



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

AUDIT REPORT
Issue Date: July 28, 2005
Report Number: 5- 22

TO: Jaime A. Guzman-Fournier
Associate Administrator for Investment

FROM: /s/ **Original Signed**
Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit Report-Audit of the SBIC Liquidation Process.

Attached is a copy of the subject report. The report contains four findings, one other matter, and 17 recommendations. You concurred with nine recommendations, partially concurred with one, and neither concurred nor non-concurred with seven that you stated were more problematic and required more detailed reviews. For the one recommendation that received your partial concurrence and the seven that you neither concurred nor non-concurred with, we will reserve our comments for the audit follow-up process. Additionally, you provided a comment about the other matter and we modified the report to reflect your comment. Written evaluations of your comments are included as part of the report and your comments are included as an attachment.

The findings in the report are the conclusions of the Office of Inspector General's Auditing Division. The findings and recommendations are subject to your review and corrective action in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response and actions to address the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation Action Sheet. The SBA Forms should be sent to:

Supervisory Auditor
SBA OIG/Auditing Field Office, Suite 1803
233 Peachtree Street, NE
Atlanta, Georgia 30303

Any questions you may have regarding this report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 2].

Attachments

AUDIT REPORT
AUDIT OF THE SBIC LIQUIDATION PROCESS

AUDIT REPORT NUMBER 5-22

JULY 28, 2005

This findings in this report are the conclusions of the OIG's Auditing Division based on testing of the auditee's operations. The findings 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 THE SBIC LIQUIDATION PROCESS

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SUMMARY

Small Business Investment Companies (SBICs) are private investment firms licensed by the Small Business Administration (SBA) to provide financing in the form of long-term loans and equity investments to small business concerns pursuant to authority granted by the Small Business Investment Act. As of September 30, 2004, there were 448 SBICs in active operation. The SBIC program is managed within the SBA by the Investment Division (Division) which is responsible for providing regulatory and financial oversight, leverage guarantees, and liquidation efforts for troubled SBICs.

Within the Division, the Office of SBIC Liquidation (OL) is tasked with liquidating SBIC assets for maximum net recoveries within the shortest time possible by determining the most efficient and effective liquidation method. As of September 30, 2004, there were 97 SBICs in liquidation status with indebtedness to the SBA for leverage guarantees totaling more than \$1.2 billion and an additional \$268 million in prioritized payments.

This audit of the SBIC liquidation process was initiated at the request of the former Associate Administrator of Investment. The objective of the audit was to determine if improvements could be made in the SBIC liquidation process. We determined that the liquidation process could be improved through the establishment and implementation of better goals and performance indicators, controls, and oversight. Specifically, we found that:

- Better goals and performance indicators were needed to show how well the OL was performing. Existing goals and indicators were limited to measuring output quantities, with no measurement of the efficiency, cost effectiveness, or timeliness of operations.
- The selection process for liquidation methods needed to include cost analyses and consideration of all possible methods. By not including cost analyses and considering alternative methods, the OL could not be assured that the most efficient and effective method had been selected.
- Better enforcement was needed of the requirement that sales of portfolio assets by SBICs be commercially reasonable. Lax enforcement created the potential for fraud, reduced recovery, and could negatively impact the program.
- Funds totaling \$136,236 were initially unaccounted for due to inadequate controls. Management subsequently accounted for \$132,201 of the funds.

In another matter, we determined that, due to weak controls, the OL had no assurance that more than \$2.9 million in payments made in calendar year 2003 to receivership agents and other service providers were properly reported to the Internal Revenue Service (IRS).

As a result of our findings, we recommend that the Associate Administrator for Investment improve the SBIC liquidation process by: (1) developing meaningful goals and performance indicators for the liquidation process and each liquidation method; (2) incorporating the goals and indicators into SBA's annual performance plan and monitoring how well they are being achieved; (3) tracking and summarizing liquidation costs and considering such costs when

selecting the liquidation method; (4) ensuring case files include documented evidence that all liquidation methods were considered; (5) ensuring that sales are made at commercially reasonable terms and that buyers are not associates of the SBIC or its principals; (6) restructuring agent contracts to include performance standards; (7) improving controls and procedures applicable to accounting for funds and for filing required tax forms; and (8) revising SOP 10 07, "SBIC Liquidation Program," to reflect improvements needed in the aforementioned areas.

Also, we recommend actions be taken to address specific conditions noted during the audit. These included: determining the status of two checks totaling \$4,034 owed to SBA and requesting replacements, if necessary, and requiring the re-filing of IRS Forms 1096 and 1099 by all receiverships for calendar year 2003, if warranted.

The Associate Administrator for Investment responded by concurring with the recommendations concerning: tracking and summarizing liquidation costs and considering such costs when selecting the liquidation method; ensuring case files include documented evidence that all liquidation methods were considered; ensuring that sales are made at commercially reasonable terms and that buyers are not associates of the SBIC or its principals; and improving controls and procedures applicable to accounting for funds and for filing required tax forms. He stated that these recommendations could be implemented immediately. He partially concurred with our recommendations concerning revising SOP 10 07, "SBIC Liquidation Program," to reflect improvements needed. He neither concurred nor non-concurred with seven other recommendations stating that the recommendations were more problematic and required more detailed review. He also stated the Investment Division was in the process of soliciting a contractor to review the entire liquidation process. He expected the contractor's report to be received toward the end of the first quarter of fiscal year 2006 and desires to receive the benefits of this review before implementing some of our recommendations.

INTRODUCTION

A. Background

In an effort to fill the gap between the availability of venture capital and the needs of small businesses in start-up and growth situations, Congress created the SBIC Program in 1958. The program uses SBA-licensed private investment firms that independently make investment decisions using their own private capital plus SBA-guaranteed borrowed funds to provide loans and equity investments to small business concerns. SBA-guaranteed funds are provided in the form of debentures with 10-year maturities and semi-annual interest only payments and participating securities with 10-year maturities and prioritized payments (interest) paid only to the extent the SBIC has positive earnings.

The SBIC program is administered by SBA's Investment Division (Division) which include responsibilities for overseeing regulatory compliance, assessing the financial condition of SBICs, guaranteeing leverage, and liquidating SBICs. Those SBICs that did not meet regulatory standards were transferred to the Division's Office of SBIC Liquidation (OL) for recovery of funds paid by SBA as a result of the guarantees and for surrender of the SBICs' licenses if requested. Funds collected through the liquidation of SBICs reduced outstanding leverage owed to SBA and the cost of the SBIC program.

The Office of SBIC Liquidation

The OL, according to Standard Operating Procedure (SOP)10 07, SBIC Liquidation Program, is responsible for maximizing the recovery of funds due SBA in the shortest time possible through the efficient and effective liquidation of SBICs in liquidation status. Once an SBIC is classified as in-liquidation status, the OL is supposed to select a method to liquidate the SBIC's assets. If the selected method does not result in the liquidation of all the SBIC's assets, residual assets can be acquired by SBA at their fair market value, as determined by an approved source, and the balance due SBA is reduced by the value of the transferred assets. The OL uses both internal staff and external parties to perform various aspects of the liquidation process. An SBIC case is considered closed upon disposition of all of an SBIC's assets. Funds due SBA that are not repaid through the liquidation process are charged-off.

As of September 2004, the OL was responsible for the liquidation of 97 SBICs and the recovery of more than \$1.2 billion. Table 1 shows an upward trend over the past 4 years in the number of new liquidation cases, as well as an increase in the leverage outstanding. From October 2002 to March 2004, the majority of the new cases transferred to liquidation were SBICs with participating securities.

Table 1

SBIC Cases with Outstanding Leverage to be Liquidated									
FYE	Total SBIC Cases on Hand	New Cases	Cases Resolved	Self-Liquidation	Receivership	Acquired Assets	Pending Liquidation Method	Litigation Pending Receivership	Leverage Outstanding
9/30/00	95	7	21	5	26	57	2	6	\$121,750,918
9/30/01	81	12	16	5	27	42	5	2	199,322,574
9/30/02	77	18	10	9	27	31	9	1	369,821,099
9/30/03	85	22	10	10	20	30	24	1	708,779,346
9/30/04	97	21	9	27*	21	27	17	5	1,236,977,835

*Self-liquidations include settlement agreements and approved wind-down plans, a liquidation method that the OL started using to liquidate participating securities in Fiscal Year 2004.

B. Objective & Scope

The objective of the audit was to determine if improvements could be made in the SBIC liquidation process.

To answer the objective, we reviewed the policies, procedures, and control activities used by the OL in the liquidation process, the processes used to select liquidation methods, and the controls used to monitor liquidation activity. We conducted tests to determine if the liquidation methods selected were cost effective, resulted in timely recoveries and closures, and maximized recoveries. We interviewed appropriate management officials and staff within the Division, the Office of General Counsel, SBA’s Receivership Office, and non-SBA personnel. Our review covered the period October 1, 1998, through March 31, 2004.

Our audit fieldwork was performed from November 2003 through October 2004 at the SBIC program office and SBA Receivership Office in Washington, DC, and in the OIG’s Atlanta Field Office. The audit was conducted in accordance with generally accepted Government Auditing Standards.

C. Statement of Management Controls

Our assessment of management controls was limited to those controls applicable to the SBIC liquidation process and the OL’s ability to maximize recovery of funds due SBA in the shortest time possible through the liquidation of SBICs. Our review disclosed material weaknesses in the control environment, risk assessment, control activities, information and communication, and monitoring aspects of the liquidation process.

Control Environment

When asked about how to measure the OL’s performance, the OL Director stated that dollars recovered and assets resolved were the best measurements of its performance. In conjunction with this statement, we noted that management did not set performance indicators and benchmarks that measured efficiency, cost effectiveness, and timeliness to evaluate its performance. Also, management elected not to use Federal procurement policies and procedures to hire contractors for receivership operations. Instead, the OL Director made all decisions impacting hiring, compensation levels, and retention of contractors. These factors resulted in an

environment that was not conducive to promoting efficiency, cost effectiveness, and timeliness in the liquidation process and achieving the goal stated in the SOP.

Risk Assessment

The OL's ability to achieve its objective was at risk from various factors. Among these factors were unnecessary time, effort and expense in liquidating SBICs. The OL had limited controls in place to address these factors and mitigate this risk. We noted that settlement agreements contained cost controls that were not based on documented analyses and did not include a requirement for incremental disposal of individual assets. Also, controls to ensure disposal of assets by SBIC management was commercially reasonable and at arms length were not enforced. Receivership agents were hired with no limitations on the length of time to liquidate the SBICs or the total costs to be incurred. These factors put the OL at risk of not achieving its goal.

Control Activities

Control activities are the policies and procedures that help ensure management directives are carried out. The directive that guided the OL was SOP 10 07, SBIC Liquidation Program. OL management stated that they did not consider the SOP applicable to participating security SBICs even though this program was started more than 3 years before the SOP became effective. Participating securities comprised about 34 percent of SBICs in liquidation status as of March 2004. We did not note anything in the SOP that indicated its requirements were not applicable to participating security SBICs.

Information and Communication

Information and communication systems should enable the capture and exchange of information needed to conduct, manage, and control operations. The OL provided reports on its performance to the Division on a monthly basis. Although the reports allowed measurement of the OL's goals of closing cases and collecting dollars, the reports were not sufficient to show whether the OL was performing efficiently, effectively, and timely. Also, the monthly report did not communicate information concerning asset resolution, a statistic that the OL Director considered to be one of the two best measures of the OL's performance.

Monitoring

Management needed to monitor its internal control system to ensure it operated effectively, continued to be relevant, and was able to address new risks. Some of the OL's monitoring efforts were not sufficient to achieve these requirements. For example, management did not:

- use benchmarks to determine the efficiency and cost effectiveness of the liquidation methods used,
- set appropriate controls and ensure that existing requirements were followed concerning the sale of assets by SBICs in settlement agreements, or
- have standards to gauge the appropriateness of the hours billed by receivership agents.

Details of specific weaknesses are discussed in the Results of Audit section of this report.

D. Prior Audits

The Office of Inspector General (OIG) issued an audit report in March 1993 addressing deficiencies that caused delays in the closing of receiverships and resulted in reduced recoveries. The Division agreed that the timely closing of receiverships would increase the level of recovery and concurred with OIG's recommendation to: (a) include in the draft SOP 50 53 the time frame when closing plans should be initiated; (b) make a determination of each case's eligibility for closing at least semiannually; (c) prepare closing plans for each case that meets the criteria for closing; and, (d) use milestones to monitor the submission of closing plans through the OL, the Office of General Counsel and the courts.

The Division's management decision stated that SOP 50 53, in effect at the time, was being revised to include requirements concerning closing procedures. It was further stated that the use of target dates and milestones in the closing process had already been implemented for those receiverships where a determination had been made to institute closing, and the other recommendations would be included in a revised draft of SOP 50 53. Our current audit showed that neither the previous SOP 50 53 nor the current SOP 10 07 included requirements that would correct the previously identified deficiencies. The SOPs did not require target dates and milestones in the closing process or require semi-annual determinations of eligibility for closure.

The Barrington Consulting Group, Inc. (Barrington), a national management consulting firm, issued a report in December 1996 based on its review and evaluation of the SBIC liquidation process. Barrington determined that the OL did not have the proper diversity of analysis, valuation, negotiation and marketing talents, a streamlined procurement program, or the required number of business and litigation attorneys on staff to properly react to the challenge provided by the variety of assets transferred to liquidation. In addition, Barrington stated that the preparation of written guidelines for new receiver agents and clarification of responsibility for the liquidation of receiverships would be improvements to the process. These recommended actions were not fully implemented.

In a January 1997, report to Congress, the OL stated that it recognized that there were certain actions that it could take to improve the efficiency of receivership operations and expedite asset sales and that it would implement many of the Barrington study's recommendations promptly. It added that it would make greater use of outsourcing to expedite the resolution of SBA-owned assets. The OL also stated that it would complete written guidelines for new receiver agents by the fourth quarter of FY 1997. Our audit work showed that the OL did outsource the liquidation of SBICs using settlement agreements, receiverships, and other contractors. However, the efficiency and effectiveness of the outsourcing efforts were not determined. The OL did not complete written guidelines for new receiver agents as promised.

In addition, in March 1995, Government Accountability Office (GAO) testified that "the receivership process can be lengthy, costly, and in some cases not financially beneficial because often SBA does not know the extent of the SBICs' financial strengths or the extent of other creditors at the time it must make a liquidation decision." The testimony did not include recommendations.

RESULTS OF AUDIT

Our audit showed that the SBIC liquidation process could be improved if the OL established and implemented better goals and performance indicators to determine how well it was achieving its mission. Also, improved controls and oversight were needed to ensure SBIC liquidations were managed efficiently and cost effectively resulting in maximum net recoveries and timely liquidations.

Finding - 1 The Office of SBIC Liquidation needed Better Performance Measures

The OL needed efficiency and cost-effectiveness goals and performance indicators to show how well it was accomplishing its objective. Existing goals and performance indicators were limited to output quantities because management thought this best demonstrated the OL's performance. As a result, SBA did not know the extent to which the OL was efficiently and cost effectively achieving its primary objective of maximizing net recoveries in liquidation within the shortest time possible.

Requirements for goals and performance indicators

Office of Management and Budget (OMB) Circular A-129 requires that agencies ensure that credit program goals are met while properly identifying and controlling costs. It also states that Federal receivables must be serviced and collected in an efficient and effective manner to protect the value of the Federal Government's assets. The Circular also requires agencies to ensure that informed and cost-effective decisions are made concerning portfolio management, including consideration of selling the portfolio.

The Government Performance and Results Act (GPRA) mandated Federal agencies to develop adequate performance goals and indicators to prevent waste and inefficiency in Federal programs. The OMB Circular A-11 defines a performance goal as a target level of performance at a specified time or period expressed as a tangible, measurable outcome against which actual achievement can be compared. Performance indicators gauge program performance and typically include measures for quantity, quality, efficiency, effectiveness and timeliness. The following table provides a definition for each type of performance indicator.

Table 2

Indicators of Performance	
Quantity	A specified amount (e.g., size, volume, and length)
Quality	Timeliness, accuracy, and conformance to requirements.
Efficiency	Relating the quantity of services provided to the costs incurred to provide the services. (e.g. unit cost, productivity ratio, and costs to dollars collected)
Effectiveness	The degree to which a pre-determined objective or goal is met. Commonly combined with cost to show cost effectiveness.
Timeliness	Elapsed time, working /cycle time (start to finish), response time, and on-time or on schedule.

The OL's overall performance measurement

The goals and performance indicators for Fiscal Year (FY) 2003 and FY 2004 were limited to measuring net dollars recovered, cases closed, and assets resolved each year. These goals and indicators partially measured the OL's effectiveness but did not measure the efficiency or fully measure the timeliness of its operations. As shown in Table 3, OL's goals and indicators for FY 2003 and FY 2004 measured performance results in terms of quantity only.

Table 3

SBIC Liquidations Targeted Performance FY 2003 & FY 2004			
FY 2004 Goals	FY 2004 Goal	FY 2003 Goal	Type of Indicator
1. Increase Collections/Monies Received by SBA	\$32.0	\$20.0	Quantity
2. Close SBA- Operated Receiverships	5	10	Quantity
3. Dispose of Assets (all sources)	184	150	Quantity
4. Collect 16 percent of Leverage Outstanding at beginning of FY	\$26.0	\$25.0	Quantity
5. Dispose of SBA-Owned Assets	24	25	Quantity

Goals that reflected dollars and volume did not measure efficiency, cost effectiveness, and timeliness. For instance, the FY 2004 goal of increasing collections to \$32 million, a 60 percent increase over the FY 2003 goal, did not take into consideration the cost of collections and the timeliness of the collection process. In order to make well informed decisions about the liquidation process, SBA needs data that will allow it to assess how well the OL is performing in all aspects. This assessment cannot be made without appropriate goals and indicators.

Performance measurement by liquidation method

In addition to needing better overall goals and indicators, the OL needed efficiency and cost-effectiveness goals and indicators for each liquidation method. While goals existed for each liquidation method used and for resolving acquired assets, they only measured quantity or timeliness. For instance, there was a goal to dispose of a specific amount of acquired assets but there was no goal addressing the timeliness of disposing of the assets. Also, the cost of disposing of these assets was not compared to recoveries to determine cost effectiveness.

As an example of the measurement of the cost effectiveness of receivership collections, we analyzed the collections for 11 receiverships that closed during the audit period. Using the final receiver's report and reconciled cash reports for each of the selected SBICs, the total disbursements were divided by the total dollars received to compute the cost of collections. We found that the cost ranged from \$.22 to \$1.07 per dollar collected with an average of \$.52 per dollar collected.(Table 4 below) Without a benchmark to measure the cost per dollar collected against, neither we nor management can state whether the liquidation efforts were cost effective.

Table 4

Cost Analysis for Selected Receiverships			
SBIC	Total Receipts	Total Disbursements	Cost per \$ Collected
[FOIA Ex. 4]	\$ 2,727,544	\$ 613,476	\$.22
[FOIA Ex. 4]	1,284,077	404,158	.31
[FOIA Ex. 4]	1,546,092	488,633	.32
[FOIA Ex. 4]	1,780,904	600,279	.34
[FOIA Ex. 4]	644,333	248,064	.38
[FOIA Ex. 4]	1,223,186	493,837	.40
[FOIA Ex. 4]	1,327,799	551,134	.42
[FOIA Ex. 4]	1,307,446	577,814	.44
[FOIA Ex. 4]	13,970,056	9,035,297	.65
[FOIA Ex. 4]	817,013	547,918	.67
[FOIA Ex. 4]	358,917	383,708	1.07
Totals	\$26,987,367	\$13,944,317	\$.52

Performance measurement for monitoring receivership agents

Another example of why goals and performance indicators are needed is the OL's monitoring of receivership agents. The OL executed 1-year renewable labor-hour service contracts with agents to liquidate receiverships. The contracts did not contain pre-established performance standards of anticipated costs, recovery, and completion time needed to measure agent performance. Neither were these standards documented in any other OL guidance. Therefore, when agents submitted their monthly invoices stating hours billed and task done, the OL had no standard by which to assess agent performance. In addition, the invoices did not include documentation to support the tasks the agents claimed were performed, and the OL generally could not verify the number of hours the agents claimed were worked. Therefore, the OL had no assurance that the costs were valid.

During FY 2003, 11 agents billed 17,781 hours to receiverships at rates ranging from \$63 to \$300 per hour. One of these agents billed more than 3,000 hours, the equivalent of working more than 8 hours per day, everyday, for a year. Two other agents billed in excess of 2,400 hours. The OL had no pre-set performance standards by which to measure the productivity of these agents and the appropriateness of the hours charged. When we discussed the matter of monitoring agent performance, OL personnel claimed that during quarterly status meetings some analysts compared agent performance to goals set at the last status meeting. We asked for notes of the status meetings that showed the expected performance for the next quarter, but none could be provided.

Goals and indicators used by the Federal Deposit Insurance Corporation (FDIC)²

The FDIC attempts to resolve failed insured depository institutions in the least-costly manner. When one of its insured institutions fails, it establishes a receivership, which is managed to maximize net return toward an orderly and timely termination. According to an FDIC official, the FDIC assesses how well it liquidates cases, based on the cost and timeliness of its efforts. For each case, the FDIC attempts to maintain a cost-to-collection ratio of 10 percent or less and set a goal of 3 years to complete the liquidation process. These goals and performance indicators measure the efficiency, effectiveness, and timeliness of its efforts. The FDIC uses an oversight committee to monitor its performance and provide quarterly updates to previously submitted business plans that address projected expenses and projected recovery for each receivership case. Justifications are required for cases with actual costs in excess of the 10 percent cost-to-collection goal and continuous updates are required for cases not closed timely.

OL's perception of its goals

The OL did not have goals and performance indicators that fully addressed its efficiency, cost effectiveness, and timeliness in liquidating SBICs because these were not perceived to be its primary objectives. The Director stated that the most important objective for his office was to recover funds since the majority of costs were from programmatic losses. According to the Director, recovering funds and repaying a portion of the leverage reduced program costs. Therefore, dollars collected was the most important indicator of how well the primary objective was achieved. He further stated that the second most important indicator was the number of assets resolved as this was a fundamental part of completing the office's liquidation task and a reflection of the extent the mission was being accomplished.

We noted that the Director's objectives and indicators did not address maximizing recoveries in a timely manner. In our opinion, the OL's goal, dollars recovered, is not meaningful without additional goals for efficiency, cost effectiveness, and timeliness. The OL should develop goals that will show how efficiently and cost effectively SBICs are being liquidated and funds owed SBA are being recovered. Also, timeliness indicators were needed to show that dollars collected and cases closed were accomplished in the shortest time possible.

Recommendations

We recommend that the Associate Administrator for Investment take the following actions:

- 1.A Revise SOP 10 07 to require the development of meaningful goals and performance indicators that will measure the efficiency, effectiveness, and timeliness of the efforts of the Office of SBIC Liquidation and to include procedures to monitor periodically how well the OL is achieving its goals.
- 1.B Revise SOP 10 07 to require the development of meaningful goals and performance indicators that will measure the efficiency, effectiveness, and timeliness of each liquidation method.

² *The Federal Deposit Insurance Corporation, an independent agency of the Federal government, insures deposits in banks and thrift institutions for up to \$100,000 and examines and supervises more than half of the institutions in the banking system.*

- 1.C. Incorporate the goals and performance indicators into the Agency's annual performance plan and use them to monitor and assess the progress towards achieving SBIC liquidation goals.
- 1.D. Restructure contracts with receivership agents to include performance standards that will be used to assess performance.
- 1.E. Revise SOP 10 07 to require periodic assessments of each receivership's progress and operations by comparing the monthly invoices and periodic status meeting results to pre-set performance standards.

SBA Management's Comments

The Associate Administrator neither concurred nor non-concurred with the recommendations and stated that the recommendations were more problematic and required a more detailed review.

OIG's Evaluation of SBA Management's Comments

We will evaluate management's comments after the completion of their detailed review.

Finding - 2 Improvements were needed in the Selection of Liquidation Methods

The selection process for liquidation methods did not include cost analyses and consideration of all possible methods. Cost analyses were not done because cost data was not accumulated for each liquidation method. We were told that all possible liquidation methods were not considered because of the lack of resources or expertise required to pursue these alternative courses of action. Given the absence of cost analyses and the limited liquidation methods used, neither the OL nor the OIG could ascertain whether the liquidation methods selected were the appropriate plans for the most efficient and effective liquidations.

Requirement for cost analyses

The OMB Bulletin No. 97-01 states that measuring cost is an integral part of measuring efficiency and effectiveness. Chapter 1, paragraph 5, of SOP 10 07 requires the OL to determine the most appropriate plan for the most efficient and effective liquidation of SBICs. The SOP also requires the OL to discuss costs of various methods when developing the most appropriate plan for liquidation and provides the following liquidation methods: (i) immediate payment; (ii) self-liquidation (settlement agreement); (iii) voluntary transfer of assets (VTA); (iv) receivership; (v) money judgment/marshalling of assets; and, (vi) compromise. In addition to the aforementioned methods, the OL started in FY 2004 to use a self-liquidation method referred to as "approved wind-down." Under this method, SBICs were allowed to submit a plan to OL and, if approved, the SBICs liquidated their assets without executing formal settlement agreements.

Inadequate support for liquidation decisions

We reviewed 37 liquidation decisions made by the OL during the period October 1, 1998, to March 31, 2004, and found that none were supported by any type of cost analyses. As shown in Table 5, we did find decision memorandums evidencing, at least in part, the rationale for

selecting a particular liquidation method for 25, or 68 percent of the decisions. For the remaining 12, or 32 percent, of the decisions, there were neither decision memoranda nor any similar documentation. In 4 of the 12 decisions, the OL believed no decision memoranda were needed due to extenuating circumstances (e.g., suspected criminal activity, egregious regulatory violations). The OL provided no explanation why the remaining 8 liquidation decisions did not have memoranda.

Table 5

Liquidation Methods Selected (10/1/98 - 3/31/04)		
	Cases Reviewed	With Memorandum
Receiverships	18	10
Settlement Agreements	6	2
Approved Wind-Downs	13	13
Grand Total	37	25

Tracking of cost data

The OL was not tracking the cost data necessary for use in selecting liquidation methods. In order to select the most efficient and effective liquidation method, the OL needed to know the costs associated with each method. This information could be made available through existing reporting mechanisms. For settlement agreements and approved wind-downs, the SBICs were required to report their income and expenses periodically. For receiverships, expenses were computed and reported monthly. For each of these methods, the expenses represented the liquidation costs. For SBA-owned assets, the OL maintained a database which included cost fields that generally were not used but, if used, would provide the necessary data. The aforementioned information could be used to compute the costs associated with each SBIC case and to estimate an average cost for each liquidation method. This information could then be used in the liquidation method selection process.

Liquidation methods generally not used by the OL

The OL was not considering certain alternative liquidation methods in its selection process. There were six liquidation methods listed in SOP 10 07. Table 5 shows the distribution of the liquidation methods chosen by the OL during our review period. When our audit was initiated, only two, settlement agreements and receiverships, were being used.

Liquidation methods not used were: (i) voluntary transfer of assets (VTA), (ii) money judgment/marshalling of assets, and (iii) compromise. Per OL staff, VTAs were not used because of a lack of resources needed to liquidate the assets acquired by SBA and because this method eliminated SBA's ability to examine the SBIC's records for inappropriate activity by the SBIC's management. They stated that money judgment/marshalling of assets was not used because of a lack of resources required to pursue each asset. Compromises were not used according to OL staff because the SBICs lacked the resources to make the required reasonable offer.

We concluded that the OL could be more resourceful in liquidating SBICs to achieve its overall goal of maximizing recovery in the shortest time possible if other liquidation methods were used. The OL could improve the liquidation process by:

Selling of SBA's Interests - We found that the Bureau of Public Debt was receptive to assisting SBA in selling its equity and debt interests in SBICs. The Bureau uses commissioned contractors that charge a fee only when a sale is made.

Voluntary Transfer of Assets – We noted that SOP 10 07, Chapter 5, states a VTA does not release the SBIC's principals from any potential personal liability if fraud or other wrongdoing is later discovered. Also, we noted the appendices to the SOP related to VTA's do not contain language that precludes SBA from pursuing the SBIC's principals and other parties if fraud is subsequently identified. Therefore, we concluded that more frequent use of VTA's should be considered when selecting the liquidation method.

Recommendations

We recommend that the Associate Administrator for Investment take the following actions:

- 2.A Ensure that each case file includes documented evidence that OL staff considered all liquidation methods.
- 2.B Track the costs for each liquidation case and summarize all costs by liquidation method yearly. After a reasonable period of time, this historical costs should be used for cost analyses.
- 2.C Revise SOP 10 07 to:
 - (i) require a documented cost analysis be included in the selection process for each SBIC liquidation case. An exception would be cases for which the suspicion of fraud is the motivating factor for selecting the liquidation method. If fraud is suspected, the case file should be appropriately documented.
 - (ii) include the additional liquidation methods of: (a) using commission-based contractors to sell acquired assets and (b) selling SBA's equity and debt interest in the SBICs.

SBA Management's Comments

The Associate Administrator stated that implementation of recommendations 2(A), 2(B), and 2(C)(ii)(b) can begin immediately. For recommendations 2(C)(i) and 2(C)(ii)(a), the Associate Administrator neither concurred nor non-concurred and stated the recommendations were more problematic and required a more detailed review.

OIG's Evaluation of Management's Comments

The Associate Administrator's response to recommendations 2(A), 2(B), and 2(C)(ii)(b) is acceptable. For recommendations 2(C)(i) and 2(C)(ii)(a), we will evaluate his response at the conclusion of the detailed review.

Finding - 3 Sales of Portfolio Assets were not Verified for Commercial Reasonableness

The OL needed to better enforce the requirement that sales of portfolio assets by SBICs in self-liquidation be commercially reasonable. The requirement, which was included in the self-liquidation agreements, was not enforced because OL staff stated they trusted the judgment of the SBICs' management. Insufficient enforcement of this requirement created the potential for fraud, reduced recovery by SBA, and could negatively impact program integrity.

Requirement for commercial reasonableness

Self-liquidation agreements (i.e., settlement agreements) were executed with those SBICs which the OL believed had the ability for full repayment of the debt owed to SBA and which the OL believed had competent and trustworthy management. These agreements allowed existing SBIC management to remain in place to effect an orderly liquidation of the SBICs' assets and repayment of the debt due to SBA. The agreements required the OL's pre-approval of the sale of portfolio assets and that the sales prices be commercially reasonable. The term "commercially reasonable", as it applied to sales of assets by SBICs, was not defined in SOP 10 07 and only defined in one of the five agreements reviewed.

Appendix 13 of the SOP, Sales of SBA-Owned Assets, however, stated that the Uniform Commercial Code, Section 9-507 suggested that if collateral were sold: (i) in the usual manner in any recognized market; (ii) at the price current in such market at the time of the sale; or (iii) in conformity with reasonable commercial practices among dealers in the type of property sold, it was sold in a commercially reasonable manner. Additionally, the Southern District of the New York State Court noted that while a low price was not conclusive proof that a sale had not been commercially reasonable, a large discrepancy between sales price and fair market value "signals a need for close scrutiny."

Commercial reasonableness not verified

Settlement agreements were executed with five SBICs from October 1, 1998, through March 31, 2003. Three of the SBICs did not conduct asset sales. The two remaining SBICs sold a stock warrant for \$700,000, two commercial properties, and ten residential properties for \$1.3 million. The OL approved the sales but did not have documentation evidencing a determination that the sales were conducted in good faith and in accordance with acceptable practices.

We obtained documentation showing that the stock warrant and commercial property sales appeared to be commercially reasonable. The commercial reasonableness of the sales of the residential properties was questionable. The residential property sales made in calendar year 2002 included ten apartments in two buildings in Queens, NY. Nine apartments were sold for a total of \$90,000, an average of \$10,000 per unit, and one apartment was sold for \$20,200. SBA pre-approved the sales but did not obtain a copy of real estate appraisals or the closing

documents. We found that in calendar years 2001 and 2002 the SBIC also sold nine other apartments in the same two buildings for prices ranging from \$24,940 to \$92,386 per apartment. We concluded that SBA had no assurance that the residential property sales were conducted in a commercially reasonable manner.

In addition, our audit work showed that the OL did not ascertain whether the buyer was an associate of the SBIC for any of the sales conducted by the two SBICs. Title 13 of the Code of Federal Regulations (CFR), Section 107.885, states that sales to associates are prohibited without SBA's prior approval and that the proposed terms of disposal for such sales must be at least as favorable to the SBIC as terms obtainable elsewhere. Because SBA did not determine whether or not the buyers were associated, it could not ensure that the CFR requirements were met.

The OL trusted SBIC management

Staff within the OL stated that it was not necessary to make determinations of commercial reasonableness because they trusted the SBICs' management to make these determinations. Without obtaining appropriate supporting documentation, SBA had no assurance that sales of portfolio assets were commercially reasonable and that maximum recovery was obtained.

Recommendations

We recommend that the Associate Administrator for Investment take the following actions:

- 3.A Revise SOP 10 07 to require OL staff to obtain, for the sale of portfolio assets by an SBIC, verification that the sale was made at commercially reasonable terms.
- 3.B Revise SOP 10 07 to require OL staff to ascertain, for the sale of portfolio assets by an SBIC, whether the buyer was an associate of the SBIC.

Management's Comments

The Associate Administrator concurred with the recommendations and stated that implementation could begin immediately.

OIG's Evaluation of Management's Comments

The Associate Administrator's response is acceptable.

Finding - 4 Cash Management Controls needed Improvement

Funds totaling \$136,236, applicable to receiverships that were scheduled to be closed, were unaccounted for. These funds were not managed properly due to inadequate controls. As a result, funds may have been lost or misused resulting in less than maximized recoveries.

Cash receipts and disbursement procedures

The management of cash receipts depended upon whether the funds were for a receivership or for SBA. The OL procured the services of a contractor to handle receipt of receivership funds. The contractor’s written procedures required all checks received to be recorded in a daily log and processed before depositing into individual receivership bank accounts. Checks received after bank accounts were closed were to be forwarded directly to SBA. The manner in which the checks should have been managed beyond this point was not addressed in the contractor’s procedures.

According to SOP 10 07, Chapter 11, two or more OL staff were to serve as Headquarters SBIC Cashier/Control Clerk (OL cashier) and alternate for SBICs in liquidation. Per the SOP, the OL cashier was charged with receiving, safeguarding, and disposing of checks by OL staff and with recording remittances received each day.

Funds not managed properly

The OL’s management of funds for receiverships whose bank accounts had been closed or were scheduled to be closed did not ensure that all funds would be accounted for. Receivership bank accounts were closed as part of the process of terminating receiverships. According to the contractor’s procedures, when checks were received for receiverships with closed bank accounts, the checks were to be recorded in a log and then forwarded to SBA. There was no requirement to show how the checks were transmitted to SBA, to whom they were given, or to obtain evidence that a deposit was made.

For the period September 2001 through April 2004, we found 16 checks totaling \$179,258 that applied to receiverships whose bank accounts were closed or were scheduled to be closed during FY 2002 and FY 2003. Of the 16 checks, 9 totaling \$136,632 either were not logged or not deposited. The unshaded areas in table 6 below show the 9 checks that were not managed properly.

Table 6

Checks for Receiverships				
Bank Accounts Closed or Scheduled to be Closed				
Dollar Amount	Number of Checks			
	Logged Deposited	Not Logged Deposited	Not Logged Not Deposited	Logged Not Deposited
a. \$ 42,626	7			
b. \$ 396		2		
c. \$ 13,930			2	
d. \$ 122,306				5
a.-d. \$ 179,258	7	2	2	5

Of the seven checks not deposited, we confirmed that one in the amount of \$12,500 was received by an OL financial analyst. The analyst stated that he did not know what happened to the check. A representative of the bank on which the check was drawn provided a verbal confirmation that the check never cleared the maker’s account. The Director of the OL stated he would contact the makers of the seven checks to determine whether or not the missing checks

cleared. As of March 31, 2005, the OL confirmed that it located or obtained replacements for five of the seven checks totaling \$132,201. Two checks totaling \$4,034 remain unaccounted for.

Controls needed strengthening

The aforementioned condition occurred because the OL's cash management procedures and controls needed to be improved. We concluded from our audit results that existing procedures did not ensure that all checks were logged and deposited into receivership accounts when possible. Also, there was no requirement that the contractor forward checks received after the receivership accounts were closed solely to the OL cashier and that the contractor obtain evidence that the checks were received by the cashier. The existing requirements of SOP 10 07 concerning formally designating an OL cashier and alternate were not followed.

Implementing controls to better track payments received as a result of closing SBIC bank accounts will improve accountability for funds due SBA and provide a better use of funds. Using the amount found in our audit involving \$136,632 pertaining to the 31-month period from September 2001 through April 2004, such controls would result in better use of funds of approximately \$52,000 annually.³

Recommendations

We recommend that the Associate Administrator for Investment take the following actions:

- 4.A Designate formally one person to be the OL cashier and another to be the alternate. Provide training to the designees concerning the requirements listed in SOP 10 07.
- 4.B Develop written procedures that require checks received for receiverships with closed bank accounts to be forwarded to the OL cashier as soon as possible. These procedures should include:
 - a record showing the check was received by the receivership office;
 - evidence that the check was sent to SBA; and,
 - documentation included in the applicable receivership's file.
- 4.C Conduct a monthly reconciliation of the receipt document to the SBA and the receiver account deposit slips.
- 4.D Determine the disposition of the two missing checks. If the checks were lost, efforts should be made to seek replacements from the makers. If improperly cashed, a referral should be made to the OIG/Investigations Division.

³ $\$136,632 \text{ divided by } 31 \text{ months} = \$4,407 \times 12 \text{ months}$

SBA Management's Comments

The Associate Administrator stated that implementation of recommendations 4.A, and 4.B can begin immediately. For recommendations 4.C and 4.D, he neither concurred nor non-concurred and stated the recommendations were more problematic and required a more detailed review.

OIG's Evaluation of Management's Comments

The Associate Administrator's response to recommendations 4.A, and 4.B is acceptable. For recommendations 4.C and 4.D, we will evaluate his response at the conclusion of the detailed review.

Other Matter

Receiverships did not always Follow Federal Tax Law Requirements

The OL had no assurance that more than \$2.9 million in payments made by SBICs in receivership to service providers was reported to the Internal Revenue Service (IRS) as required by law. This condition occurred because there were no formal procedures and controls concerning the reporting of payments to contractors to the IRS. As a result, service providers had the opportunity to conceal income and improperly reduce their tax liability. Thus, the receiverships may have violated Federal law and were exposed to the possibility of financial penalties.

IRS requirements for service providers

Under 28 United States Code, Section 960, the OL was required to make appropriate filings with Federal taxing authorities for SBICs in receivership status. These filings included IRS Form 1099, MISC (Form 1099), and IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns (Form 1096). According to Internal Revenue Code Section 6041A, the Forms 1099 were required to be prepared and filed with the IRS by the service recipient and a copy provided to the service provider whenever payments for services totaled \$600 or more during a calendar year.⁴ The purpose of filing Form 1099 was to enable the IRS to identify taxpayers who did not file income tax returns, as well as those who did not report all of their income. In addition, service recipients had to file Form 1096. The purpose of this form was to summarize and transmit Forms 1099.

The OL's procedures and controls

The OL contracted to have Forms 1099 prepared for each service provider that received payments in excess of \$600 and Forms 1096 prepared for each SBIC in receivership for calendar year 2003, with one exception. An OL official stated that the contractor responsible for preparing the IRS forms was supposed to send packets containing Forms 1096 and Forms 1099 to the receivership agents. The agents were to sign the Forms 1096 and return the packets to the contractor who would then send the packets to the IRS. The OL had no controls to ensure that this process was followed. Also, these procedures were not included in the SOP applicable to the liquidation process, and we found no evidence they were documented elsewhere.

For the one SBIC receivership that was an exception, Fidelity Capital Corporation (FCC), the contractor was not assigned to prepare the 1099s/1096. Management believed this was because the information was not available at the receivership office. When the agent was asked about these forms, he stated that the topic (IRS Forms 1099 and 1096) had never come up and he was unaware of any arrangements to have the forms prepared.

SBICs in receivership status

⁴ Generally payments made to corporations are excluded except for payments made to corporations for legal services.

The OL did not ensure the Forms 1099 and 1096 were filed. For calendar year 2003, at least 118 Forms 1099 representing payments totaling over \$2.9 million made by 26 receiverships should have been filed with the IRS. Of the 118 forms, 35 were for payments totaling more than \$1.2 million made to the agents, and 83 were for payments totaling more than \$1.7 million made to other service providers. We requested documentation from the OL evidencing that agents filed the required 118 forms. We were provided a sample letter, dated February 2004, from the contractor to the agents instructing the agents to sign the forms and mail them directly to the IRS. The OL had no evidence that the agents mailed the forms or, if mailed, that the proper amounts were reported. Not ensuring that the required forms were filed with the IRS could have caused SBICs in receivership to be subject to fines totaling at least \$5,900 (\$50 fine for each Form 1099 not filed) and could have facilitated the under-reporting of income to the IRS. We could not determine the number of Forms 1099 that should have been filed by the FCC receivership.

IRS verification of filing

We requested that the responsible OL official contact the IRS to confirm that the agents had filed the required forms. We were told by an IRS official that our request about the Forms 1099 submissions could not be satisfied. This means that the OL could not readily determine whether the principal agents filed the required forms with the IRS.

The responsible OL official stated that the events of calendar year 2003 were contrary to existing procedures. The official further stated that the procedures were changed without the OL's knowledge or consent and that the process would be amended prior to calendar year 2004 IRS forms being filed.

Recommendations

We recommend that the Associate Administrator for Investment take the following actions:

- 5.A Develop and implement internal controls which will involve the OL staff to ensure that the required IRS Forms are filed timely and accurately.
- 5.B Incorporate revised procedures for filing IRS Forms 1096 and 1099 into SOP 10 07.
- 5.C Determine through coordination with the IRS and the service providers whether IRS Forms 1099 and 1096 were filed accurately for calendar year 2003. If not filed accurately, implement actions to file the forms, as required.

Management's Comments

The Associate Administrator concurred with the recommendations and stated that implementation could begin immediately.

OIG's Evaluation of Management's Comments

The Associate Administrator's response is acceptable.

**U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416**

APPENDIX A

DATE: July 15, 2005

TO: Robert G. Seabrooks
Assistant Inspector General
for Auditing

FROM: Jaime Guzmán-Fournier
Associate Administrator
for Investment

SUBJECT: Response to Draft Report, Audit of SBIC Liquidation Process

Thank you for your recent draft audit report on the Office of SBIC Liquidation (OL) and its liquidation process. We believe the report will be very helpful as we move forward on improving our administration of the SBIC program. We can concur immediately with a number of your recommendations and are presenting them below. A number of the other recommendations are more problematic and require a more detailed review on our part.

Additionally, we are in the process of soliciting a contract with a third party to conduct a review of the entire liquidation process and believe we should receive the benefit of its recommendations before implementing some of your suggested changes. We hope to award the contract shortly with the report to be received towards the end of the first quarter of FY 2006. At that time we would expect to consider the report's recommendations along with those submitted by the IG. We will then discuss with you how best to proceed given the various recommendations. All accepted recommendations will then be incorporated into a revised SOP.

Detailed below are the recommendations we think we can begin to implement immediately.

Recommendation:

2.A Ensure that each case file includes documented evidence that the OL staff considered all liquidation methods.

2.B Track the costs for each liquidation case and summarize all cost by liquidation method yearly. After a reasonable period of time, this historical cost should be used for cost analysis. While we are willing to implement this tracking system, we question its value as each case is completely different from every other case and there is really no basis for a comparison.

2.C(ii)(b) Revise SOP 10 07 to include the additional liquidation method of selling SBA's equity and debt interest in the SBICs.

Recommendation:

3.A Revise SOP 10 07 to require OL staff to obtain, for the sale of portfolio assets by an SBIC, verification that the sale was made at commercially reasonable terms.

3.B Revise SOP 10 07 to require OL staff to ascertain, for the sale of portfolio assets by an SBIC, whether the buyer was an associate of the SBIC.

Recommendation:

4.A Designate formally one person to be the OL cashier and another to be an alternate. Provide training to the designees concerning the requirements listed in SOP 10 07.

4.B Develop written procedures that require checks received for receiverships with closed bank accounts to be forwarded to the OL cashier as soon as possible. These procedures should include:

- a record showing the check was received by the receivership office
- evidence that the check was sent to SBA

Recommendation:

5.A Develop and implement internal controls which will involve the OL staff to ensure that the required IRS Forms are filed timely and accurately.

5.B Incorporate revised procedures for filing IRS Forms 1096 and 1099 into SOP 10 07.

5.C We will attempt to determine, through coordination with the IRS and the service providers whether IRS Forms 1099 and 1096 were filed accurately for calendar year 2003. If not filed accurately, implement actions to file forms, as required.

While we agree to implement the items under Recommendation 5, we do not agree that a violation of law occurred.

As mentioned earlier the balance of the recommendations should be considered in the context of the report we expect to receive from a contractor towards the end of the first quarter of FY 2006. At such time we may well concur with a number of your remaining recommendations. We will share that report with you and work with you to implement those recommendations we agree are appropriate.

cc: Steve Galvan, Chief of Staff
Calvin Jenkins, Deputy ADA/CA

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