U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

Audit Report
Issue Date: March 31, 2003
Report Number: 3-19

TO: James E. Rivera,
Associate Administrator for Financial Assistance

Eugene Cornelius, Jr.
Associate Administrator for Procurement and Grants Management

FROM: Robert G. Seabrooks,
Assistant Inspector General for Auditing

SUBJECT: Audit of SBA Oversight of the Due Diligence Contractor for Asset Sales 3 & 4

Attached is a copy of the subject audit report. The report contains two finding and six recommendations addressed to your offices. Written responses to the draft report were not received with the exception of a comment to recommendation 1.A from the Office of Procurement and Grants Management.

The recommendations are subject to review and implementation of corrective action in accordance with the existing Agency procedures for audit follow-up. Please provide your management decision for the recommendations within 30 days of the date of this report using the attached SBA Forms 1824, Recommendation and Action Sheet.

Any questions or discussion of the findings and recommendations contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachment

AUDIT OF SBA OVERSIGHT OF THE DUE DILIGENCE CONTRACTOR FOR ASSET SALES 3 & 4

AUDIT REPORT NUMBER 3-19

March 31, 2003

The findings in this report are the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

AUDIT REPORT

AUDIT OF SBA OVERSIGHT OF THE DUE DILIGENCE CONTRACTOR FOR ASSET SALES 3 & 4

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SUMMARY

Public Law 85-536 authorized the SBA Administrator to sell any evidence of debt, contract, claim, personal property, or security assigned to or held in connection with the payment of loans granted under the Small Business Act. In 1999, the Asset Sales Program was initiated to sell SBA Section 7 (a) business, disaster assistance, and Section 504 business development loans. These loan portfolios consist of approximately $2.4 billion in business loans and $6.9 billion in disaster loans. Since initiation of this program, SBA has sold about 167,000 business and disaster loans with outstanding loan balances of $5.8 billion through seven asset sales. To conduct the sales, SBA relies on contractors to provide services to develop information for investors' use in bidding on various loan portfolios.

This report examines the appropriateness of certain payments made to METEC Group (the Contractor) under a fixed price contract to provide due diligence services for SBA asset sales. The objective of the audit was to determine if SBA's oversight of the Contractor was sufficient to preclude over-payment for contracted services.

SBA oversight of the Contractor was not sufficient to preclude acceptance and payment of unauthorized invoices. The audit found that SBA paid $2.2 million in excess of written contract terms for "drive-by" appraisals provided for Asset Sale 3 and over $23,000 for duplicate or upgraded third party reports for Asset Sale 4. The payments occurred because (i) the contracting officer significantly modified the terms of the contract through an oral agreement, and (ii) SBA did not closely scrutinize invoices and supporting documentation.

We recommend that the Director, Office of Procurement and Grants Management:

- Seek recovery of the $2,181,125 overpayment from the Contractor or ratify, if justified, the verbal modification of the contract in accordance with SBA and applicable Federal requirements.
- Ensure that all future contract changes are made using a properly signed written contract modification.

Also the Assistant Administrator, Office of Financial Assistance in coordination with the Director, Office of Procurement and Grants Management should:

- Ensure SBA's oversight responsibilities of due diligence contracts awarded to the Contractor for Asset Sales 1, 4, and 6 are accomplished by obtaining reconciliation data detailing all third party reports billed against each loan. The reconciliation should include appropriate techniques to detect over billings.
- Recover amounts paid for unwarranted duplicate and upgraded third party report costs identified as a result of the above reconciliation from the Contractor.

- Require the due diligence contractor to conduct an analysis to verify the accuracy of invoicing for third party reports against its reports database to identify and adjust payments for any unwarranted duplicate or upgraded third party reports.

- Contract with a recovery audit firm to identify and recover any erroneous payments, i.e., unwarranted, duplicate, or upgraded third party report costs if SBA is not satisfied with the Contractor analysis.

The Offices of Financial Assistance and Procurement and Grants Management were provided the draft report but the only comment received concerned recommendation 1.A.

A. Background

Public Law 85-536 authorized the SBA Administrator to sell at public or private auction any evidence of debt, contract, claim, personal property, or security assigned to or held in connection with the payment of loans granted under the Small Business Act.

In 1999, the Asset Sales Program was initiated to sell SBA Section 7 (a) business, disaster assistance, and Section 504 business development loans. The SBA portfolio consisted of business and disaster loans valued at $2.4 billion and $6.9 billion, respectfully. Since initiation of the Program, SBA has sold through seven sales about 167,000 business and disaster loans valued at $5.8 billion. The Contractor was awarded contracts for due diligence services for Asset Sales 1, 2, 3, 4, and 6.

Outside contractors were used to assist SBA with the administration of the Asset Sales Program to include:

- A program financial advisor to provide assistance in credit reform analysis and presentation, coordination of efforts, and overall portfolio strategy planning.
- A transaction financial advisor to develop a comprehensive sales plan, including a budget, timeline, schedule of events, conduct weekly status meetings on the progress of due diligence contractor services, and prepare lessons learned reports after each sale.
- A due diligence contractor to provide asset sales support services (due diligence) to prepare loans for sale. These services include loan data collection, verification and analysis, and obtaining third party reports (e.g. real property appraisals and credit and title reports). Additionally, the contractor maintains a loan database, images loan file data, and makes loan file information available to potential investors. SBA paid $48.2 million to the Contractor for due diligence services related to Asset Sales 3 and 4.

B. Objectives and Scope

The objective of the audit was to determine if SBA's oversight of the Contractor was sufficient to preclude over-payment for contracted services for Asset Sales 3 and 4.

To determine the adequacy of SBA's oversight of the Contractor for these sales, we reviewed applicable due diligence and transaction financial advisor contracts and records. A judgmental sample of 126 third party reports was analyzed by accessing SBA's aggregate loan database and "Loan View" electronic records for 25 loans. SBA payment vouchers and supporting documents were also reviewed to compare/contrast the cost of third party reports with billed amounts and the contract compensation schedules. Finally, responsible SBA, Contractor, and transaction advisor personnel were interviewed.

Audit fieldwork was performed from January 2002 through October 2002. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

FINDING 1 SBA Overpaid the Due Diligence Contractor

Payment to the Contractor for Asset Sale 3 "drive-by" (exterior observation) appraisals for property held as collateral for SBA loans exceeded contract compensation schedule allowances. These payments occurred because (i) the contracting officer verbally modified the terms of the contract and (ii) SBA's contract technical representatives did not identify and resolve pricing discrepancies. As a result, SBA over-paid $2.2 million for "drive-by" property appraisals.

Due Diligence Contract Requirements for "Drive-by" Property Appraisals

One requirement of SBA's due diligence contract for Asset Sale 3 was to require the Contractor to perform "drive-by" property appraisals. Such appraisals rely heavily on public records to determine property value. The appraiser also researches current sales of similar neighborhood properties, views the exterior of the comparable sales, and analyzes and adjusts for differences, thus arriving at an estimated value. The "drive-by" appraisal provides the appraiser the opportunity to observe and document the quality, style, exterior condition, location, and external amenities that are not found in public records.

The contract required the delivery of items in accordance with a compensation schedule. Task requirement 3.6.B of the schedule provided that the cost of "drive-by" property appraisals would not exceed $300. SBA, however, was billed and paid $3,174,875 (an average of $898) for the 3,535 "drive-by" appraisals. Based on the contract compensation schedule of not to exceed $300 per appraisal, SBA should have paid $993,750 for the appraisals. SBA, however, paid $2,181,125 in excess of written contract limits for these appraisals (see Appendix A).

Unauthorized Modification of the Contract

The excess billing was the result of a verbal agreement between the SBA contracting officer and the Contractor. The due diligence contract was awarded pursuant to the authority established in SBA's Basic Ordering Agreement (BOA) for Contract Services. The BOA, Section G.3 (i), states that "No changes in or deviation from the scope of work shall be effected without written modification to the contract executed by the contracting officer authorizing such changes". Section G.3 (iii) further states "Changes in the time and date of delivery or the scope of the work will be made only by the Contracting Officer by a properly signed written modification to the contract". The verbal agreement which resulted in a $2.2 million increase in "drive-by" costs (10 percent of the contract amount) is considered a change in the contract scope of work. Therefore, the verbal contract modification to allow payment in excess of the $300 maximum per appraisal was not properly authorized.

Section I of the BOA incorporates several Federal Acquisition Regulation (FAR) clauses by reference. Incorporated are FAR clauses that address modifications to fixed price supply contracts. FAR 43.205(a)(1) and 52.243-1(b) provide that the contracting officer may, by written order, make changes within the general scope of a contract, and if such change causes an increase or decrease in the cost of performance of work, the contracting officer shall make an equitable adjustment in the contract price and modify the contract. Therefore, a change in the contract price requires the contracting officer to modify the contract in writing.

The Contractor's Vice President for Financial Services, stated that the "drive-by" appraisals were not over-billed, but instead were appropriate because of an SBA verbal agreement. The verbal agreement allowed pass-through costs (without mark-up) at the direct rates billed by the Contractor's third party report vendors. Moreover, the contractor stated that pass-through rates were necessary because of the unanticipated complexities of some collateral properties such as golf courses, trailer parks, large tracts of land, etc.

The Contractor provided a copy of a May 16, 2000 cost proposal addressed to the contracting officer describing cost modifications including pass-through charges. Another letter noted that the Contractor's President had met with the Office of Procurement and Grants Management and reached agreement on "drive-by" appraisal costs. While the Contracting Officer admits to verbally agreeing to accept pass through costs, SBA did not analyze the cost proposal nor ratify or modify the contract in writing.

Ratification of Unauthorized Contract Modifications

SOP 00 11 1, chapter 14, states that execution of otherwise proper contracts made by contracting officers in excess of the limits of their delegated authority, may be later ratified. To be effective, ratification must be in the form of a written document clearly stating that ratification of a previously unauthorized act was intended and must be signed by a person authorized to ratify the acts. Additionally, the following elements must be present in a ratification action:

- A statement by the SBA employee who initiated the unauthorized action indicating the circumstances surrounding the unauthorized act as well as how the price was determined to be most reasonable to the Government.
- A statement from the vendor indicating the circumstances surrounding the unauthorized act.
- A statement by the individual's supervisor indicating what steps have been taken to assure a similar action will not be taken.
- An SBA Form 2 with all appropriate documentation.

- A statement of fact by the contracting officer surrounding the unauthorized act and recommendation whether to ratify or not ratify.

- An appropriate contract form, if the contracting officer elects to ratify the unauthorized act.

- A review of the ratification file by the Office of General Counsel or Regional Council for legal sufficiency.

SBA Oversight of the Due Diligence Contract

The Appointment of Contracting Officer's Technical Representative (COTR) letter for the due diligence contract obligated the COTR to monitor contractor performance with the technical terms of the contract, inspect deliverables to assure compliance with contractual requirements, review invoices to resolve discrepancies, and *certify the invoices as correct and proper for payment*. The COTR failed to discover that the Contractor bills were incorrect, thus approving the payment of funds in excess of the contract compensation schedule.

The COTR stated she was unaware of these over-payments because she did not have the time to review the individual line items supporting the total invoiced amount. We also identified several instances where both the COTR and Contracting Officer certified multiple invoices for payment in a single day. In one instance, the COTR and contracting officer certified 50 invoices for payment. Moreover, the COTR stated she wasn't aware of paying high prices for "drive-bys" until the OIG brought it to her attention. Instead of reviewing individual line items, the COTR stated she focused on the total invoiced amounts to preclude exceeding the total obligated contract amount of $24.5 million. By certifying invoices as correct and proper for payment without reviewing the individual invoices, SBA paid amounts ranging from $195 to $7,000 for each "drive-by" appraisal. As mentioned above, these payments exceeded the contract price by over $2 million.

RECOMMENDATIONS

We recommend that the Director, Office of Procurement and Grants Management take the following actions:

1.A Either seek recovery of the $2,181,125 overpayment from the Contractor or, if justified take the necessary steps to properly ratify the contract in accordance with SOP 00 11 1, chapter 14.

1.B Ensure that all future contract changes are made by a properly signed written contract modification.

We recommend that the Associate Administrator, Office of Financial Assistance in coordination with the Associate Administrator for Procurement and Grants Management take the following actions:

1.C Ensure that SBA's oversight of diligence contracts awarded to the Contractor for Asset Sales 1, 4, and 6 is accomplished by obtaining reconciliation data detailing all third party reports billed against each loan. The reconciliation should include appropriate techniques to detect over billings.

1.D Recover amounts paid to the Contractor for unwarranted duplicate and upgraded third party report costs identified as a result of the reconciliation performed under recommendation 1.C.

Offices of Financial Assistance Comments

The Office of Financial Assistance did not provide comments in response to the draft report.

Office of Procurement and Grants Management Comments

The Office of Procurement and Grants Management only commented on recommendation 1.A. They believe there are no unauthorized invoices and that a recovery payment of $2.2 million is not warranted. However, due to the limited review restraints of the draft report, they will provide a detail position during the final audit resolution process.

Evaluation of Management's Comments

As stated in the audit report the verbal contract modification of the due diligence contract was not proper. FAR Sections 43.205(a)(1) and 52.243-1(b) provides that the contracting officer may, by written order, make changes within the general scope of a contract, and if such change causes an increase or decrease in the cost of performance of work, the contracting officer shall make an equitable adjustment in the contract price and modify the contract. Further, Section G.3 (i) of the SBA BOA states that "No changes in or deviation from the scope of work shall be effected without written modification to the contract executed by the contracting officer authorizing such changes". Section G.3 (iii) further states "Changes in the time and date of delivery or the scope of the work will be made only by the Contracting Officer by a properly signed written modification to the contract". The verbal agreement which resulted in a $2.2 million increase in "drive-by" costs (10 percent of the contract amount) is considered a change in the contract scope of work. Therefore, a change in the contract price requires the contracting officer to modify the contract in writing in order to not be in violation of government-wide Federal procurement regulations.

FINDING 2 Duplicate and Upgraded Third Party Reports

The Contractor obtained and billed SBA for Asset Sale 4 duplicate and upgraded property appraisal reports that exceeded contractual requirements. As a result of our limited review, SBA overpaid the Contractor $23,707 for 17 duplicate and 3 upgraded[1] third party reports.

Duplicate reports

Invoices and supporting documentation for contractor services did not provide sufficient data for SBA to detect duplicate third party reports. For 25 loans (including related loans) sampled, the contractor billed 1 to14 third party reports per loan on 8 vouchers spanning a 4 1/2-month period. In addition, the supporting documents did not contain relevant fields, such as loan unpaid balance, borrower name, or collateral property address – information necessary for detecting duplicate or upgraded third party reports.

To illustrate, three third party reports (property appraisals) ordered from different vendors were billed separately in April, May, and July 2001. Additionally, the Contractor assigned the reports different collateral ID numbers and the relevant property address field was omitted. Because these appraisals were billed separately over a period of 3 months, SBA could not detect that two of these appraisal reports were duplicates, as shown below:

Voucher No.	Voucher Date	Vendor Name	Loan No.	Collateral ID	Product	Price
75	4/16/01	[ ]	[ ]	4825	Appraisal	$5,050

Voucher No.	Voucher Date	Vendor Name	Loan No.	Collateral ID	Product	Price
101	5/25/01	[ ]	[ ]	4827	Appraisal	$5,050

Voucher No.	Voucher Date	Vendor Name	Loan No.	Collateral ID	Product	Price
114	7/19/01	[ ]	[ ]	12956	Appraisal	$4,293

In contrast, our analysis, which included: (i) identifying the borrower; (ii) obtaining addresses for the "unique" collateral ID's; (iii) listing unpaid loan balances; and (iv) consolidating information from the three vouchers, provides a comprehensive

[1] A more comprehensive and costly report, such as a "drive-by" appraisal vs. broker price opinion.

All redactions – FOIA Ex. 4, "trade secrets."

perspective not discernable from the individual vouchers presented. Our analysis is presented for loan number [ ] in the following table.

Vou No.	Vou Date	Vendor Name	Collateral ID	Product	Price	Borrower	UPB	Address
75	4/16/01	[ ]	4825	Full Appraisal	$5,050	[ ]	$491,987	[ ] MO 63005
101	5/25/01	[ ]	4827	Full Appraisal	$5,050	[ ]	$491,987	[ ] MO 63005
114	7/19/01	[ ]	12956	Drive-by Appraisal	$4,293	[ ]	$464,088	[ ] MO 63005

This type analysis disclosed the three loans were related and collateralized by the same property. The property was assigned three different collateral ID numbers and had two full and one "drive-by" appraisals resulting in duplicate excessive costs of $9,343.

Other duplicate reports resulted in excessive costs of $2,697 because the Contractor had assigned more than one unique collateral identification (ID) number to a single property collateralizing related loans. A Contractor representative stated that each collateral property was assigned a unique collateral ID number for identification and control of third party reports. We found, however, that when a particular property collateralized related[2] loans, the same property could be assigned two or more collateral ID numbers, unique to each loan, not unique to the property. Subsequently, when the Contractor ordered third party reports based on the collateral ID numbers, duplicates were obtained and billed to SBA. Also, duplicate third party reports occurred when identical third party reports were ordered from different vendors.

Upgraded Reports

The due diligence contract requires that appraisals for real estate secured loans be obtained subject to the following loan unpaid principal balance (UPB) requirements:

- Broker Price Analysis (BPO) — UPB of $15,000 to $250,000
- Drive-By Appraisal — UPB of $250,001 to $500,000
- Full Appraisal — UPB greater than $500,000

We found three loans with UPB's under $250,000 where the Contractor substituted upgraded "drive-by" appraisals for BPO's, over-billing SBA $11,667. Based

[2] Two or more SBA loans that have common obligors or are secured by the same collateral.

All redactions - FOIA Ex. 4, "trade secrets."

on contractual requirements, three BPO's should have cost $1,212 ($404 each), but because "drive-by" appraisals were ordered, SBA was billed $12,879 ($4,293 each). Contractor personnel stated that they ordered upgraded third party reports because the complexities of some properties required an upgraded appraisal. They also stated that some states (Pennsylvania, Mississippi, New Mexico, North & South Carolina, Oregon, Utah, and Alabama) would not allow BPO's, thus requiring upgraded "drive-by" appraisals.

We noted that the due diligence contract was not modified to authorize upgraded reports, and further, found that upgraded reports were not requisite substitutions. In the affected states, a third party vendor stated that similar reports to BPO's, known as real estate evaluations prepared by licensed appraisers, could have been obtained for about $750. For one loan, the Contractor received a real estate evaluation but billed SBA $4,293 for a "drive-by" appraisal.

Appropriate oversight by the COTR would have assured that the Contractor invoices were correct and proper for payment.

RECOMMENDATIONS

We recommend that the Associate Administrator, Office of Financial Assistance in coordination with the Associate Administrator for Procurement and Grants Management take the following actions:

2.A Require the due diligence contractor to conduct an analysis to verify the accuracy of invoicing for third party reports against its third party reports database to identify and adjust payments for any unwarranted duplicate or upgraded third party reports.

2.B Contract with a recovery audit firm to identify and recover any erroneous payments, i.e., unwarranted, duplicate, or upgraded third party report costs if SBA is not satisfied with the Contractor's analysis.

Offices of Financial Assistance and Procurement and Grants Management Comments

The Offices of Financial Assistance and Procurement and Grants Management did not provide comments in response to the above draft report recommendations.

Amount of "Drive-By" (DB) Appraisals Billed and Paid Compared to Amount Due per Contract Price Schedule

Appendix A

Vou. No.	DB Bus # Billed	DB Bus $ Paid	Avg.	DB Hm # Billed	DB Hm $ Paid	Avg.	DB 7A # Billed	DB 7A $ Paid	Avg.	DB CDC # Billed	DB CDC $ Paid	Avg.	Tot. #	Tot. $	DB # Cum.	Contr. Amt.	Total
12	2	450	225	7	2,100	300							9	2,550	9	300	2,700
25	1	225	225										1	225	10	300	300
31	6	1,390	232										6	1,390	16	300	1,800
32	1	225	225										1	225	17	300	300
33	62	17,150	277										62	17,150	79	300	18,600
34	80	22,400	280										80	22,400	159	300	24,000
35	33	9,075	275										33	9,075	192	300	9,900
36	6	1,650	275										6	1,650	198	300	1,800
38	24	6,215	259										24	6,215	222	300	7,200
54	435	146,525	337				39	12325	316	1	375	375	475	159,225	697	300	142,500
60	21	5,775	275										21	5,775	718	300	6,300
61	143	39,325	275										143	39,325	861	300	42,900
62	127	34,925	275										127	34,925	988	300	38,100
63	76	21,000	276										12	21,000	1,000	300	3,600
	Price Scale Split												64		1,064	290	18,560
64	41	11,275	275										41	11,275	1,105	290	11,890
65	13	5,345	411				3	1275	425				16	6,620	1,121	290	4,640
66	2	4,925	2,463										2	4,925	1,123	290	580
68	13	3,575	275										13	3,575	1,136	290	3,770
69	6	1,650	275										6	1,650	1,142	290	1,740
74	1	5,000	5,000										1	5,000	1,143	290	290
77	2	450	225										2	450	1,145	290	580
78	1	225	225										1	225	1,146	290	290
79	1	225	225										1	225	1,147	290	290
81	1	225	225										1	225	1,148	290	290
87	13	3,575	275										13	3,575	1,161	290	3,770
95	296	1,157,906	3,912				11	41732	3794	3	7,112	2,371	310	1,206,750	1,471	290	89,900
97	95	32,540	343										95	32,540	1,566	290	27,550
99	43	10,200	237										43	10,200	1,609	290	12,470
100	132	559,700	4,240										132	559,700	1,741	290	38,280
108	778	193,950	249				23	5775	251	2	550	275	259	200,275	2,000	290	75,110
	Price Scale Split												544		2,544	270	146,880
111	5	20,000	4,000				2	8000	4000				7	28,000	2,551	270	1,890
112	2	825	413										2	825	2,553	270	540
122	6	1,350	225				8	1925	241				14	3,275	2,567	270	3,780
123	98	217,410	2,218				23	52500	2283				121	269,910	2,688	270	32,670
124	110	24,875	226				3	675	225	1	225	225	114	25,775	2,802	270	30,780
125	8	32,000	4,000				1	4000	4000				9	36,000	2,811	270	2,430
128	6	10,900	1,817				3	8200	2733				9	19,100	2,820	270	2,430
129	60	25,500	425				3	1275	425				63	26,775	2,883	270	17,010
132	153	65,025	425				7	2975	425				117	68,000	3,000	270	31,590
	Price Scale Split												43		3,043	250	10,750
135	53	10,448	197										53	10,448	3,096	250	13,250
136	273	52,868	194										273	52,868	3,369	250	68,250
143	313	86,650	277				19	5225	275				332	91,875	3,701	250	83,000
145							4	900	225				4	900	3,705	250	1,000
147	14	2,725	195										14	2,725	3,719	250	3,500
149	5	25,000	5,000							1	5,000	5,000	6	30,000	3,725	250	1,500
152	1	7,000	7,000				1	3600	3600				2	10,600	3,727	250	500
155	81	25,540	315				3	1035	345				84	26,575	3,811	250	21,000
165	9	26,850	2,983				41	139350	3399				50	166,200	3,861	250	12,500
	3,652	2,932,062	803	7	2,100	300	194	290767	1499	8	13,262	1,658	3,861	3,238,191			1,075,250

Amount Billed & Paid	3,238,191
Contract Price	1,075,250
Difference (Overpayment)	2,162,941

Appendix B

AUDIT REPORT DISTRIBUTION

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