

**Certified Development
Company Program**

September 1999

INSPECTION REPORT



**Office of Inspector General
U.S. Small Business Administration**

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ABBREVIATIONS

ADC	Associated Development Company
ALP	Accredited Lenders Program
CDC	Certified Development Company
CFR	Code of Federal Regulations
CPA	Certified Public Accountant
FY	Fiscal Year
GAAP	Generally Accepted Accounting Principles
GPRA	Government Performance Results Act
IRS	Internal Revenue Service
NADCO	National Association of Development Companies
OFA	Office of Financial Assistance
OIG	Office of Inspector General
PCLP	Premier Certified Lenders Program
SBA	Small Business Administration
SOP	Standard Operating Procedure

EXECUTIVE SUMMARY

Background. The Small Business Administration's (SBA) 504 loan program provides long-term, fixed-rate financing to small businesses for the purchase of land, buildings, machinery, or other fixed assets. The program is delivered through non-profit¹ Certified Development Companies (CDCs) established to promote local economic development. Typically, 40 percent of a project's cost is funded by the CDC and backed by an SBA-guaranteed debenture, 50 percent by a third-party lender, and 10 percent by the borrower.

Approximately 270 CDCs currently serve assigned geographic areas nationwide. Their loan portfolios must create or retain one job for every \$35,000 of debenture proceeds provided by the SBA. Since 1987, the 504 Program has approved 39,500 loans and provided \$13.4 billion in guaranteed debentures.

The Office of Inspector General (OIG) initiated this inspection to assess SBA's oversight of CDC performance and the program's compliance with Agency regulations. It focuses on specific areas where we believe problems exist and examines whether SBA has the tools required to identify and correct those problems.

Risk Management and Lender Oversight. Over the last year, the 504 program staff in SBA's Central Office has created a new CDC database combining information from the Agency, the program's fiscal agent,² and its servicing agent.³ This data allows SBA to monitor the CDC's portfolios in much greater detail than previously possible. The 504 staff, together with an agency-wide risk management committee, also developed five risk factors, including default and liquidation rates to measure the level of risk of each CDC's portfolio. SBA intends to use these factors to trigger mandatory site reviews of CDCs that pose a higher risk to the Agency. While we believe the risk factors and review procedures have significant potential, they had not been finalized at the time of the inspection, so we confined our review to the oversight methods actually in use.

CDC Annual Reports. CDCs are required to provide a standardized annual report that includes information on a CDC's loan portfolio, job creation and retention impact, organizational structure, and financial condition. This is a key tool for monitoring CDC activity, and it is supposed to be reviewed closely by SBA district offices before forwarding to the Central Office. The inspection team found that the district offices were not transmitting annual reports, along with summaries of their reviews, to the Central Office, as required. In the case of 1997 CDC reports, for example, 138 (51 percent) were not in Central Office files at the time of our review. To be certain that the Agency's evolving oversight process has the information it needs, *we recommend that SBA ensure that the district offices obtain, review, and forward all CDC annual reports and summary assessments to the Central Office in a timely manner.*

¹ For-profit CDCs certified by SBA prior to January 1, 1987 may retain their for-profit status.

² The fiscal agent is responsible for all aspects of selling the SBA-guaranteed 504 debentures on the secondary market.

³ The servicing agent manages funds allotted to and disbursed by the 504 program.

In a survey we conducted of district directors, many indicated that sections of the annual report either duplicated available information or were not useful for their CDC reviews. In the case of the latter, however, we also found that program officials in the Central Office considered some of the same sections essential for oversight. This divergence suggests that SBA district offices may not handle the fundamental monitoring of CDC activities in a consistent manner. To ensure a uniform oversight process, SBA needs to decide what criteria to use for monitoring and make certain that all reviews meet minimum standards. *We recommend that 504 program officials, in consultation with the district offices, review the CDC annual report requirements to ensure that the Agency solicits the information necessary to conduct effective program oversight. SBA then needs to provide the field offices with appropriate guidance on reviewing the reports.*

Reporting of Fees. CDCs are allowed to charge 504 loan recipients processing, closing, and servicing fees, as well as late and assumption fees, when applicable. Our review of CDC annual reports found that some CDC financial statements listed 504 packaging and origination fees. To determine whether these fees were in addition to those allowed were simply permissible fees listed by a different name, we compared the 504 processing revenues reported in the 1997 annual reports to allowable processing revenues. Due to aggregate reporting in some CDC annual reports, however, we were only able to identify what appeared to be 504 processing fees for half of the CDCs. Based on an analysis of these, we found that nearly 25 percent were charging processing fees that were at least 10 percent higher than the allowable 1.5 percent of the net debenture.⁴ However, after reviewing these reports in more detail, we could only determine that five of these CDCs were charging excessive processing fees. We concluded, therefore, that the majority of the annual reports do not provide sufficient information about their revenues to allow SBA to verify specific 504 fees charged by CDCs. *We recommend that SBA (1) track net debentures so it can identify CDCs that may be charging excessive processing fees and take corrective action; (2) require CDCs to list separately the dollar amount of revenue received from 504 processing, closing, servicing, late, and assumption fees in their financial statements; and (3) require CDCs to list separately and explain all 504 expenses in their financial statements.*

Compliance with Generally Accepted Accounting Principles (GAAP). We found that the audited financial statements of nine CDCs were not in compliance with GAAP, as required by program rules. Compliance could not be determined for nearly half of the CDCs, because audited statements are not required. As long as the GAAP requirement exists, the Agency needs to provide an acceptable and affordable means for CDCs to verify compliance short of retaining a Certified Public Accountant (CPA). *We recommend that SBA develop a means for certifying compliance with GAAP requirements by CDCs that do not have their financial statements audited by a CPA.*

⁴ Because SBA does not track net debentures, the team used gross debenture dollar amounts. Several CDCs estimate that gross debentures are roughly 2-3 percent higher than net debentures. Using gross rather than net debentures made our analysis more conservative than if we had used net debenture amounts.

Oversight of CDC Contracts. With prior approval from SBA, CDCs may contract for certain services, such as marketing, packaging, processing, and servicing, and obtain staff support from affiliates, e.g., local economic development agencies. Although contracting out functions may be an effective way to reduce costs or improve services, the contracts require close monitoring by SBA to curb potential abuse. SBA district offices are responsible for reviewing annually all contracts, except those for legal and accounting services. A small sampling of district offices with jurisdiction over at least one CDC, however, revealed that they did not consistently have either a prior approval or an annual review process in place. We also found that some CDCs were not regularly notifying the district offices when changes were made to their contracts.

Relying on contract information presented in the annual reports was also problematic. Unless a contract is new or changed, a CDC is only required to provide a summary in the annual report. We found that the summaries did not always supply basic information about the contractor, the compensation arrangement, the specific services provided, or the term of the agreement.

Overall, we believe that SBA's oversight of CDCs needs considerable tightening to be effective. *We recommend that CDCs be required to include copies of all current contracts in their annual reports for review by district office and Headquarters officials. SBA should also provide the district offices with standard procedures for reviewing all third-party and affiliate contracts and hold the district offices accountable for conducting the annual reviews.*

Additional Fees Charged by Contractors. If a CDC uses a contractor for loan packaging services, the fee must be paid by the CDC out of the 1.5 percent processing fee it receives from the borrower. In an anonymous survey of 237 CDC executive directors, 17 indicated that their loan packagers were charging fees to the borrower in addition to the 1.5 percent processing fee, while another nine did not know if their loan packagers charged an additional fee. *We recommend that SBA ensure that loan packagers contracted by CDCs are not charging additional fees to the borrowers. SBA should also issue guidance to all district offices and CDCs clarifying what fees can be charged to the borrower.*

Contracts with For-Profit Management Companies. The inspection team found three contracts that appeared to violate program regulations prohibiting a CDC participant from self-dealing. Each CDC contracted out all its functions to a for-profit, third-party contractor or affiliate, and in two instances the executive director/president of the CDC was also the owner or president of the management company under contract. In the third case, the contractor assisted the CDC in choosing its members and board of directors. We believe that these CDCs were circumventing the requirement that a CDC be non-profit by acting as a "shell" for the related for-profit management companies. In each case, compensation from the CDC to the management company appeared to be quite generous compared to other contractual agreements we reviewed. One company received all CDC fee income, a management fee to cover all expenses, and a management bonus tied to the CDC's operating income. Another received all compensation payable to the

CDC. The third company received \$85 an hour plus 25 percent of the CDC's fee income; according to its 1997 financial statements, the CDC's fee income totaled \$1.84 million, and the management fee charged to the CDC was \$1.16 million. ***We recommend that SBA clarify its policy on contracting out the majority of services to for-profit companies and exercise more oversight to prevent program violations.***

Performance Measurement. The 504 program's goals, according to SBA's FY 2000 Annual Performance Plan, include funding 5,200 loans and creating or retaining 113,966 jobs for 504 program loan recipients. The number of jobs created or retained is based on the calculation that every \$12,855 of 504 funding creates or retains one job. According to SBA officials, the \$12,855 figure has been used for several years and was originally based on CDC annual reports from different fiscal years. It is not clear, therefore, whether that amount is still valid. We believe that SBA should recalculate it on an annual basis, using data from the same fiscal year, to ensure that the figure is kept reasonably current and accurate. To further improve accuracy in reporting total jobs created and retained, SBA should not add together estimated and actual jobs. ***We recommend that SBA base 504 outcome measures in its Annual Performance Plan on actual jobs created and retained as of two years after funding. SBA should also take steps to improve the quality of outcome measures collected by the CDCs.***

Results of the CDC Survey. The inspection team conducted a survey of CDC executive directors to obtain their perspectives on the 504 program and identify ways in which it might be improved. Of the 268 surveys distributed, 237 (88 percent) were completed and returned to the OIG. Overall, the CDC directors viewed their relations with the district offices very favorably, with 64 percent indicating they were "excellent" and 31 percent "good." Many CDCs were not satisfied with the Accredited Lender Program (ALP), which is designed to provide faster SBA review to qualified CDCs that assume responsibility for processing and servicing their own loans. CDC directors stated that district offices often did not meet the required three-day turnaround on ALP loans; 90 percent felt it was "important" or "very important" to obtain approval within this timeframe. Conversely, if an ALP CDC fails to provide satisfactory loan packages for approval, thus forcing the district office to spend more time on reviews, SBA should consider rescinding its ALP designation. ***We recommend that SBA ensure that district offices approve ALP applications in three days or take the necessary steps to revoke the ALP status of CDCs that submit sub-standard loan packages.***

In terms of oversight, the survey showed that 21 percent of CDCs had not received a site visit from their district office in four or more years. We believe that even CDCs that perform well should receive site visits at least once every three years. ***We recommend that SBA ensure that all district offices are performing site visits of CDCs at least once every three years.***

Finally, SBA needs to provide more guidance to the CDCs on closing fees. According to the survey, closing fees ranged from zero to \$10,000. ***We recommend that SBA monitor closing fees in excess of \$2,500 to ensure that the charges are reasonable for the work performed.***

SBA COMMENTS

The Office of Financial Assistance (OFA) agreed in full with all but three of the report's recommendations. It partially agreed with the recommendation to develop a means for certifying compliance with GAAP requirements by CDCs that do not have their financial statements audited by a CPA. OFA is considering requiring audited financial statements from CDCs whose 504 loan portfolios exceed a certain size. For CDCs with smaller portfolios, OFA is considering accepting their most recent Federal tax returns in lieu of audits.

OFA partially agreed with the recommendation to base 504 outcome measures in the Agency's Annual Performance Plan on actual jobs created and retained as of two years after funding. OFA believes implementing this recommendation would be a radical departure from SBA's traditional approach and would not reflect funded loans that have not reached their two-year anniversary. Nonetheless, OFA will consider reporting jobs data using both its past procedure and our recommended method.

OFA disagreed with the recommendation to monitor closing costs in excess of \$2,500 to ensure that the charges are reasonable for the work performed. This recommendation was based on our survey of CDC executive directors, which revealed that closing costs such as attorney, filing, and miscellaneous fees charged to borrowers ranged from zero to \$10,000. OFA officials indicated they had never received a complaint on this issue and suggested that the CDCs may have included other eligible project charges as closing costs.

BACKGROUND

The Small Business Administration's (SBA) 504 Loan Program provides long-term, fixed-rate financing to small businesses through privately operated Certified Development Companies (CDCs). The loans are used for purchasing fixed assets, such as real estate and equipment, to enable the small businesses to expand or modernize. The CDCs are non-profit⁵ corporations established to contribute to the economic development of their local communities by helping small businesses grow and create jobs. Loans originated by CDCs must meet at least one of the following economic development goals: (1) job creation, (2) filling a special community need, or (3) meeting a statutory public policy goal.

Approximately 270 CDCs serve defined geographical areas in the 50 states, the District of Columbia, the Virgin Islands, Puerto Rico, and Guam. CDC "members," made up of representatives from local government, businesses, financial institutions, and community organizations, oversee individual CDC activities. The Board of Directors is chosen by the members and includes at least one individual with commercial lending experience. Most CDCs are involved in other Federal, State, and local development programs, such as technical assistance, revolving loan funds, small business incubators, and rural development. These other programs complement the 504 program and further the objective of improving the economy of the local community.

Typically, 40 percent of a project's cost is funded by the CDC and backed by an SBA-guaranteed debenture, 50 percent by an unguaranteed bank loan holding the first lien, and the remaining 10 percent by the borrower. SBA allows the debenture portion to reach up to \$1 million, making total available financing a maximum of \$2.5 million. The fixed rate and the 10-20 year term of 504 loans make them attractive to small businesses. Since 1987, the 504 loan program has approved 39,500 loans and provided \$13.4 billion in guaranteed debentures. In fiscal year 1998, CDCs made 4,930 loans totaling \$1.8 billion under this program.

Ninety-six percent of the CDCs are members of the National Association of Development Companies (NADCO), the trade association for the CDCs. NADCO provides legislative and regulatory support for the 504 program and works closely with SBA in reviewing program regulations and ensuring that CDCs carry out program objectives. NADCO offers its members training, networking, and the opportunity to advocate regulatory and program changes.

SBA allows CDCs varying levels of authority in making approval, servicing, and foreclosure decisions, depending on their track record and capability. In the regular program, CDCs must submit completed financial packages to their SBA district offices for close scrutiny and final approval, and SBA provides oversight of servicing and liquidation functions. Under the Accredited Lenders Program (ALP), district offices are expected to produce a faster turnaround because they simply review ALP-CDCs'

⁵ For-profit CDCs certified by SBA prior to January 1, 1987 may retain their for-profit status.

decisions on borrower eligibility and credit, rather than making their own in-depth analysis. In exchange, the ALP-CDCs assume more responsibility for processing and servicing the loans. Currently, there are 79 CDCs in the ALP program.

Two pilot programs have also been established to give selected CDCs additional responsibilities, including loan liquidations. The Premier Certified Lenders Program (PCLP), enacted in 1994, allows CDCs to approve, close, service, foreclose, litigate,⁶ and liquidate 504 loans subject to SBA regulations, procedures, and policies. In return, PCLPs reimburse SBA for ten percent of any losses incurred as a result of defaulted debentures issued under PCLP. To cover this exposure, CDCs must maintain a loss reserve of one percent of the debentures it issues under the PCLP program. The Liquidation Pilot Program, begun in June 1997, allows a small number of eligible CDCs to assume all liquidation and foreclosure responsibilities on their defaulted loans. If proposed legislation passes, both pilots would become permanent programs, and would be open to all qualified CDCs. Currently, there are 25 CDCs in the PCLP program and 20 CDCs in the Liquidation Pilot Program.

⁶ A bill before the House (H.R. 2614), if passed, would give a CDC authority to litigate in situations where a defaulted loan has gone into liquidation. Presently, SBA district offices are responsible for litigation.

OBJECTIVES, SCOPE, AND METHODOLOGY

The purpose of this inspection was to assess SBA's oversight of CDC performance and compliance with Agency regulations. It focuses on specific areas where we believe violations may be occurring and examines whether SBA has the tools needed to identify and correct instances of CDC non-compliance.

The inspection team contacted program officials at Headquarters and in the field to identify their primary means for providing oversight and obtain their suggestions for how it could be improved. The team also reviewed the content and scope of recent CDC annual reports and the Agency's risk management database to determine if they contained the information necessary for effective oversight of CDC operations. This included examining whether program officials were able to assess CDC revenues from the 504 program and the legitimacy of CDC contractual agreements. We also obtained data from Colson Services, SBA's servicing agent,⁷ to determine if servicing fees charged by CDCs were consistent with program regulations.

To obtain CDC perspectives and assess their satisfaction with program delivery, the inspection team met with officials of 15 CDCs chosen to reflect diverse aspects of the program, including geographic location, portfolio size, and type of participation (PCLP, ALP, etc.). We also conferred with the leadership and various board members of NADCO and obtained CDC perspectives on industry-wide issues by attending NADCO's legislative and regulatory summit and annual meeting.

The team also conducted an anonymous survey of CDC executive directors, obtaining an 88 percent response rate. The results were analyzed to measure CDC satisfaction with particular aspects of the program and to identify significant program-wide issues. In response to their requests to be contacted, we called many of the surveyed directors to obtain more in-depth information.

Other research included analyzing CDC income to try to determine if compensation received was in line with program rules. We compared CDC financial statements to their Internal Revenue Service (IRS) tax submissions to verify balance sheet and income statement information. We found no significant discrepancies between the annual report and the tax form figures. We further attempted to determine processing and servicing fee income, as well as compensation to CDC affiliates, contractors, and staff, but could not document compensation and specific 504 fees because they were not itemized in the tax forms and/or in the annual reports. As a result, we do not have any findings attributable to IRS data comparisons. To determine if CDCs were charging higher fees on 504 loans than allowed, we called a random sample of loan recipients who had recently obtained 504 loans. Because most borrowers could not recall the specifics of their loans, such as the amount paid for processing and closing fees, we terminated this approach.

⁷ The servicing agent manages funds allotted to and disbursed by the 504 program.

This report presents the results of our research in six main areas: 1) the CDC annual report requirement; 2) allowable fees charged by CDCs; 3) oversight of third-party contractors; 4) CDC financial statement compliance with Generally Accepted Accounting Principles; 5) Agency conformance with the Government Performance and Results Act; and 6) the views of CDC executive directors.

All work on this inspection was conducted between October 1998 and August 1999 in accordance with the Quality Standards for Inspections issued in March 1993 by the President's Council on Integrity and Efficiency.

RISK MANAGEMENT AND LENDER OVERSIGHT

In December of 1998, SBA formed an agency-wide risk management committee to identify the risk elements that lead to loan defaults. One of the committee's goals is to develop benchmarks for evaluating lender performance and identifying high-risk lenders for site visits from their respective SBA district offices. The benchmarks and lender oversight procedures have not yet been formalized, so we confined our review to the 504 program's existing risk management efforts and its lender oversight database.

Over the past year, 504 program staff at SBA's Central Office have developed a database combining information from SBA; Harris Trust, the fiscal agent,⁸ and Colson Services, the servicing agent. As a result, program officials have been able to obtain much more detailed information about a CDC's 504 portfolio and status, including loan approvals, portfolio diversity, average dollar investment per job created, and the percent of lending to firms owned by minorities and women. The database distinguishes PCLP, ALP, and regular 504 loan performance beginning in fiscal year 1999. To monitor a CDC's status, the Agency keeps data on the date of certification, last annual report submitted, last district office review, and regular, ALP or PCLP status.

Program officials are also tracking the performance of the portfolios of individual CDCs and the 504 program as a whole. The risk factors being used include—

- currency rate – ratio of loans that are 0 to 30 days current to the total active portfolio.
- delinquency rate – ratio of loans more than 30 days delinquent, including loans in liquidation, to the total active portfolio.
- default rate – ratio of loans more than 60 days delinquent, including loans in liquidation, to the total active portfolio.
- liquidation rate – ratio of the balance of loans in liquidation to the total active portfolio.
- loss rate – ratio of the balance of loans charged off to the total dollar amount of loans funded.

Central Office officials indicated that when a loan becomes 90 days past due, they notify the district office to ensure that efforts are being taken to bring it current. Other rates are also calculated, such as “currency rate with deferments,”⁹ which gives Headquarters officials an indication of whether the CDC is taking action to correct servicing problems. As mentioned above, these risk factors will be used to determine which CDCs represent a higher risk to the Agency and to trigger mandatory site reviews by district offices.

⁸ The fiscal agent is responsible for all aspects of selling the SBA-guaranteed 504 debentures on the secondary market.

⁹ This factor counts a loan as current if the CDC has an SBA-approved workout plan in place or if SBA is planning to purchase the debenture.

SBA appears to be developing the proper tools to evaluate risk of the CDCs' loan portfolios, including a 504 database that collects useful information on each CDC's activities. However, SBA does not currently have a mechanism in place for ensuring that CDCs are following key program regulations and procedures. The balance of this report focuses on specific findings and recommendations for improving the tools used to oversee the CDCs.

CDC ANNUAL REPORTS

CDCs are required to submit an annual report on their operations to SBA to assist the Agency in monitoring 504 loan activities. It provides summary information on a CDC's financial condition, portfolio, job creation/retention impact, management, board of directors, and contractual arrangements, among other items. Program regulations require that each CDC submit two copies of its report to its SBA district office within 90 days after the close of its fiscal year. The field office is then supposed to review the report, using a standardized checklist, and forward a summary of its findings, along with a copy of the CDC report, to the Central Office for review and filing. The reports are designed to produce uniform reporting by all CDCs and provide comparable data to SBA in a timely manner.

The annual report is composed of three sections—

- *Management report*, which provides analytical data on the impact of the CDC's assistance to small business and a summary of the status of its portfolio;
- *Operating report*, which contains information for verifying that the CDC's membership and method of operations are consistent with the requirements of the program;
- *Financial report*, which provides data on the status of the CDC's financial condition, including its financial statements.

After determining that there were insufficient 1998 reports on file at Central Office for a meaningful review, the team examined 240 1997 annual reports that were in Central Office files or submitted to us by district offices.¹⁰ While we believe that the annual reports can be an effective oversight tool, we are also concerned about the lack of compliance by some CDCs with key reporting requirements in SBA's Standard Operating Procedure (SOP). We have identified a number of changes that would make the annual reports more useful for oversight purposes.

¹⁰ The inspection team requested 138 CDC annual reports from SBA district offices that were missing from Headquarters' files.

Timeliness of Annual Report Submission

The inspection team found that SBA district offices were not forwarding the CDC annual reports to the Central Office in a timely manner. When we examined the annual reports, we found that many were missing; even after receiving a special request, district offices responsible for almost 30 CDCs failed to send in the reports for 1997. Program officials in Headquarters also had to make a special request for copies of the 1998 annual reports from district offices. According to their records, by July 1999, 38 percent of the 1998 annual reports had still not been forwarded to Central Office. Because a CDC's fiscal year normally ends in June, September, or December, the 1998 annual reports should have been submitted to district offices seven to twelve months ago. Further, over 10 percent of the most current annual reports on file at Headquarters dated back to 1991-93.

The CDC annual reports provide detailed information that is useful for assessing CDC activities. Now that the Central Office has a systematic review process in place, as discussed below, it is even more important that the district offices obtain timely submissions from the CDCs, prepare their summary assessments, and forward both documents to Headquarters.

Recommendation 1: SBA should ensure that its district offices obtain, review, and forward all CDC annual reports and summary assessments to the Central Office in a timely manner.

Use of the Annual Reports by SBA Program and District Officials

In the past, due to limited staff and resources, Central Office officials have usually examined annual reports only when particular issues arose. Thus, there has not been any comprehensive review of the annual reports by 504 program officials at SBA Headquarters.

During the course of our inspection, however, 504 staff developed new procedures that they plan to use for more systematic checking of annual reports. The areas to be reviewed include—

- financial statementscontractual agreements
- job opportunities
- economic development strategy
- CDC membership and board meetings
- legal actions
- changes to CDC structure

Also, under the new procedures, when a CDC applies for expansion into a new territory or for a change to ALP or PCLP status, the Central Office will first verify that the CDC has met all annual reporting requirements. These procedures could be part of an effective

oversight program if they were fully employed and accompanied by immediate follow-up on any deficiencies that were identified.

As indicated earlier, district offices are expected to review all annual reports using a checklist that is specified in the Agency's SOP. The process includes examining CDC loan activity, organizational changes, and financial capacity, then forwarding the results to the Central Office, along with the annual report and the district office's overall rating of the CDC's underwriting and servicing performance.

Of the 1997 reports that were on file at Headquarters, however, 17 percent were missing the checklist, which provides evidence of a review by a district office.¹¹ This is of concern because it is unclear to what extent district offices are actually conducting a thorough review of CDCs.

Annual Report Survey

The inspection team conducted a survey of district directors to obtain their views on the usefulness of CDC annual reports for oversight purposes. The results showed that while there was some variation in the way district offices used the reports, the majority found them helpful.

Of 46 respondents, 38 indicated that they considered the annual report useful for monitoring CDC activities. The sections of the report cited as most valuable for oversight purposes were the Management and Program Activity Summary (33 responses), the Analysis of Employment Impact (31), the Financial Report (31), and the Officers/Directors/Membership/Staff Update (27). The sections cited most often as not useful were CDC Board Meetings (24 responses), Analysis of Income (16), Economic Development Strategy (14), Legal (14) and Summary of Other Programs and Activities (12). Several respondents indicated that the Analysis of Income section duplicated much of the information provided in CDC financial statements and others thought the Overview of CDC Activity and Economic Development Strategy sections were often redundant.

This survey, as well as follow-up phone calls to district offices, also revealed that district officials were not consistently using the information provided in the annual reports to monitor CDC activities. Some district officials indicated that they did not use the reports at all for oversight. This is a concern because the inspection team and officials at SBA headquarters believe the annual report is essential for oversight. For example, some district offices indicated that the Financial Report and Contractual Agreements sections were not useful and should not be required. It appears clear to us, however, that a financial report is useful because it lists a CDC's revenues, expenses, and net income and provides an overview of the CDC's financial performance over a one-year period. Additionally, it can be used to determine whether 504 revenues collected by CDCs comply with program rules. CDC contracts are important because regulations stipulate

¹¹ Many of the annual reports submitted directly to the OIG were also missing the review checklist, but it is unclear if they omitted it intentionally, because it was not specifically requested, or if it was never completed.

that district offices review them to ensure that they meet program requirements and preclude self-dealing. The fact that some district officials did not find these sections useful raises questions about the degree of oversight exercised in the field offices.

SBA's Office of Financial Assistance should provide guidance to the district offices on how to make effective use of CDC annual reports. In preparing the guidance, SBA needs to review existing CDC annual report requirements to ensure the Agency solicits the information necessary to conduct meaningful oversight. For example, we found that the Analysis of Income section duplicated information provided in CDC financial statements.

Recommendation 2: SBA 504 program officials, in consultation with the district offices, should review existing CDC annual report requirements to ensure that the Agency solicits the information necessary to conduct effective program oversight. 504 program officials should then provide guidance to the district offices on how to effectively review CDC annual reports.

A number of district directors also suggested that electronic transmission of annual reports would make them easier to produce and provide a record of receipt that could be retained at SBA Headquarters. Another respondent mentioned that to ensure uniformity, all of the CDCs should be provided a standard software package to create the annual report. Based on our discussions with 504 officials and CDC executive directors, we believe that electronic submission of the annual reports would improve their timeliness and consistency.

Recommendation 3: SBA should examine the costs and benefits associated with the electronic submission of annual reports, in which all the CDCs would use a standardized software package to transmit their annual reports on-line to SBA.

Reporting of Fees

CDCs are allowed to charge 504 loan recipients processing, servicing, late, and assumption fees. After reviewing CDC annual reports, we found that some CDC financial statements listed 504 packaging and origination fees. To ascertain whether these fees were in addition to those allowed or simply listed by a different name, we compared the 504 processing revenues reported in the 1997 annual reports to allowable processing revenues. Due to a lack of consistency in CDC reporting, however, we were often unable to determine whether individual CDCs were charging more than the allowable amounts.

We found that 504 fees were often combined with each other or with revenues from other CDC programs. Nearly half of the 240 annual reports reviewed by the team did not list separately the revenues obtained exclusively from 504 processing and servicing fees. In addition, revenues received solely from 504 closing, assumption, or late fees were rarely defined. In many cases, the processing fees were given different names, such as

packaging, origination, or application fees. These inconsistencies made it virtually impossible to determine if CDCs were charging fees that were in conformance with program regulations. To perform meaningful oversight of the program, SBA first needs to require more uniform reporting of 504 revenues by the CDCs.

Processing Fees. Approximately half of the CDC annual reports we reviewed contained revenues that appeared to be strictly 504 processing fees.¹² For purposes of our analysis, we also treated 504 packaging and origination fees as processing fees, because they are not allowed as separate charges. We also included 504 application fees, where they were itemized separately, because they are supposed to be part of the processing fee. Program rules stipulate that CDCs may charge borrowers up to 1.5 percent of the *net* debenture proceeds to process 504 loans. Because SBA does not track net debentures, the team calculated allowable processing fees by multiplying each CDC's 504 *gross* debenture dollar amount at fiscal year-end by 1.5 percent.¹³ Comparing the allowed processing fees, as calculated, to revenues considered 504 processing fees, we found that approximately 25 percent of the CDCs appeared to be charging processing fees that were at least ten percent higher than allowed. This is a conservative estimate—if the actual net debenture amounts had been available for calculating allowable processing fees, a larger percentage of CDCs would have been identified.

Because of concerns with the way CDCs record 504 processing fees, the team looked more closely at 31 CDCs that appeared to be charging borrowers more than the allowed amount. Based on the data submitted by the CDCs in their annual reports, we determined that at least five of these CDCs charged excessive processing fees. Due to reporting inconsistencies, however, the team could not conclude if the fees of the other 26 CDCs also exceeded allowable amounts.

The lack of data required to determine if a CDC is charging more than the allowed processing fee substantiates the need for 504 fees to be reported separately from other revenues in CDC financial statements. It also raises serious concern that SBA is currently unable to monitor this aspect of the program.

To provide a more complete picture of CDC activity, each revenue and expense associated with the 504 program should be listed separately in CDC financial statement. For effective oversight, SBA must be able to determine a CDC's income from 504 processing, closing, servicing, late, and assumption fees. There also needs to be greater uniformity in the way CDCs itemize 504 revenues and related expenses.

Recommendation 4: SBA should track net debentures so it can identify CDCs that may be charging excessive processing fees and take corrective action.

¹² The team made every effort to review only 504 processing fees, but due to the reporting inconsistencies among CDCs, other fees may have been included in what was considered a 504 processing fee.

¹³ Several CDCs estimated that gross debenture amounts are roughly 2-3 percent higher than net debenture amounts.

Recommendation 5: SBA should require CDCs to list separately the dollar amount of revenue received from 504 processing, closing, servicing, late, and assumption fees in their financial statements.

Recommendation 6: SBA should require CDCs to list separately and explain all 504 expenses in their financial statements.

Servicing Fees. According to program regulations, CDCs may charge a servicing fee of between 0.5 percent and 2 percent per year on the unpaid balance of the loan as determined at five-year anniversary intervals. A servicing fee in excess of 1 percent (or 1.5 percent in rural areas) requires prior written approval by SBA. To determine if CDCs were charging excessive servicing fees, we obtained data from Colson Services, SBA's servicing agent, on all active loans that had a servicing fee greater than 1 percent. Out of a total portfolio of nearly 25,000 loans, only 136 loans made by 13 CDCs had servicing fees greater than 1 percent and none was above 1.5 percent. We looked at these CDCs' portfolios more closely and determined that they were not charging servicing fees above 1 percent on the majority of the loans they funded.

Our review of annual reports revealed that most CDCs are charging the minimum servicing fee of .5 percent. This was confirmed by officials from several district offices, who indicated that CDCs only charge higher than .5 percent on loans originated in rural areas, where servicing is more difficult. Although oversight procedures for such fees varied among district offices, officials at two suggested that because CDCs typically charge the .5 percent minimum servicing fee, they would question any service fee over this amount. The CDC must either provide a written request to the district office or explain the reason for charging the higher fee.

Compliance with Generally Accepted Accounting Principles (GAAP)

According to program rules, CDC financial statements must conform to GAAP.¹⁴ Although the Agency SOP indicates that statements do not have to be audited by a Certified Public Accountant (CPA), more than half of the 240 annual reports we reviewed contained audited financial statements. A favorable opinion rendered by a CPA typically provides proof that a CDC's financial statements are in conformance with GAAP requirements. The financial statements of some other CDCs had been given a lower level of scrutiny by a CPA, i.e., the statements were "compiled" or "reviewed."¹⁵ In these cases, noncompliance with GAAP requirements can be determined, but compliance

¹⁴ GAAP encompasses the conventions, rules, and procedures necessary to define accepted accounting practice. These principles provide guidance on recording revenues, expenses, net income, costs, assets, liabilities, and equity in an organization's financial statements. GAAP also requires adequate disclosure of certain information, consistent reporting, and financial statements at set time intervals.

¹⁵ A compilation presents unaudited financial information provided by management. A review includes a CPA's analysis to determine the reasonableness of financial data based on discussions with management and referencing related historical data. It is more comprehensive than a compilation but less than an audit.

cannot be confirmed. Many others, especially those with a relatively low number of 504 loans, did not use CPA services at all, often due to the cost.

According to the CPAs, financial statements of nine CDCs that were audited or compiled were not in full compliance with GAAP. Some CDC financial statements were not in compliance because they used the cash basis of accounting instead of the accrual basis. The accrual basis of accounting provides more complete financial information about an organization. Other CDCs omitted a statement of changes of financial position or other financial disclosures required by GAAP.

Our concern is that SBA does not have a practical way to determine whether unaudited financial statements submitted by CDCs are in conformance with GAAP. Some CDCs do not conduct sufficient transactions to warrant services from a CPA, and many small CDCs cannot afford audits. As long as the GAAP requirement is in place, the Agency needs to provide an acceptable and affordable means for CDCs to verify compliance short of retaining a CPA.

A method of self-certification for CDCs that are not audited might serve to increase their awareness of GAAP requirements, lead to greater conformance, and provide grounds for pursuing any CDCs that fraudulently claim compliance. However, self-certification offers minimal accountability, makes circumvention of the requirements relatively easy, and provides little assurance to SBA. The Agency should explore this and other possible approaches, make the SOP requirements more specific with regard to satisfying GAAP, and provide guidance to CDCs on how to meet the requirements in an affordable and effective manner.

Recommendation 7: SBA should develop a means for certifying compliance with GAAP requirements by CDCs that do not have their financial statements audited by a CPA.

Examination of Third-Party Contractual Agreements

SBA regulations allow CDCs to contract out certain services, such as marketing, packaging, processing, and servicing, to outside providers subject to prior written approval from SBA. In addition, because many CDCs have affiliates,¹⁶ such as local economic development agencies, the SOP allows an affiliate of the CDC, with SBA's approval, to provide staff to the CDC. Contracts for legal and accounting services do not require approval from SBA. Our analysis of the CDCs' annual reports indicates that 114 of the 240 (48 percent) CDCs that we reviewed contract out services to a third party or an affiliate.

¹⁶ Code of Federal Regulations (CFR) 13, §121.103 defines affiliation as “when one concern controls or has the power to control the other, or a third-party or parties control or has the power to control both. SBA considers factors such as ownership, management, previous relationships or ties to another concerns, and contractual relationships when determining whether affiliation exists.”

CDCs often use contractors to reduce costs or improve the quality of services. Some CDCs are affiliates of local economic development agencies or government councils that share staff and operating expenses. Other CDCs, especially those that are new or very small, may not have the cash flow to justify hiring a full-time employee or pay benefits. In some cases, however, we found that 504 fee income was generating revenues to the for-profit contractors rather than being used to further economic development as intended by statute.

After reviewing CDC contracts with third parties and affiliates, examining CDC financial statements, and speaking with CDC directors and district officials, we identified three concerns—

- SBA does not consistently provide effective oversight of contracts.
- Some contractors are charging additional fees to the borrowers.
- Certain CDCs have contracts with for-profit management companies that make the CDC little more than a nonprofit front for the contractor.

Oversight of CDC Contracts. Although contracting out functions may be an effective way for CDCs to reduce costs or improve services, the contracts require close monitoring by SBA to curb potential abuse. CDCs are required to obtain written approval from SBA prior to implementing a contractual agreement with either third parties or affiliates. Further, the district office is required to review all contracts for services provided on an annual basis. We found that district offices are not always providing the required oversight of CDC contracts by reviewing and approving them prior to implementation.

We contacted seven district offices that had jurisdiction over at least one CDC that contracted out most or all of its functions. Only two of the seven district offices indicated that they had a “prior approval process” in place. One district office mistakenly believed it had no approval authority and that all contract approvals were made by the Central Office. Another district office didn’t interpret a CDC’s affiliate relationship as requiring a contract, but rather viewed it as an accounting transaction intended to spread overhead and staffing costs over several programs. Two indicated that their CDCs’ contracts had been approved by Central Office when the CDCs applied for certification and that annual reviews were not performed because the contracts had not changed. Another district office said it didn’t question the CDC’s contract because the CDC claimed it was fashioned after a contract previously approved by the Central Office for another CDC. One district office mistakenly believed that the Central Office had approval authority for contracts.

In addition, we found that CDCs do not regularly notify the district offices when changes are made to their contracts. Two district offices indicated that their CDCs were not diligent in requesting approval for contracts. One CDC refused to provide SBA a copy of its contract, stating that, in order to protect the confidentiality of its vendor, it could only provide contracts to funding sources.

The problem of inadequate oversight of CDC contractual agreements also extends to SBA Headquarters. CDC annual reports are required to include copies of contracts only if they are new or changed from the previous year. Due to space constraints, the 504 program office retains only the most recent CDC annual report, so if a contract was neither new nor changed in 1997, it would not be in the annual reports kept on file at Headquarters. As a result, many of the annual reports we reviewed did not contain copies of contracts. While many CDCs included written summaries of their contract agreements in their annual reports, as required, we were often unable to determine if the summaries referred to new or existing contracts. Further, without a copy of the contract, in many cases we were unable to determine any information about the contractor, the compensation arrangements, the specific services provided, or the term of the agreement. In short, the summaries did not provide enough information to be useful to SBA for oversight purposes.

Contracts contain information on services provided, fees charged, and the names of contractors. They could be an effective tool for SBA monitoring of the CDC program — a regular review of contracts would help ensure that the CDCs comply with program regulations, provide SBA with a better sense of the fees being charged by contractors, and keep SBA current on CDC activities.

Other contractual agreements we examined did not provide enough information to identify possible problems. For example, the lack of information on a contracting firm's owners or managers made it difficult to determine if there might be self-dealing or other conflicts of interest. The SOP requires the district offices to review each contract for services provided, excluding legal and accounting, on an annual basis to ensure there is no self-dealing. Several district offices indicated that they do not review contracts annually, or in some cases at all, because the contracts have terms up to ten years or were in place when the CDC was certified by SBA. Even if no changes are made to a contract itself, other variables affecting the circumstances of the contract may change, rendering it no longer acceptable. For example, changes in ownership and control of a CDC or its contractor may create a conflict of interest. Therefore, we believe it is necessary for the district office not only to review each contract on an annual basis, but also to obtain any other information about the affiliate or contractor that would help make an informed decision. Our findings show a clear need for additional training of district office personnel in the review of CDC contracts.

Recommendation 8: CDCs should include copies of all current contracts in their annual reports for review by district office and Headquarters officials.

Recommendation 9: SBA should provide the district offices with standardized procedures for reviewing all third-party and affiliate contracts and hold them accountable for conducting the reviews on an annual basis.

Contractors Charging Additional Fees. The inspection team also examined the fees charged by third-party contractors and found evidence that contractors — especially loan packagers¹⁷ — are charging unallowable fees to borrowers. The SOP states —

Under no circumstances must the compensation paid under the contract be charged directly to the small business receiving assistance. The CDC, not the small business, is to compensate the packager out of the fees it is authorized to collect. A CDC that violates this provision risks being decertified.¹⁸

A CDC is authorized to collect a 1.5 percent processing fee, which is supposed to cover the costs of underwriting the loan. If the packager were allowed to charge additional fees, a CDC could contract out all the underwriting functions while still collecting the 1.5 percent fee. Market forces would not necessarily force fees downward because some geographic areas are covered by only one or two CDCs.

The loan guarantee and the servicing agreement both list the fees the CDC charges to the borrower but do not indicate whether a loan packager is being used, what fee is being charged, or whether the borrower is paying the packager directly. Our anonymous survey of 237 CDCs indicates that 17 were aware that their loan packagers were charging fees in addition to the 1.5 percent processing fee, while another nine CDCs claimed they did not know if their loan packagers charged an additional fee. (See appendix A)

Because contracts were often unavailable to determine packagers' compensation, we were unable to determine the extent of the problem. We believe that the results of our survey, however, warrant a closer look by SBA. We also do not know if CDCs are intentionally allowing packagers to charge borrowers disallowed fees or if they lack a clear understanding of which fees are allowed.

Recommendation 10: SBA should ensure, as part of its regular oversight process, that loan packagers contracted by CDCs are not charging fees to the borrowers.

Recommendation 11: SBA should issue guidance to all district offices and CDCs clarifying what fees can be charged to the borrower.

Contracts with For-Profit Management Companies. Typical functions of a CDC include marketing, packaging, processing, closing and servicing 504 loans. Many CDCs that outsource most of these functions enter into contracts with non-profit affiliates such as local economic development agencies. These affiliates often provide the staff, including the Executive Director of the CDC. The contracts we reviewed often based compensation on a portion of the 1.5 percent processing fee. At least three contracts, however, effectively gave responsibility for all CDC functions to a third-party contractor

¹⁷ As defined in the CFR, loan packagers are agents compensated by either loan applicants or lenders to prepare loan applications.

¹⁸ SOP, §120.824 (3)(g), p.378.

or affiliate. In all three cases, the “management contract” was given to a for-profit company. In two of the cases, the executive director/president of the CDC was also an owner or president of the management company. In the third case, the contractor assisted the CDC in choosing both its members and its board of directors.

In these three cases, compensation from the CDCs to the management companies appeared to be quite generous. One company received all CDC fee income, a management fee to cover all expenses, and a management bonus tied to the CDC’s operating income. Another received all compensation payable to the CDC. The third company, according to its contract, received \$85 an hour plus 25 percent of the CDC’s fee income. According to 1997 financial statements, the CDC’s fee income totaled \$1.84 million, and the management fee charged to the CDC was \$1.16 million.

A fourth relationship also appeared to violate SBA regulations because the CDC contracted out not only the allowable marketing, processing, packaging, and servicing functions to a third party, but also all management responsibilities. Further, the third-party contractor was the CDC’s Director, Officer, and Board member. The district office, which became aware of the situation when reviewing the CDC’s request for expansion, delayed the request pending its re-evaluation of the contract. It ultimately required the CDC to correct the violations, and we were provided documentation showing that the contract was renegotiated and is now in conformance with SBA regulations.

In the 1980s, SBA changed the regulations to no longer allow CDCs to be for-profit, unless they were grandfathered in. Agency officials were worried about the direction the for-profit CDCs were taking the program. At the time, 504 program officials expressed concern about CDCs that were being established and operated for the purpose of generating income for themselves rather than to further the economic development goals of the program.

With for-profit CDCs no longer a problem, OFA officials are now concerned about contractual relationships allowing CDCs to generate profits for themselves or other private parties. Some CDCs appear to be accomplishing by indirect means what is directly prohibited by regulations; through the creation of non-profit “fronts” or “shell” organizations, they can evade the rules barring for-profit CDCs. Several district offices we contacted also voiced concern about this type of contractual relationship existing in their jurisdictions, and one may recommend that a CDC be de-certified because of it. Some of the comments were—

- Support from members of the CDC is limited when all operations are contracted out.
- We believe contracting out all the services of the CDC to a for-profit business circumvents the intent of the 504 program. In effect, we have for-profit CDCs.
- Since the CDC has no employees, no cash reserve, and in some cases, no place of business or office equipment, the CDC is at the mercy of the management firm.

- It is doubtful that a for-profit company would market the program to smaller businesses that need small loans. Their tendency would be to concentrate on the larger loans where most of the money is made.
- When all of the revenues ultimately go to the management provider without any set-aside provision for the CDC's self-sufficiency, the program is not operating as intended.

While regulations forbid a participant to self-deal, they do not distinguish "affiliation," which is allowable, from "self-dealing," which is not. We believe, however, that the examples cited above contravene the intent of the program and violate regulations that forbid self-dealing and obligate CDCs to act ethically. While we do not believe that this is an extensive problem within the program, SBA should respond to these cases.

Recommendation 12: SBA should clarify its policy on contracting out the majority of services to for-profit companies and exercise more oversight to prevent program violations.

PERFORMANCE MEASUREMENT

The Government Performance and Results Act (Results Act). The Results Act of 1993 was enacted to improve Government performance and accountability through better planning and reporting of agencies' results. The Act requires Federal agencies to set strategic goals, measure performance, and report to the President and Congress on the degree to which goals are met. Congress intended for the Results Act to assist it in allocating funds based on agencies' ability to show the results of their programs and services.

The Results Act requires each agency to prepare a five-year strategic plan and an annual performance plan covering each program activity in the agency's budget. These two plans link long-term agency goals with the daily activities of managers and staff. The annual performance plan describes progress towards the performance goals, the resources needed to achieve those goals, and the methods for verifying and validating the measures. Beginning in March 2000, agencies will report to the President and Congress on program results from the previous year, comparing the performance indicators established in the annual plan with actual program performance. For goals that are not met, the agency must explain the reasons and the actions it plans to take to achieve the goals in the next year. It will also be important to look for trends over time.

SBA's FY 2000 Annual Performance Plan has both "output" and "outcome" measures for the 504 program. Output measures to meet SBA's strategic goal of increasing opportunities for small businesses include funding 5,200 loans and creating or retaining 113,966 jobs for 504 program loan recipients. The plan also emphasizes increasing the number of loans to minority, women, and veteran-owned businesses. The outcome measures for the 504 program are job creation, job retention, and increased revenue by the small businesses that received 504 loans.

This inspection focused on SBA's use of job creation and retention as a measure of 504 program performance, because job growth is both a legislative goal of the 504 program and the only 504 outcome measure for which SBA currently collects data. We have not examined other business growth indicators, such as taxes paid and sales, that SBA hopes to use as measures in the future.

Background of the Job Creation Requirement. The statutory purpose of the 504 program is to “foster economic development and to create or preserve job opportunities;¹⁹ improving the economy of the locality . . . ; or the achievement of one or more public policy goals”²⁰ In 1988, a monetary requirement was added to the Code of Federal Regulations (CFR) of at least one job opportunity for every \$15,000 of debenture assistance; two years later the requirement was increased to \$35,000. Community development and national objectives can substitute for job creation, provided the CDC's portfolio maintains an average of one job opportunity per \$35,000 of 504 financing.

CDCs ask borrowers to project the number of jobs that will be created and retained as a result of 504 funding. Two years later, CDCs ask borrowers how many jobs were actually created and retained. In order to determine whether a CDC's entire portfolio meets the requirement of one job per \$35,000 of funding, the CDC adds the estimated data for loans less than two years old to the actual jobs for loans over two years old.

Tracking Job Creation and Retention. After reviewing job opportunity numbers collected by 30 CDCs, we found substantial variations in the way they collected and reported job opportunity data. The SOP for the 504 program defines a “retained” job as one that would have been eliminated absent 504 financing. Five CDCs did not track jobs retained for many or all of loans in their portfolio, and two counted all existing jobs as retained. We could not determine whether the jobs were created or retained on one CDC's portfolio because they were combined in a category called “employment impact.” Another CDC simply compared the number of jobs before and after the financing. We also found that two CDCs reported job opportunities up to 11 years after funding, rather than the required two years. This approach produces figures that are incompatible with the two-year data of the rest of the CDCs; moreover, the validity of attributing job growth to a CDC's 504 loans that long after funding is highly questionable due to the influence of external factors. Finally, many of the actual job opportunities reported two years after a loan was funded varied greatly from the number originally projected. About half of the CDCs' projections were higher than actual jobs and about half were lower.

Other OIG and SBA officials have also questioned the reliability of the CDCs' jobs data. A 1994 OIG audit of six CDCs found that they “. . . did not always comply with SBA's job opportunity reporting requirements and in some cases made errors in the number of jobs reported.” The district office that had jurisdiction over the audited CDCs responded that the findings were consistent with its experience in trying to get CDCs to gather and report jobs data properly. In another case, the district office's review of a CDC reported,

¹⁹ A job opportunity is defined as a job created or retained.

²⁰ Small Business Investment Act of 1958, Title V, §501(a), p.340 & Title V, §501(d)(2) & d(3), p.341.

“There were still errors in job counts even after I asked for corrections.” An SBA Headquarters official also expressed concern about the method of estimating jobs for the first two years, adding that job creation alone does not give a complete picture of the results of a loan.

We understand that SBA uses projections because the legislation requires the CDCs to show that each borrower meets one of the economic goals in order to qualify for a loan. We also understand that CDCs must add estimates to actual figures to ensure that their total portfolio meets the job requirement. As described below, we are concerned that the data reported in the CDC annual reports provides the foundation for job creation estimates currently found in SBA’s Annual Performance Plan.

Reporting Outcome Measures for the Agency’s Annual Performance Plan. The data in the FY 2000 plan uses estimates based on CDC-reported historical data. The 504 program calculates that one job is created or retained for each \$12,855 of 504 funding, and to obtain a total job projection, it divides that figure into the amount expected to be loaned in FY 2000. According to SBA officials, the \$12,855 figure has been used in the past and was derived from an aggregation of CDC annual reports. It is not clear, however, what time period was used to calculate the amount or whether it is still valid.

Another reason to question the validity of the \$12,855 amount is because the most recent annual reports are not often available in the Central Office. For example, at the time of the inspection, Headquarters was missing more than one-third of the CDCs’ most recent annual reports. To include all CDCs in the calculation, SBA would have to combine jobs data from annual reports dating from 1991 to 1998. More than 10 percent of the available data came from reports over four years old. This raises additional questions about the reliability of any base figure generated. SBA needs to improve its method for estimating the average loan amount per job created. At the very least, it needs to be recalculated on an annual basis, to ensure reasonable currency, and be based on data in CDC reports from the same fiscal year.

Finally, adding estimates and actual job opportunities is not a valid method for reporting outcome measures for the Agency’s annual plan. The Results Act legislation requires SBA to describe in its performance plans the methods used to verify and validate measures. Under the present system, the Agency will not be able to verify or validate jobs data for the 504 program because not only is it self-reported by loan recipients, but it is based, in part, on estimations of jobs that will be created and retained. For annual plan purposes, rather than giving estimated and actual jobs created/retained for the entire 504 portfolio, SBA should report only those jobs actually created two years after funding. This data can be obtained from the “Analysis of Employment Impact” in the CDCs’ annual reports. Even in this case, SBA would need to include a caveat that its numbers are based on what the loan recipients and CDCs report.

Recommendation 13: SBA should base 504 outcome measures in the Agency’s Annual Performance Plan on actual jobs created and retained as of two years after funding.

SBA also should explore ways to improve the quality of data it receives from the CDCs. Prior to 1988, regulations required job opportunity estimates to be based on objective data submitted with the loan application. The regulations today, however, are silent on job estimate justification. Estimates might be more reliable if district offices required CDCs to submit justification such as business plans or outyear forecasts. In addition, Central Office staff should ensure that district offices are reviewing the job creation/retention impact of the CDCs' portfolios. This could be accomplished by adding questions to the district office annual report review checklist, such as, "In what percentage of loans did the CDC estimate exceed the actual number of jobs by more than 10 percent?"

CDCs should also track their clients so they can answer the fundamental question, "Is the borrower better off now than prior to 504 funding?" CDCs already collect financial statements from their borrowers and could easily track sales and revenue. To obtain better cooperation from the borrowers, SBA could require them to sign a document at closing in which they agree to provide certain data to the CDCs. In addition, CDCs could sort their portfolio by industry type so that SBA could determine which types of loans have the greatest impact on the economy or whether external forces, such as new technology, have a negative impact on job creation. A more descriptive analysis of the impact the funding had on the business community, along with a greater focus on trends over time, would allow SBA to better report its accomplishments to Congress.

Recommendation 14: SBA should take steps to improve the quality of outcome measures collected by the CDCs.

RESULTS OF CERTIFIED DEVELOPMENT COMPANY SURVEY

The inspection team distributed surveys to all CDC executive directors to obtain their perspectives on the 504 program and ways in which it might be improved. Of the 268 surveys distributed, 237 (88 percent) were completed and returned to the OIG.

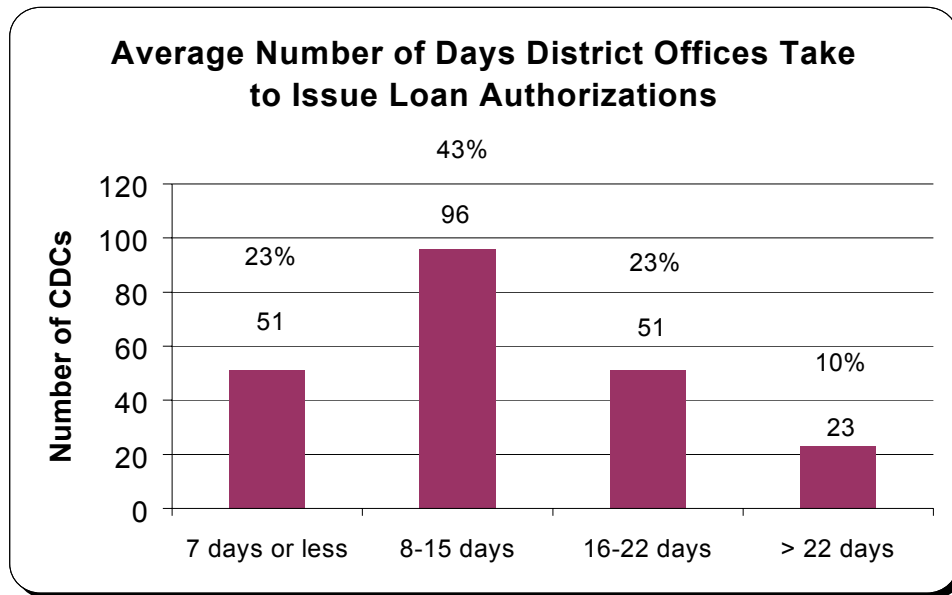
Relationship with District Office. Overall, the CDCs were very positive about their relations with SBA district offices, with just over 64 percent indicating they were "excellent" and 31 percent "good."

The picture was less clear on how effectively SBA was providing the required oversight of the CDCs. Current 504 regulations require a site visit of each CDC every three years, but according to SBA officials, limited resources make this difficult. In the survey, 79 percent of the CDC executive directors reported having received an oversight visit within the last three years, but 21 percent indicated that it had been four or more years since SBA district officials last visited their CDCs.

Some CDC directors expressed concern about the length of time it takes SBA to authorize loans. Current program regulations require that regular CDC loans be approved

by the district offices within 15 days. As shown in Figure I, while the survey revealed that timeliness varied significantly among district offices, it also found that two-thirds of the directors had their loans approved on an average of 15 days or less. The largest group (43 percent) averaged 8-15 days, and almost a quarter (23 percent) normally received approval within seven days. Another quarter, however, reported authorization times of between 16 and 22 days, and ten percent indicated they normally exceeded 22 days. These results are consistent with the different levels of satisfaction expressed by the CDC directors: over a third were “very satisfied” with loan approval timeliness, another third were “somewhat satisfied,” and one-fifth indicated that they were “somewhat dissatisfied” or “very dissatisfied” with loan approval times (see Figure II).

Figure I



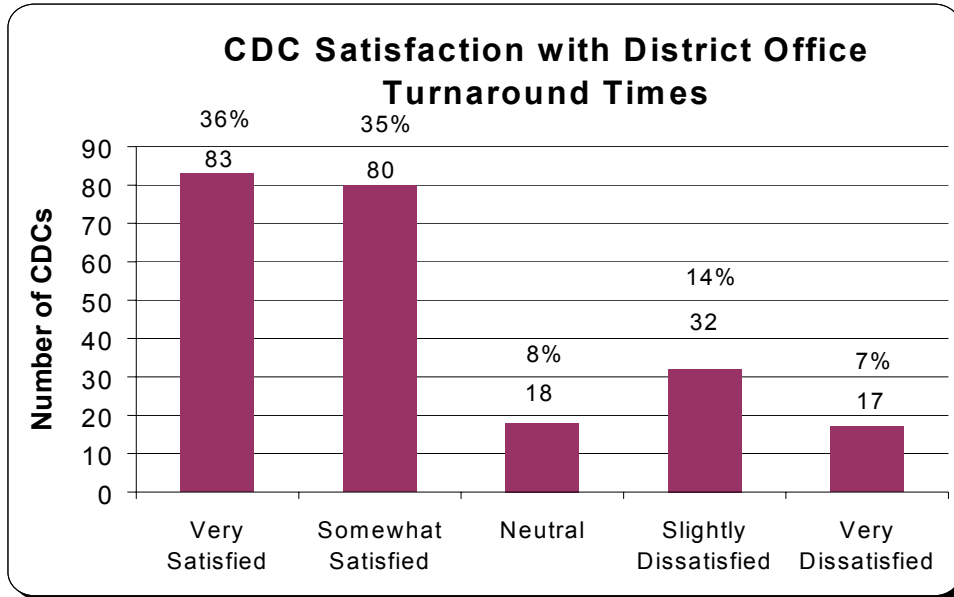
Total CDC respondents: 221
 (Percentages do not total 100% due to rounding)

Accredited Lender’s Program (ALP). The ALP was designed to give district offices the opportunity to rely more heavily on qualified CDCs to process and service loans. In exchange, these CDCs expect to receive a quicker approval of their loan packages from the district offices. District offices are required to process, approve, and issue the authorization for a loan submitted by an ALP-CDC in three business days.

The survey found that only 13 percent of ALP loans were approved within three days. Another third were approved within a week, leaving 54 percent of loan approvals exceeding seven days. Further, 57 percent of ALP respondents indicated that the three-day approval time is “very important,” and another 33 percent said it was “important.” The survey also provided space for comments about the ALP program. The predominant view was that the ALP status made little or no difference in turnaround times, and delays were often blamed on SBA’s legal review. Typical comments were—

- There is no difference between ALP and non-ALP. In terms of processing time, it does not work.
- There is no benefit to being an ALP lender. Our loans take just as long going ALP as they did under regular processing.
- The office does not seem to care about the deadline for ALP packages.

Figure II



Total CDC respondents: 230

Program officials indicated that they were aware of the problem. A Procedural Notice was sent to the district offices in October 1998 reminding them that ALP applications should be approved in three business days or less. It also reiterated the district offices' authority to suspend the ALP status of CDCs that routinely send incomplete or substandard packages. Therefore, it is incumbent upon the district offices not only to approve ALP loans on time, but also to initiate suspension of a CDC's ALP status when warranted. This is particularly important if poor quality ALP applications delay turnaround times.

Fifteen CDCs included positive comments about the ALP program. For some, having ALP status has made a difference, particularly with servicing actions. Comments included—

- Program has resulted in expeditious processing and servicing.
- ALP has been very helpful to our CDC with respect to servicing issues.
- It has helped us tremendously with our service to small business.

Premier Certified Lenders Program (PCLP). The PCLP is a pilot program that allows the participating CDCs to process, approve, close, service, and liquidate 504 loans. The SBA processing office only reviews loan requests for eligibility issues. In all other respects,

the CDC has authority to act in SBA's place. As part of the program, SBA requires each PCLP-CDC to fund a loan loss reserve. CDCs will use this loss reserve to reimburse SBA for ten percent of any loss sustained by SBA when a PCLP loan is charged-off. SBA has specified that a goal of 50 percent of participating CDC's yearly loan activity be made under PCLP.

Nineteen of the 20 PCLP-CDCs responded to the survey.²¹ Over half (53 percent) indicated that the program has lived up to their expectations when they joined the program "to a great extent", and 18 percent said it met them "to some extent." About a quarter of the respondents were "uncertain." Respondents indicated that the primary benefits of the program were faster service by SBA (72 percent), more authority to make decisions (72 percent), and the use of PCLP status for marketing and promoting the 504 program (61 percent).

We asked non-PCLP respondents if they planned to apply for participation in the PCLP program within the next three years. More than one-third indicated "no" (16 percent) or "probably not" (21 percent), and about a third said "yes" or "probably." Of those who stated they were not inclined to apply to the program, almost a third indicated the reason was that the "reserve requirement of one percent is a burden," a quarter said they "do not want added financial risk," a fifth were not interested because their "CDC has a low loan volume," and a fifth were "satisfied with current service by SBA."

Use of affiliates, contractors, and loan packagers and fees. A quarter of the respondents (59) indicated that they contract with or accept loan packages from a loan packager.²² Current regulations do not allow any charges for marketing, packaging or processing to the borrower in excess of the 1.5 percent processing fee. The survey found a number of cases in which fees being charged to borrowers violated these rules. Seventeen of the CDCs indicated that their packagers charge the borrower a fee in addition to the 1.5 percent processing fee charged by the CDC. The loan packager fees varied from an hourly rate to a percentage of the debenture between 0.25 percent and 2.5 percent. Some respondents also said fees could depend on the services provided. Nine other CDCs indicated that they do not know if additional fees were being charged to their borrowers. SBA needs to make sure that all CDCs are aware of the regulations and take appropriate action to curb charges in excess of the allowable fees. (See recommendations 10 and 11.)

Closing Costs. SBA regulations allow CDCs to charge borrowers a fee for "reasonable legal expenses . . . and reasonable miscellaneous closing costs." The survey asked CDC directors what closing fees, including attorney fees, were charged to borrowers, excluding the 1.5 percent processing fee. We were surprised by the large variation in closing fees. While six CDCs indicated that there were no additional charges, seven listed charges ranging from \$6,000 - \$10,000. Many CDCs gave a range of fees, with \$2,500 as the most frequently cited amount (70 CDCs). Such large variations in legal and closing costs

²¹ Since the survey, SBA has admitted five more CDCs to the PCLP program.

²² This question had one of the lowest response rates, with only 179 of 268 (75 percent) CDC directors choosing to complete it.

paid by borrowers call into question whether the vague wording of the regulations provides enough guidance to the CDCs. At the time of the inspection, there were no oversight policies that required a review of CDC fees to see if they were reasonable.

Variations may occur due to the size of the loan amount, the complexity of the loan deal, or differences in geography. Because the survey was conducted anonymously, however, we were unable to determine to what extent such factors might have been involved. The variations lead us to suggest, though, that SBA monitor CDCs where legal fees exceed \$2,500 to ensure that the charges are reasonable for the work performed.

Expansion. Program regulations call for SBA to approve geographically defined “areas of operation” for CDCs. The SOP states that each area “must not be less than citywide, and preferably county-wide, multi-county or statewide.” Expansion by one CDC into another’s area of operation has become an issue for many CDCs. Current rules allow a CDC to expand if the proposed area of expansion is not being adequately served and the expanding CDC has the resources and expertise to serve it.

Approximately one-third of the CDCs said their territory did not overlap with any other CDC’s territory, another third had some overlap, and one-third said all their territory overlapped with that of other CDCs (see Figure III).

Asked if competition among CDCs in overlapping areas was beneficial or harmful to the 504 program, CDC directors provided mixed responses. Thirty-five percent indicated that competition was “beneficial” or “probably beneficial” to the program, while 38 percent believed that it was “harmful” or “probably harmful”. A quarter of those surveyed were uncertain of the effect. Directors voiced concerns about the ability of CDCs from other areas to serve local needs and maintain a “community-based” program. They also worried that large CDCs would push out small ones. Other executive directors endorsed competition as a means to improve and expand service into under-served areas.

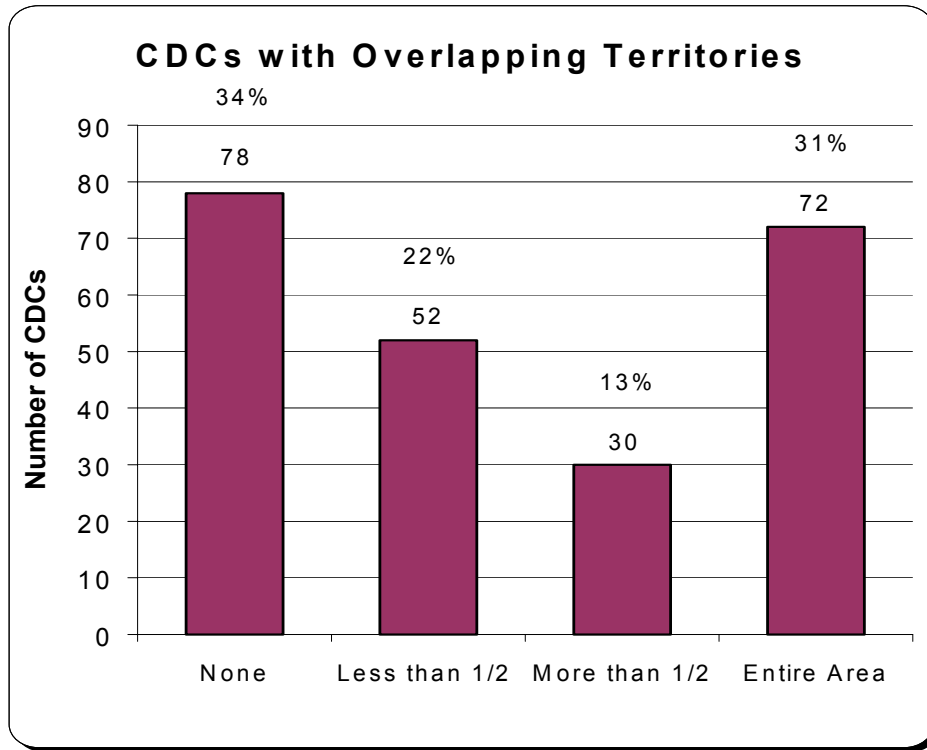
At the time of the inspection, SBA was considering allowing CDCs to expand into under-served territories in non-contiguous states as long as they established a separate membership, board of directors, and loan committee, with representation by the local community. SBA officials indicated that they would like to preserve the local character of the program while increasing 504 penetration into under-served territories.

Servicing Centers. The survey also asked respondents to compare the service they received from the Little Rock and Fresno Servicing Centers to the service previously received from SBA’s district offices. Overall, Little Rock received more positive feedback than Fresno. Fifty-two percent indicated that the service provided by Little Rock was “significantly better” (27 percent) or “somewhat better” (25 percent) than prior district office servicing, and almost a third stated that it was about the same. Only 13 percent indicated that it was “not as good” or “much worse.”

Thirty-eight percent of the respondents indicated that the Fresno Service Center was “significantly better” (21 percent) or “somewhat better” (17 percent), but forty percent

indicated that it was “not as good” (24 percent) or “much worse” (16 percent) than district office servicing. Seventeen percent believed servicing was about the same.

Figure III



Total CDC Respondents: 232

These results were further substantiated when respondents provided written comments about the service. Their views of the Little Rock servicing center were overwhelmingly positive (58 positive comments and 10 negative comments), while comments on Fresno were more negative (22 positive and 30 negative).

Summary. In conclusion, many CDC directors were not satisfied with the ALP program. District offices are not meeting the required three-day turnaround on these loans, and 90 percent of CDCs find it “very important” or “important” that loans are approved within this timeframe. SBA officials need to ensure that district offices are relying on the credit and eligibility analysis of the CDCs on ALP submitted loans. Prior to receiving ALP status, the CDCs should complete a rigorous qualification process to demonstrate that they not only provide SBA with complete and accurate loan packages, but also have a history of making reliable underwriting decisions. It is incumbent upon the Agency to monitor the program closely. If a CDC submits loan packages that no longer meet district office standards, the CDC should have its ALP status suspended or revoked.

Recommendation 15: SBA needs to ensure that district offices are approving ALP applications in three days and taking the necessary steps to revoke ALP status for any CDCs that submit loan packages that do not meet standards.

We are also concerned that 21 percent of the CDCs have not received a site visit from their district offices in four or more years. One director could not recall ever being visited by a district office representative. At the time of the inspection, SBA was in the process of issuing guidelines for performing site visits based on CDC performance. Even those CDCs that are performing well, however, should still be receiving site visits at least once every three years. While we believe that the CDC annual report submissions and daily or weekly contact are a valuable tool for providing oversight, effective monitoring also requires regular on-site reviews.

Recommendation 16: SBA should ensure that all district offices conduct site visits of CDCs at least once every three years, with CDCs experiencing performance problems receiving them more often.

SBA also needs to provide more guidance to the CDCs on closing fees. While some variation in fees charged to borrowers is reasonable due to loan complexity or geographic location, the wide range suggests that SBA does not clearly define what is acceptable.

Recommendation 17: SBA should monitor closing costs in excess of \$2,500 to ensure that the charges are reasonable for the work performed.

SBA Office of Inspector General
Survey of Certified Development Companies

1. In what year was your CDC certified? _____

# Respondents	237
Average year	1984

2. Approximately how often does the district office visit your CDC to examine its operations and look at files?

Response	#	%
Annually	80	34%
Every 2 years	65	28%
Every 3 years	40	17%
Every 4 years	10	4%
Less than 4 years	39	17%
Total	234	

3. What best describes your relationship with the district office? (If you work with two or more district offices, please answer for the two offices you work with most often.)

Primary District Office			Secondary District Office		
Response	#	%	Response	#	%
Very poor	0	0%	Very poor	0	0%
Poor	1	0%	Poor	1	2%
Fair	9	4%	Fair	7	17%
Good	74	31%	Good	16	38%
Excellent	152	64%	Excellent	18	43%
Total	236		Total	42	

4. On average, how long does it take the district office to issue an authorization for your regular (non-ALP or PCLP) 504 loans? (If you work with two or more district offices, please answer for the two offices you work with most often.)

Response	Primary		Secondary	
	#	%	#	%
7 business days or less	51	23%	8	22%
8 -15 business days	96	43%	18	50%
16-22 business days	51	23%	8	22%
More than 22 business days	23	10%	2	6%
Total	221		36	

5. How satisfied are you with the time it takes for regular 504 loans to be approved?

Response	#	%
Very satisfied	83	36%
Somewhat satisfied	80	35%
Neutral	18	8%
Slightly dissatisfied	32	14%
Very dissatisfied	17	7%
Total	230	

If you participate in the ALP program, please answer questions 6 – 8. Otherwise go to question 9.

6. On average, how long does it take the district office to issue an authorization for your ALP 504 loans? (If you work with two or more district offices, please answer for the two offices you work with most often.)

Response	Primary	%	Secondary	%
3 business days or less	10	13%	2	20%
4 -7 business days	27	34%	1	10%
8-15 business days	29	36%	7	70%
16-22 business days	10	13%	0	0%
More than 22 business days	4	5%	0	0%
Total	80		10	

7. How important is it to you that ALP loans be approved within three days?

Response	#	%
Very important	47	57%
Important	27	33%
No opinion	2	2%
Slightly important	3	4%
Not important	3	4%
Total	82	

8. Please add any comments regarding the ALP program.

If you participate in the PCLP program, please answer questions 9-12. Otherwise go to question 13.

9. How many loans have you processed under the PCLP program to date? _____

# Respondents	19
Total PCLP Loans Processed	394
Average # of loans	20.7

10. In your opinion, what are the primary benefits to participating in the PCLP program? (Check all that apply.)

Response	#	%
Faster service by SBA	13	72%
More Authority to make decisions	13	72%
Increased responsibility for liquidating loans	6	33%
Status is useful for marketing and promoting the 504 program	11	61%
Other	8	44%
# of PCLP respondents that marked items	18	

11. To what extent has the program lived up to the expectations you had when your CDC joined the program?

Response	#	%
To a great extent	9	53%
To some extent	3	18%
Uncertain	4	24%
To a slight extent	1	6%
Not at all	0	0%
Total	17	

12. Please provide any comments you would like to add regarding the PCLP program.

If you are not a PLCP participant, please answer questions 13–14. Otherwise go to question 15.

13. Do you plan to apply for participation in the PCLP program within the next 1-3 years?

Response	#	%
No	34	16%
Probably not	46	21%
Uncertain	63	29%
Probably	33	15%
Yes	41	19%
Total	217	

14. If no or probably not, why not? (Check all that apply.)

Response	#	%
CDC has low loan volume	45	19%
Reserve requirement of 1% is a burden	71	31%
Satisfied with current service by SBA	48	21%
Do not want added financial risk	59	26%
Other	8	3%
Total	231	

15. Which SBA servicing center currently handles your CDC loans?

Response	#
Fresno	119
Little Rock	102

16. Which best describes the service that you currently receive on 504 loans from the servicing center, as compared to the service you formerly received from SBA’s district office(s)?

Response	Fresno		Little Rock	
	#	%	#	%
Significantly better	26	21%	31	27%
Somewhat better	20	17%	28	25%
About the same	20	17%	35	31%
Not as good	29	24%	12	11%
Much worse	19	16%	2	2%
No opinion or not applicable	7	6%	5	4%
Total	121		113	

17. Please add any comments about the service you receive from SBA’s servicing center.

18. If your CDC contracts services to an affiliate of the CDC, please indicate for which services by checking the appropriate box(es) below. (According to SBA regulations, “Concerns are affiliates of each other when one concern controls or has the power to control the other, or a third party or parties controls or has the power to control both.”)

Response	#	%
Attorney	13	8%
Accountant	12	8%
Executive Director	21	14%
Marketing	19	12%
Loan packaging	21	14%
Loan processing	18	12%
Loan servicing	20	13%
Office space, telecommunications, &/or computers	24	16%
Others	5	3%
Total	153	

19. If your CDC uses independent contractors, please indicate for which services. (Check all that apply.)

Response	#	%
Attorney	178	48%
Accountant	69	19%
Executive Director	11	3%
Marketing	16	4%
Loan packaging	38	10%
Loan processing	19	5%
Loan servicing	15	4%
Office space, telecommunications, &/or computers	17	5%
Others	8	2%
Total	371	

20. If you contract with, or accept loan packages from, a loan packager, does the packager charge the borrower a fee that is in addition to the 1.5 percent processing fee charged by your CDC?

Response	#	%
Yes	17	9%
No	43	24%
Don't use a loan packager	111	62%
Don't know	9	5%
Total	180	

21. Do you use an Associate Development Company to provide any of the services indicated in question 19?

Response	#
Yes	15
No	212
Total	227

22. If yes, to what extent has your relationship with the Associate Development Company been beneficial to your CDC?

Response	#	%
To a great extent	1	7%
To some extent	3	20%
Uncertain	1	7%
To a slight extent	9	60%
Not at all	1	7%
Total	15	

23. Excluding the 1.5 percent processing fee, what is the closing fee, or range of closing fees, charged by your CDC (i.e., attorney fee, filing fees, and miscellaneous closing costs)? _____

Closing Fees	#	%
\$0 - \$1000	19	9%
\$1001 - \$2499	60	28%
\$2500 - \$3000	98	46%
\$3001- \$4999	25	12%
\$5000 - \$10,000	11	5%
Total	213	

24. Does your CDC's area of operation overlap with another CDC's territory?

Response	#	%
Yes, all of my CDC's area overlaps with one or more CDCs	72	31%
Yes, more than 1/2 of my CDC's area overlaps with one or more CDCs	30	13%
Yes, less than 1/2 of my CDC's area overlaps with one or more CDCs	52	22%
No, none of my CDC's area overlaps with one or more CDCs	78	34%
Total	232	

25. Where there is competition among CDCs in overlapping areas, is such competition beneficial or harmful to the 504 program?

Response	#	%
Beneficial	36	18%
Probably beneficial	33	17%
Uncertain	50	26%
Probably harmful	38	19%
Harmful	38	19%
Total	195	

26. Please add any comments you have regarding the issue of CDC expansion into other territories, including both within and outside state borders.

27. During the last three years, did your CDC's 504 revenues exceed 504 expenses? (Please check appropriate boxes.)

Response	Yes	%	No	%	Total
1996	172	75%	56	25%	228
1997	179	78%	51	22%	230
1998	191	82%	41	18%	232

28. How long did it take your CDC's 504 operations to reach a positive cash flow once certified by SBA?
(Number of years) _____

Years to profitability	
Responses	173
Average # of years	6.6

29. Please provide any additional comments or suggestions for improving the 504 program.

OPTIONAL: Your name: _____ Phone: _____

CDC name: _____

Please check here if you would like to be contacted to discuss these or other CDC-related matters.

Thank you very much.



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

APPENDIX B

DATE: September 30, 1999

TO: Tim Cross
Assistant Inspector General
for Inspection and Evaluation

THRU: Jane Palsgrove Butler
Associate Administrator
for Financial Assistance

FROM: Gail H. Hepler
Chief, 504 Loan Policy Branch

SUBJECT: Response to the Office of Inspector General's report dated September 22, 1999, entitled "SBA Oversight of the CDC Program"

The report from the Office of Inspector General (OIG) entitled "SBA Oversight of the CDC Program" is the result of a year-long study that included interviews with the Office of Financial Assistance (OFA) to enable the study to concentrate on aspects of the program where we had concerns. We also shared with OIG the steps the Loan Programs Division was taking to improve its oversight abilities.

OFA appreciates OIG's efforts in conducting this inspection. As our responses indicate, over the past year, OFA has made major strides in improving its management and oversight of the Certified Development Company (CDC) 504 Loan program. We believe that, in many cases, the survey and this inspection report serve to validate actions already taken and to support the general direction in which OFA is moving.

During this same year, the Office of Financial Assistance (OFA), the 504 Loan Policy Branch, developed and implemented a new database that combined the accounting for the 503/504 loans as well as the debentures. There are three sources of accounting information: SBA's database and that of two outside contractors. SBA tracks on an original basis approval and liquidation information on each debenture. Colson Services tracks loan accounting from disbursement of the debenture through SBA's purchase of the debenture. Harris Trust tracks the accounting for the debentures held by investors.

Using the data available from these sources, SBA creates a "report card" for each CDC. This report, "CDC at a Glance," (Exhibit 1) identifies on a monthly basis the currency rate, delinquency rate, default rate (for the debentures), liquidation rate, and loss rate for each CDC. It also compares the CDC with a tier group. And, it compares the CDC with

the benchmarks SBA has established to indicate acceptable and unacceptable risk for each of the factors.

The report also identifies other information about the CDC's portfolio including the number of approvals for the past three years as well as for the year in progress, when the CDC was certified, when its last annual report was received by SBA-Headquarters, what fiscal year the annual report was for, and whether the CDC has been approved for any expedited processing or closing designations and the date of such approvals and renewals.

Finally, during the period that this report covers, OFA also issued several notices and developed two regulations intended to address several areas of concern as identified by OFA prior to the OIG inspection.

The OFA response addresses the seventeen recommendations of the report grouped together by subject whenever possible.

Annual Reports

IG Recommendation No. 1: SBA should ensure that its district offices obtain, review, and forward all CDC annual reports and summary assessments to the Central Office in a timely manner.

OFA Answer: Agree. Three initiatives have been undertaken that address this recommendation.

1. OFA's "CDC at a Glance" (Exhibit 1) tracks the receipt at OFA of each CDC's annual report.
2. Each month the OFA financial analyst generates a report listing CDC annual reports that are past due. (Exhibit 2) Each field office is then sent an e-mail identifying the annual reports that are still missing. (Exhibit 3) Also the field offices are reminded during the monthly conference calls with OFA.
3. OFA issued a notice to remind the field offices to forward the CDC annual reports. (Exhibit 4)

IG Recommendation No. 2: SBA 504 program officials, in consultation with the district offices, should review the CDC annual report requirements to ensure that the Agency solicits only the information necessary to conduct effective program oversight.

OFA Answer: Agree. The 504 Loan Policy Branch has designed a prototype checklist that it is testing as part of its review of the 1998 annual reports received most recently. The commercial loan specialist that is testing the checklist is a Certified Public Accountant. When OFA is satisfied that the questions being asked are appropriate, we will finalize the checklist and provide it to the field offices for mandatory use as part of their annual reviews. (Exhibit 5)

Regarding the annual reports themselves, the 504 Loan Policy Branch is now closely reviewing each annual report to determine where any update or revision of the “CDC Program Annual Report Guide” (SBA Forms 1253 and 1253a) is required. The new “CDC at a Glance” system enables SBA to obtain on its own some of the information requested by SBA Form 1253, including Sections A, B, D & E. However, there is other information that SBA is not receiving that it should have in order to determine that the CDC is following the regulations and policies. OFA will continue to refine its CDC reporting requirements as it continues to improve its 504 program delivery and oversight mechanisms.

IG Recommendation No. 3: SBA should examine the costs and benefits associated with the electronic submission of annual reports, in which all the CDCs would use a standardized software package to transmit their annual reports on-line to SBA.

OFA Answer: Agree. Designing an electronic version of the CDC annual report is part of the Agency’s on-going systems modernization initiative. It is expected that this will be implemented within the structure of this major project.

IG Recommendation No. 4: SBA should track net debentures so it can identify CDCs that may be charging excessive processing fees and take corrective action.

OFA Answer: Agree. “Net” debentures do not include the closing costs that are included in “Gross” debentures. SBA guarantees the full amount of the “Gross” debenture and, therefore, uses this number for the loan approval amount. However, the “Net” debenture amounts are now being put in a database by Colson Services, the servicing agent. The “Net” debenture number is located on the Servicing Agent Agreement submitted with each loan closing. At OFA’s request,, Colson has recently been forwarding this information to the 504 Loan Policy Branch. Once SBA receives the detailed 504 income information as suggested by Recommendation No. 5, the “Net” debenture information will assist that OFA is now receiving will assist SBA in determining where it needs to take corrective action when overcharging by CDCs is indicated.

IG Recommendation No. 5: SBA should require CDCs to list separately the dollar amount of revenue received from 504 processing, closing, servicing, late, and assumption fees in their financial statements.

and

IG Recommendation No. 6: SBA should require CDCs to list separately and explain all 504 expenses in their financial statements.

OFA Answer to both recommendations: Agree. A copy of a proposed notice requiring detailed information beginning with the CDCs’ 2000 annual reports is enclosed. This notice is in clearance. (Exhibit 6)

IG Recommendation No. 7: SBA should develop a means for certifying compliance with GAAP requirements by CDCs that do not have their financial statements audited by a CPA.

OFA Answer: Partially agree. Prior to October, 1992, the OFA policy was to require an opinion audit if the CDC's portfolio was \$10 million or more. Below that a "review" was required unless the CDC could make a case that this requirement would cause undue hardship. When the policy was revised in 1992, it was meant to relax these requirements to permit the CDC the latitude of determining whether or not it needed an independent verification by a CPA in order to state that the financial statements were prepared in accordance with GAAP.

OFA is considering returning to the requirement of an independent verification of the CDC's financial statements if the CDC has a certain 504 portfolio size. SBA also is considering, in lieu of accountant-prepared financial statements, accepting the most recent federal tax returns if the CDC's portfolio is under a size standard. Both of these size standards are yet to be established. A copy of the current SBA field office review form regarding compliance with GAAP is enclosed. (Exhibit 7) By March 31, 2000, OFA will determine what new or revised policy it will implement, and will begin this implementation process.

CDC Fees and Contracts for Staff

IG Recommendation No. 8: CDCs should include copies of all current contracts in their annual reports for review by district office and Headquarters officials.

OFA Answer: Agree. SBA Form 1253 already requires copies of the contracts (Exhibit 8). However, OFA will implement a policy requiring each field office to forward to OFA a copy of each contract when the contract is pre-approved by the SBA field office. This will reinforce with both the CDCs and SBA field offices the requirement that SBA must pre-approve any contracts.

IG Recommendation No. 9: SBA should provide the district offices with standardized procedures for reviewing all third-party and affiliate contracts and hold them accountable for conducting reviews on an annual basis.

OFA Answer: Agree. On April 7, 1999, OFA requested copies of all contracts CDCs had with management companies, packagers and other service providers (Exhibit 9). This request was made in anticipation of OFA's development of standardized procedures for SBA field offices to pre-approve and review annually any CDC contracts for management and staff. A review of the SBA field offices responses as well as some of the contracts demonstrates the need for OFA to clarify and provide training for SBA field offices regarding oversight responsibilities. OFA will develop written procedural guidance by June 30, 2000. In addition, subject to availability of

funds, by the end of FY 2000 OFA will design appropriate field office training as part of the Office of Capital Access Lender Oversight program.

IG Recommendation No. 10: SBA should ensure, as part of its regular oversight process, that loan packagers contracted by CDCs are not charging fees to the borrowers.

OFA Answer: Agree. SOP 50-10, Subpart H, states that any staff services provided under contract by an outside individual or organization must be paid from the fee collected by the CDC for processing the loan. (Exhibit 10) OFA will issue a reminder of this requirement.

IG Recommendation No. 11: SBA should issue a guidance to all district offices and CDCs clarifying what fees can be charged to the borrower.

OFA Answer: Agree. On April 2, 1999, SBA published a proposed rule specifying the fees that can be charged to the borrower or to the first mortgage lender in the project. (Exhibit 11) OFA is analyzing the responses and expects to publish a final regulation by December 31, 1999. After the final rule is published, by March 31, 2000, OFA will issue guidance to the field/CDCs in the form of a notice and update to the SOP.

IG Recommendation No. 12: SBA should clarify its policy on contracting out the majority of services to for-profit companies and exercise more oversight to prevent program violations.

OFA Answer: Agree. OFA has addressed this issue in a proposed regulation, currently being reviewed by OMB, prior to publication for comment.

Annual Performance Plan

IG Recommendation No. 13: SBA should base 504 outcome measures in the Agency's Annual Performance Plan on actual jobs created and retained as of two years after funding.

OFA Answer: Partially agree. The Small Business Investment Act of 1958, Title V, Section 501 (d) requires that the overall portfolio of the development company must meet or exceed the job creation or retention criteria. It also requires that in order to qualify for assistance under this title, the development company must demonstrate that the project to be funded is directed toward at least one of the following economic development objectives: "the creation of job opportunities within two years of the completion of the project or the preservation or retention of jobs attributable to the project," improving the economy of the locality, or the achievement of one or more of the public policy goals. Since the Act requires that the CDC's overall portfolio must at least meet the job creation or retention criteria. (Exhibit 12) The recommendation would be a radical departure from SBA's methodology and would cease to reflect all

funded loans that have not reached their two-year anniversary. However, SBA will consider reporting both in accordance with the Agency's reporting outcome requirements for all the programs.

IG Recommendation No. 14: SBA should take steps to improve the quality of outcome measures collected by the CDCs.

OFA Response: Partially agree. Within the context of the Agency's overall outcome measures' reporting for all Agency programs, OFA will consider additional outcome measures for the 504 program. Regarding improving field offices review of the reported job creation/retention, OFA will consider adding a modification to the proposed CDC annual report checklist to review the job information that the CDC submits.

ALP Status

IG Recommendation No. 15: SBA needs to ensure that district offices are approving ALP applications in three days and taking the necessary steps to revoke ALP status for any CDCs that submit loan packages that do not meet standards.

OFA Response: Agree. The 504 Loan Policy Branch has received complaints from CDCs that their ALP requests were not being processed in three days. It was not possible for OFA to verify the validity of the complaints because ALP loans were not recognized in the SBA database any differently than other 504 loans. To resolve this problem, OFA issued a notice to the field requiring coding of all ALP-processed loans. (Exhibit 13) By December 31, 1999, OFA will review the data to determine if there are problems with turnaround time. If there are, OFA will work in coordination with the Office of Field Operations to correct the problems. (It must be noted that while OFA can issue reminders regarding this processing time requirement, OFA does not have line authority regarding field office performance.)

Regarding the ALP status of CDCs, ALP status is renewed every two years. With the new "CDC at a Glance" system, SBA is able to consider portfolio risk in making its determination whether or not to renew the CDC's status. Also the 504 Loan Policy Branch is able to remind district offices which CDCs need to be considered for renewal of their ALP status.

CDC Oversight Responsibilities of District Offices

IG Recommendation No. 16: SBA should ensure that all district offices conduct site visits of CDCs at least once every three years, with CDCs experiencing performance problems receiving them more often.

APPENDIX B

OFA Response: Agree. On September 17, 1999, OFA issued a notice to implement a Policy and Program Oversight System. (Exhibit 14) This system covers both the 7(a) and 504 programs and is mandatory for use by all field offices with all lenders.

IG Recommendation No. 17: SBA should monitor closing costs in excess of \$2,500 to ensure that the charges are reasonable for the work performed.

OFA Response: Disagree. OFA has never had a complaint regarding this issue. It may be that CDCs misunderstood the survey question and included, as closing costs, such items as appraisals and environmental surveys. These items are appropriately considered to be eligible projects costs. (Exhibit 15) Other costs may arise because the borrower is allowed to employ an attorney to represent him at both the debenture closing and at the first mortgage closing. (This is not an SBA requirement.) However, OFA will review the questionnaire and responses to determine what the issues may be, and, if necessary, will issue appropriate guidance or policy changes.

Note: The exhibits referred to in this response were too voluminous to include in this report

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