



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

MEMORANDUM AUDIT REPORT
Issue Date: December 31, 1997
Number: 8-6-F-007-006

To: John E. Scott, II,
District Director, Las Vegas District Office

From: Peter L. McClintock
Assistant Inspector General for Auditing

Subject: New Ventures Capital Development Company
Loan Origination and Services Practices

We have completed our audit of the New Ventures Certified Development Company (New Ventures) loan origination and servicing practices. The audit objective was to determine whether New Ventures complied with policies and procedures relating to the Small Business Administration (SBA) Section 504 Program.

Eleven loans valued at \$6.4 million originated by New Ventures and approved by SBA were randomly selected for review (Exhibit B). We performed detailed examinations of the 11 loan files and interviewed SBA and New Ventures officials. Borrowers were also interviewed and project sites were visited. This was the first audit of New Ventures operations. Field work was completed in February 1997. The audit was conducted in accordance with Government Auditing Standards.

BACKGROUND INFORMATION

The 504 Loan Program was established to foster economic development, create or preserve job opportunities, and stimulate small business growth, expansion, and modernization. Under this program, New Ventures was created to help small businesses obtain interim and permanent financing for the construction or purchase of real property used in business operations.

Permanent financing for each 504 project requires small businesses to contribute a minimum of 10 percent of total project costs with up to 40 percent provided from the sale of debentures guaranteed by SBA. These debentures are collateralized by a second lien on the property. The remainder of the financing comes from the private sector or a bank loan collateralized by a first lien on the property.

SBA certified New Ventures, a for profit corporation, as a Certified Development Company (CDC) in 1985. New Ventures approved 187 loans valued at \$68.1 million from its inception to September 30, 1996 (Exhibit A). Code of Federal Regulations, Title 13, Section 120.826, requires CDC's to operate in accordance with applicable statutes and regulations including SBA's Standard Operating Procedures. CDC's must also maintain records as required by SBA.

AUDIT RESULTS

New Ventures generally complied with SBA's 504 Loan Program policies and procedures. Key documents, however, were not always in the loan file which would provide evidence that procedures were followed. Also, several practices gave the appearance of conflicts of interest. These two issues are discussed in the following findings.

FINDING 1 Project loan files were incomplete

New Ventures generally complied with SBA's 504 Loan Program policies and procedures. New Ventures, however, did not maintain loan files as required by Section 24e of Standard Operating Procedure (SOP) 50 22 3 because documents relative to capital injections, site visits, collateral condition, loan closing correspondence, and loan applications were missing.

Section 24e states that a CDC shall maintain information and documents related to its loan portfolio for SBA review to include:

- (1) Evidence of the 10 percent capital injection
- (2) Evidence of field visits
- (3) Condition of the collateral
- (4) All correspondence related to the loan prior to closing
- (5) Loan applications

Examples of the deficiencies follow:

- Eight of the 11 loan files did not have evidence of the capital injections. As a result, there was no assurance that the borrowers made capital injections.

- Site visit reports were not available for seven loans reviewed. Seven of the nine borrowers stated they were not aware of site visits by New Ventures personnel. The New Ventures' President stated that site visits were unannounced and their representatives may not have spoken to the borrowers.
- None of the loan files had records of the project status during the construction phase. New Ventures thought no action was necessary until the projects were completed.
- Seven loan files lacked copies of the counsel opinions because the opinions were sent directly to SBA.
- Four loan files lacked copies of credit reports for the borrowers or businesses. New Ventures relied on the lenders to provide copies of credit reports.

Recommendation

1. We recommend the District Director, Las Vegas District Office, direct New Ventures Capital Development Company to maintain loan file documents in accordance with SBA SOP 50 22 3.

Management's Response

The Deputy District Director stated that the finding was discussed with the CDC President who assured SBA that required documentation will be maintained in the files. A copy of the response from the District Office and the CDC are included as Attachments 1 and 2, respectively.

Evaluation of SBA Management's Response

Management officials agreed with the results of the draft report. The actions taken or planned are responsive to the recommendation.

FINDING 2 New Ventures employees engaged in apparent conflicts of interest

Actions by New Ventures employees resulted in two apparent conflicts of interest. The President received a direct financial benefit from commissions on approved loans from the CDC. Another employee received loan processing fees directly from New Ventures for preparing loan processing documents although the President claimed the employee was an independent contractor for New Ventures' contract attorney.

Section 120.140, 13 CFR, states a CDC participant may not have a real or apparent conflict of interest. SOP 50 22 3, Section 19b, addresses conflicts of interest in that it prohibits self-dealing by the CDC's board of directors and employees. The SOP further states

that without SBA's prior written approval, a CDC shall not permit a relationship to exist or be created between the development company or related parties if such a relationship could constitute a conflict of interest or the appearance thereof.

We identified New Ventures practices which appear to be in violation of these requirements as detailed in the following paragraphs.

- The President received commissions on loans that were closed by New Ventures and fees for property that is rented to New Ventures. In 1996, he received \$27,000 in commissions. The commission arrangement gave the appearance of a conflict of interest because the President had a direct, personal financial interest in the approval of a loan. In addition to his salary and commissions, the President owned the building in which New Ventures leased its office space. The commission and rental arrangements, while giving the appearance of a conflict of interest (i.e., self-dealing), were not approved, in writing, by the SBA district office.
- The compensation agreements for services (SBA Form 159) showed New Ventures charged borrowers \$1,000 for attorney fees and \$700 for loan processing. The \$700 loan processing fee was paid directly to a New Ventures employee for preparing loan closing documents for the attorney's review. New Ventures claimed its employee worked for the attorney during her off-hours. We noted, however, that the employee performed some of the loan document preparation in her New Ventures workplace during normal business hours. Also, New Ventures issued payments directly to the employee for this loan processing work. The contract attorney reported that the New Ventures employee did not work for him nor did he supervise her. This action gives the appearance of a conflict of interest because an employee of New Ventures received a financial benefit by receiving fixed payments for services paid by borrowers that (1) were disguised as attorney's closing costs, and (2) were at least partially performed as normal New Venture duties.

Recommendation

2. We recommend the District Director, Las Vegas District Office, require New Ventures Capital Development Company to disclose any arrangements which appear to be conflicts of interest for SBA's determination of propriety.

Management's Response

The Deputy District Director, Las Vegas District Office, stated the findings were discussed with the President, New Ventures, and he assured that necessary procedures will be put in place to solve the errors. The President, New Ventures, stated that from the inception of New Ventures in 1990 through May 1994, a consulting firm, which he owned, provided on-going day-to-day operational services. This arrangement was approved by the Las Vegas District and Central Offices. In June 1994, New Ventures employees took over day-to-day

operations. Payments made to the former consulting firm were for obligations incurred prior to May 4, 1994.

The President, New Ventures, stated his compensation included a 15 percent commission on each 504 loan. He also stated that as of November 1, 1997, an independent attorney will perform the entire closing function.

A copy of the District Office response along with the written response from New Ventures is included with the report as Attachments 1 and 2, respectively.

Evaluation of SBA Management's Response

The actions taken or planned are partially responsive to the recommendation. With respect to the President's commissions, the District Office should carefully consider whether the commission arrangement is a desirable and proper form of compensation, considering that it provides a personal financial incentive to "push through" loans that may not meet the 504 program's criteria. With respect to the leasing of office space, the District Office should ensure that the costs are reasonable and approved, in writing, by SBA. With respect to preparation of loan processing documents, the actions, when implemented, should alleviate the appearance of any conflict of interest.

The findings included in this report are the conclusion of the Office of Inspector General's Auditing Division based on testing of the auditee's operation. The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please record your management decisions on the attached SBA Forms 1824, Recommendation Action Sheet, and provide target dates for completion. We would appreciate receipt of these forms within the stated timeframes.

This report may contain proprietary information subject to the provisions of 19 USC 1905 and must not be released to the public or another agency without the permission of the Office of Inspector General.

Attachments

EXHIBIT A

NEW VENTURES CAPITAL DEVELOPMENT COMPANY

Loans Approved by Fiscal Year and Amount

Fiscal Year	Loans Approved	Value
1985	1	\$139,000
1986	1	284,000
1987	0	- 0 -
1988	2	512,000
1989	7	1,325,000
1990	25	6,908,000
1991	27	8,100,000
1992	24	8,417,000
1993	22	7,723,000
1994	32	14,436,000
1995	23	9,041,000
1996	23	11,281,000
Totals	187	\$68,166,000

NEW VENTURES CAPITAL DEVELOPMENT COMPANY

Loans Selected and Reviewed

Loan Number	Borrower Name	Date Approved	Approved Amount
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	\$517,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	321,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	344,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	750,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	583,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	875,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	613,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	627,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	749,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	504,000
<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	<i>(FOIA Deletion)</i>	532,000
	Total Value		\$6,415,000

**OFFICE OF INSPECTOR GENERAL
AUDITING DIVISION**

AUDIT REPORT DISTRIBUTION

<u>Recipient</u>	<u>Number of Copies</u>
Associate Deputy Administrator for Economic Development.....	1
Associate Administrator for Financial Assistance	1
Associate Administrator for Field Operations.....	1
General Counsel.....	2
Office of the Chief Financial Officer	1
District Director, Las Vegas District Office.....	1