district offices in 4 or more years. As a result of these findings, **OIG recommends that SBA (1) monitor closing fees in excess of $2,500 to ensure that they are reasonable for the work performed, (2) ensure that district offices approve ALP applications within the required 3-day time period, (3) take necessary steps to revoke the ALP status of CDCs that submit loan packages that take longer to review because they do not meet ALP standards, and (4) ensure that all district offices perform site visits of CDCs at least once every 3 years**

*** * * * * * ***

Disaster Assistance

<u>North Dakota College President Sentenced for Failure to Refund Unearned Federal Student Aid Funds</u>. The former president of a corporation that operated a business college in Grand Forks, North Dakota, was sentenced to serve 18 months in prison and 3 years on supervised release. She was also ordered to pay $914,000 in restitution to the U.S. Department of Education. She previously pled

guilty to one count of **failure to refund unearned Federal student aid funds**. *(Updated from the March 1999 Semiannual Report.)*

Virgin Islands Grocery Store Owner Sentenced for Making False Statements to SBA. The owner of a grocery and feed shop on St. Croix, U.S. Virgin Islands, was sentenced to serve 2 years on probation and ordered to pay $4,050 in fines. He previously pled guilty to **making false statements to SBA** in connection with two disaster loan applications, totaling $215,900, which he had submitted for his business and for his home. *(Updated from the March 1999 Semiannual Report.)*

* * * * * * *

Entrepreneurial Development

Audits of Women's Business Development Center Finds Unallowable Costs. An audit of a women's business development center **identified $167,448 of claimed costs that were unallowable**. The audit found that the grantee used grant funds to purchase equipment and supplies, and entered into consulting agreements with board members. In addition, the grant period had expired and there were unexpended Federal funds totaling $60,007. Of the amount identified as unallowable, $142,779 was attributed to lack of documentation to support the expenditures. The cooperative agreement required the grantee to maintain complete and accurate records, including supporting documentation. Furthermore, the grantee did not meet the cash match requirements. The audit recommended reimbursement for the unallowable costs. Since the project had ended, no recommendation was necessary to address the conflicts of interest. The Assistant Administrator for Administration agreed with the findings and recommendations.

A second audit of the same grantee found an additional $16,799 of claimed costs that were unallowable, $2,650 of unexpended funds, and the required amount of training sessions had not been conducted. The audit report recommended that the center reimburse SBA $15,000 for unallowable and unexpended Federal funds. The Assistant Administrator for Administration concurred with the recommendation.

* * * * * * *

Agency Management and Financial Activities

SBA's Financial Statements Receive Unqualified Opinion. The SBA's FY 1998 financial statements received an unqualified opinion from its independent auditors. The unqualified opinion means that the auditors found SBA's principal financial statements to be presented fairly in all material respects in accordance with OMB guidelines and SBA accounting policies. The results of the audit were transmitted to the Chief Financial Officer by OIG, which contracted for the independent audit. This was the third year that the Agency received an unqualified opinion.

The Auditors did, however, find three problems that were considered "reportable conditions" in the internal control structure: (1) lack of planning for financial reporting which resulted in untimely and erroneous draft financial statements; (2) incorrect calculations were used in the credit reform subsidy modeling and re-estimating process for the Section 7(a), 504, and disaster programs, resulting in substantial errors (these calculations were corrected upon discovery by the auditors); and (3) inadequate SBA computer security and applications development standards. The independent auditors considered the three reportable conditions to be material control weaknesses. The auditors issued a separate report for the material weaknesses related to SBA information systems.

Audit Memorandum Survey of Electronic Records Management. After completing a survey, the OIG decided not to perform an audit of SBA's electronic records management (ERM) because SBA's ERM program was in too early a stage of development. An audit memorandum was issued with the results of the survey which found that SBA had not implemented a comprehensive ERM program (i.e., complete inventories and schedules were not developed, program offices were not aware of ERM requirements, and ERM guidance was lacking). The survey recommended that the Associate Deputy Administrator for Management and Administration implement an ERM program that meet the requirements in the Code of Federal Regulations 36, Sections 1222, 1228 and 1234. In response to the audit memorandum, the ADA/MA indicated her awareness of the importance of ERM.

SBA Employee in Colorado Indicted for Embezzlement and Misusing Social Security Number. A former voucher examiner in SBA's Office of Chief Financial Officer (OCFO), Denver, Colorado, was indicted on 13 felony counts of **embezzlement** and one count of **misusing a Social Security number**. She subsequently pled guilty to one felony count of **embezzlement**; in return, the Government agreed to dismiss the other counts on which she had been indicted. OIG's investigation determined she fraudulently obtained more than $21,000 in SBA funds by means of false electronic travel vouchers and false electronic vendor invoices. Her scheme involved entering false information via her work computer in order to have Government funds electronically deposited into her bank account. After being contacted by OIG, the employee resigned her position at SBA. An internal review by OCFO of their procedures following OIG's investigation revealed that substantially more funds were embezzled than OCFO was initially aware of. This investigation was initiated based on a referral from OCFO's Denver Finance Center.

SBA Employee Indicted for Child Pornography on Office Computer. An economic development specialist in SBA's Sacramento District Office was indicted by a Federal grand jury on four counts of **knowingly possessing visual depictions of minors engaged in sexually explicit conduct**. Subsequently, the employee pled "not guilty" during his initial court appearance. OIG initiated the investigation after complaints were received that he was accessing pornographic sites while on duty, using the computer SBA had assigned him. The investigation determined the employee was accessing Internet sites where images of children involved in a variety of sexual acts were displayed and he was storing many of these images on the hard drive of his SBA computer. OIG presented the results of the investigation to an assistant U.S. attorney who requested that FBI join the case. After the indictment, a U.S. Magistrate issued an arrest warrant and agents of OIG and FBI arrested the employee at SBA's Sacramento District Office.

Editor's Notes:

The following identifies the use of adjectives in these **Updates** to describe tax returns fraudulently submitted in support of loan applications:

Fictitious tax returns: The applicant submits "copies" of tax returns never filed with the IRS.

Altered tax returns: The applicant submits altered copies of tax returns actually submitted to the IRS.

Bogus tax returns: The applicant submits tax returns containing false information to both the IRS and SBA.

Most audit and inspection reports can be found on the Internet at:

WWW.SBAONLINE.SBA.GOV/IG/REPORTS.HTML

Other IG related material can be found at:

WWW.IGNET.GOV

The Activity Update is produced by the SBA/OIG, Phyllis K. Fong, Inspector General.

Comments or questions concerning this update or request for copies of OIG audits, inspections, or other documents should be directed to Donna M. Ching, SBA/OIG, 409 Third Street, SW, Washington, DC, 20416-4110.

Telephone number (202) 205-6580
FAX number (202) 205-7382

If you are aware of suspected waste, fraud, or abuse in any SBA program, please call the OIG Fraud Line.

OIG FRAUD LINE (202) 205-7151
in Washington, DC metropolitan area

TOLL-FREE FRAUD LINE
(800) 767-0385