U.S. Small Business Administration

S
P
R
I
N
G

2
0
0
1

# Semiannual Report of the Inspector General

A Report to Congress
October 1, 2000 – March 31, 2001
**Pursuant to Public Law 95-452**

# Foreword

I am pleased to submit our Semiannual Report on the Office of Inspector General's (OIG) activities from October 1, 2000, to March 31, 2001.

During this period, the Office issued reports on 17 audits and 2 inspections. OIG investigations resulted in 32 indictments and 28 convictions for criminal violations. The Office brought its collective experience to bear in reviewing 115 legislative, regulatory, policy, and procedural proposals concerning SBA and Government-wide programs. Overall, OIG dollar accomplishments from all activities totaled over $20 million. All of this was accomplished with an appropriation level of $12.4 million (before rescission) and an average staff level of about 108.

While the numbers are impressive, they do not tell the whole story. The Office must continually strive to address those critical issues facing the Agency. As part of this effort, we developed a new list in December 2000 of the top ten management challenges facing SBA. We will continue to work with SBA managers to ensure that appropriate actions are taken to address these challenges. With respect to financial management within SBA, we contracted with a CPA firm to conduct the audit of SBA's FY 2000 financial statements. The Agency obtained an unqualified opinion on its financial statements for the fifth year in a row. The report contained no material weaknesses, based on SBA's actions over the past year to address financial reporting and systems control problems. In the area of information systems and computer security, we reviewed the Agency's activities under PDD 63 and its information systems controls. We will continue to assess SBA's progress in developing its loan monitoring system. As to lender oversight, we issued audit reports on ineligible borrowers and early defaulted loans, and continued to pursue investigations involving allegations of fraud against borrowers, lenders, and loan agents. Finally, we completed three more audits in a series of reviews on SBA's implementation of the Government Performance and Results Act. These reports contain significant findings and recommendations for continued improvements in SBA's operations.

I would like to express my deep appreciation for the ongoing support and interest of the Acting Administrator and SBA's senior staff. Without their willingness to assist us and take action on our recommendations, we would not be effective. Over the past year we have worked together to address many of the challenges facing SBA, and I believe that this has made a positive difference in the way Agency programs are being delivered to our customers, the small business men and women in America.

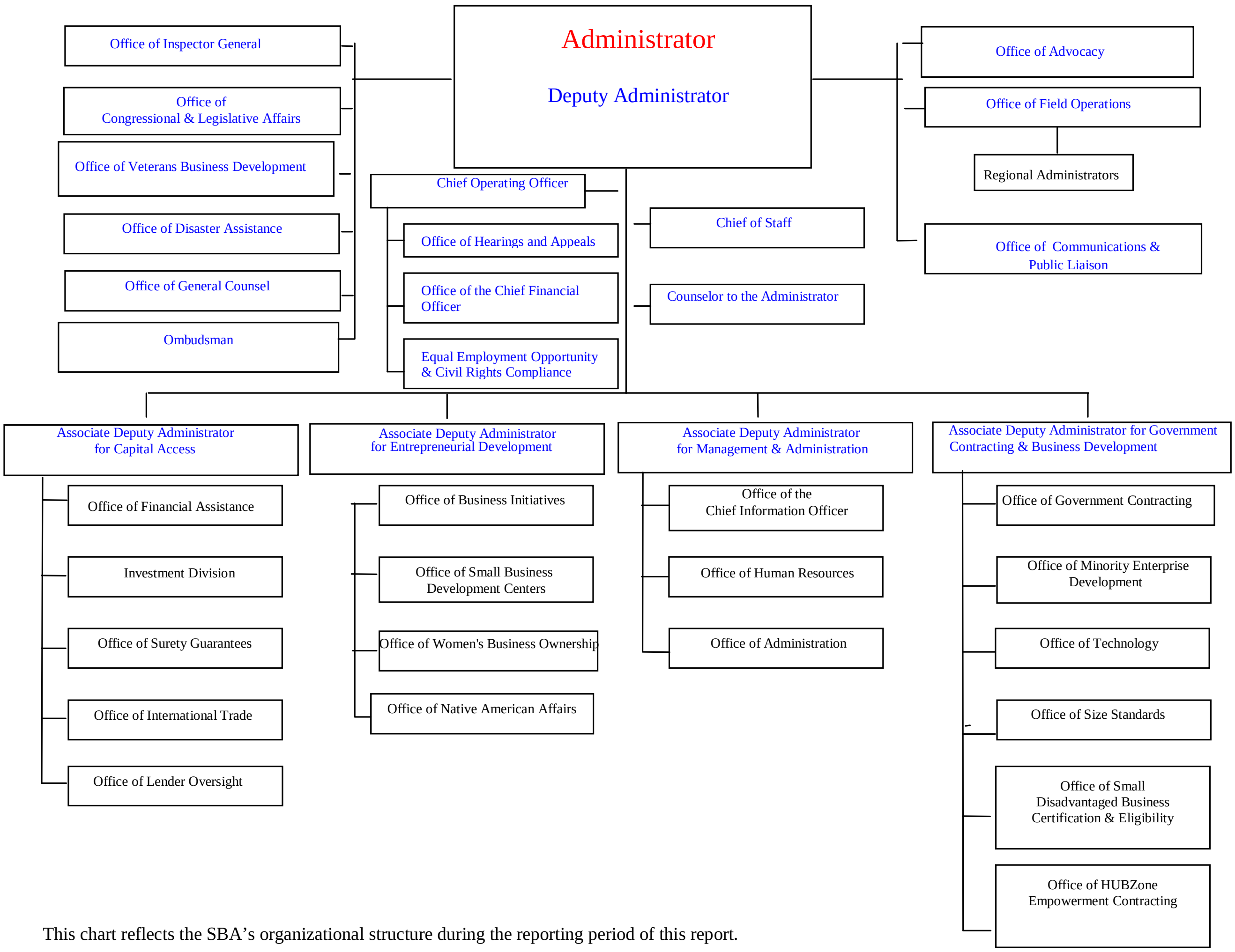
Phyllis K. Fong

Phyllis K. Fong
Inspector General

# Table of Contents

# SBA Overview

## United States Small Business Administration




This chart reflects the SBA's organizational structure during the reporting period of this report.

**Agency Overview**. The Small Business Administration (SBA) was established in 1953 to assist small businesses from startup through the many stages of growth. SBA's two major goals are to help small businesses succeed and help Americans recover from disasters. SBA offers many services to entrepreneurs, including assistance with developing a business plan, obtaining financing, marketing products and services, and addressing management issues. SBA programs are delivered by a network of field offices in every state, the District of Columbia, the Virgin Islands, Guam, and Puerto Rico. SBA has a FY 2001 appropriation of $899.5 million and has 4,190 employees including Disaster Assistance and Office of Inspector General (OIG).

**The Office of Capital Access** has several loan and other programs that assist small businesses. The largest business loan program is the Section 7(a). Currently, the Agency is authorized to guarantee up to $1 million of a small business loan. The maximum guarantees are 75 percent for loans over $150,000, and 85 percent for loans of $150,000 or less. Under the Section 7(a) authority, SBA offers a variety of specialized products and processes including the Certified and Preferred Lender programs (CLP and PLP), Low Documentation (LowDoc), SBA*Express*, Community Express, Pre-Qualification, CAPLines, Defense Loan and Technical Assistance (DELTA), Community Adjustment and Investment Loan, Export Working

Capital, International Trade Loan, Energy and Conservation Loan, and Pollution Control Loan programs. In addition, under the authority of Section 7(a) of the Small Business Act, SBA provides loans and grants to not-for-profit organizations that use these funds to provide small loans (currently up to $25,000) and technical assistance to small businesses. The Small Business Investment Act also authorizes SBA to guaranty debentures used to fund long term fixed asset purchases for developing small businesses. The Small Business Investment Company (SBIC) program provides supplemental funding to licensed SBICs who make equity-type investments in small business. All of the specialized business loan programs are intended to provide entrepreneurs financing vehicles needed to help them start or grow their small business. In FY 2000, the Office of Lender Oversight (OLO) was established to effectively coordinate oversight of the Sections 7(a) and 504 programs. In addition to the loan programs, the Office of Capital Access (OCA) also has the Surety Bond Guarantee (SBG) program, and an International Trade program.

**The Office of Entrepreneurial Development** administers programs that offer counseling and assistance through SBA's many resource partners and district offices. The resource partners include Service Corps of Retired Executives (SCORE), Small Business Development Centers (SBDC), Business Information Centers (BIC), Tribal Business Information Centers (TBIC), U.S. Export Assistance Centers (USEAC), One Stop Capital Shops (OSCS), and Women's Business Centers (WBC). These resource partners provide guidance and expertise to new entrepreneurs.

**The Office of Government Contracting and Business Development** administers programs that assist small businesses with Federal procurement opportunities. The Office of Business Development (BD) provides technical and procurement assistance to eligible businesses through two principal programs: (1) Business Development, which encompasses the Section 8(a) program and the Mentor-Protégé program; and (2) Management and Technical Assistance. BD also encompasses the Office of Small Disadvantaged Business Certification and Eligibility (SDBC&E), which certifies companies applying as small disadvantaged businesses. The Office of Policy, Planning and Liaison (OPPL) provides policy support for all of the Agency's procurement assistance programs. OPPL also encompasses the Office of Technology, which expands the competitiveness of small high technology research and development businesses in the Federal marketplace through two programs: Small Business Innovation Research and Small Business Technology Transfer. OPPL also includes the Office of Size Standards, which reviews and establishes industry size standards. The HUBZone Empowerment Contracting (HUBZone) program is designed to stimulate economic development and create jobs in urban and rural communities by providing contracting preferences to small businesses located in historically underutilized business zones. The Office of Government Contracting (GC) works with Federal agencies to establish and achieve goals for small business participation in Federal contracting. Through its field structure, GC reviews proposed procurements and identifies opportunities for all categories of small businesses.

**The Office of Disaster Assistance** offers assistance to victims of hurricanes, floods, earthquakes, wildfires, tornadoes, and other physical disasters. SBA's disaster loans are the primary form of Federal assistance for non-farm, private sector disaster losses. SBA is authorized by the Small Business Act to make three types of disaster loans: (1) physical disaster loans, which provide a primary source of funding for permanent rebuilding and replacement of uninsured disaster damages to homeowners, renters, non-farm businesses of all sizes, and nonprofit organizations; (2) economic injury disaster loans, which provide businesses with necessary working capital until normal operations resume after a physical disaster; and (3) pre-disaster mitigation loans. The disaster program is SBA's largest direct loan program, and the only SBA program for entities other than small businesses. SBA delivers disaster loans through four specialized Disaster Area Offices located in Niagara Falls, NY; Atlanta, GA; Ft. Worth, TX; and Sacramento, CA.

# Significant Activities and Management Challenges

## OIG Strategic Plan

OIG's Strategic Plan articulates the office's vision to improve SBA's programs by identifying key issues facing the Agency, ensuring that corrective actions are taken, and promoting a high level of integrity. OIG continues to focus on serving the needs of our customers and stakeholders and on safeguarding SBA resources from waste, fraud, and abuse. We strive to provide a work environment in OIG that is conducive to excellent performance by our employees. Our vision was translated into a new Strategic Plan for FYs 2001-2006 and a companion FY 2001 Annual Performance Plan that expands on the goals and objectives in the Strategic Plan. The three goals in the Strategic Plan are to: (1) improve the economy, efficiency, and effectiveness of SBA programs; (2) prevent and detect fraud and abuse, and foster integrity in SBA programs and operations; and (3) ensure the economical, efficient, and effective operation of OIG. These goals provide the broad framework of our mission from which we further focus our work in the following five cross-cutting areas: (1) financial management systems; (2) information systems and computer security; (3) lender oversight; (4) other selected high-risk issues; and (5) Agency initiatives. A summary of our Strategic Plan is provided on the inside cover of this report.

## Top 10 Major Management Challenges

In response to a congressional request on December 1, 2000, OIG submitted a list and assessment of the 10 most serious management challenges facing SBA in FY 2001. The current list identifies three new challenges and updates and/or consolidates those submitted last year.

This year, we do not list oversight of the Small Business Lending Companies (SBLC) as a separate challenge because we no longer consider it to be a major challenge on its own. SBA has agreed with nearly all the recommendations made in the Farm Credit Administration examination reports. Because the Agency has not yet implemented the recommended actions, however, we have included SBLC oversight in our challenge on improving lender oversight. SBA has established OLO that will oversee the SBLC examinations. Because cost accounting is now included in SBA's Systems Modernization Initiative (SMI), we have incorporated last year's cost accounting challenge into this year's challenge on modernizing Agency information systems for loan monitoring and financial management.

We also consolidated last year's challenges on loan agent fraud and criminal background checks on business loan borrowers into a single challenge on preventing loan fraud. The legislation needed to conduct criminal background checks on loan agents and on loan applicants, without requiring fingerprints, was proposed by SBA last year, but it was not reported out of the congressional conference committee. The fraud prevention measures cannot be implemented without specific legislative authority, so OIG is working with SBA to resubmit this proposal for Congressional approval this year.

OIG solicited and received substantial feedback from Agency managers and staff in developing these challenges. While OIG and SBA do not fully agree on some issues, the Agency's feedback helped OIG ensure that all points of view were given careful consideration and that the narrative discussions were factually accurate. The first four challenges focus on agency-wide issues that are critical to SBA's goal of modernizing the Agency. The following summaries represent the status of the challenges as of December 1, 2000, and do not reflect activities subsequent to that date.

### Agency-wide Issues

SBA needs to improve its managing for results, loan monitoring and financial management systems, information systems security, and human capital strategies.

**Challenge 1.** SBA needs to improve its managing for results processes and produce reliable performance data.

SBA needs to develop effective outcome measures, ensure that its performance data are accurate and reliable, and establish systems to manage for results. The Agency has taken steps to identify more program outcomes, improve performance measures, and increase the accuracy of its data. SBA still needs to develop: (1) agency-wide guidance on preparing performance goals and indicators; (2) standards and procedures for data verification and validation; and (3) client surveys and other methods to obtain outcome information.

**Challenge 2.** SBA faces significant challenges in modernizing its major loan monitoring and financial management systems.

SBA has ambitious plans to upgrade its systems for loan monitoring and financial management, but implementing those plans will require sustained commitment to achieve objectives and overcome systems development obstacles. The Agency has identified modernizing these systems as a major priority and has made progress in developing information technology procedures and controls. SBA needs to continue to formulate and implement sound procedures for systems development and acquisition to enable more effective and efficient loan monitoring and financial management.

**Challenge 3.** Information systems security needs improvement.

SBA operations depend heavily on the Agency's information systems; therefore the security of those systems is critical. The Agency has made a substantial commitment of resources for enhancing computer security, providing technical staff support, and developing security training. Although SBA has continued to make significant progress in implementing its information security program, further improvements are still needed. It needs to fully implement its agency-wide systems security program to include assessing risks, establishing and updating policies and controls, promoting awareness, and evaluating security effectiveness.

**Challenge 4.** Maximizing program performance requires that SBA fully implement its human capital management strategies.

The nature and scope of SBA's work has changed significantly, requiring a different set of skills in the Agency's workforce to maintain productivity. SBA has prepared an analysis that projects future workforce needs, expanded training and candidate development programs, and contracted for a workload and staffing study. The Agency needs to continue to develop its workforce planning, retraining, and other human capital management activities to ensure optimal performance of its employees.

### Loan Programs

The Agency needs to apply the guaranty purchase requirements consistently and continue to improve lender oversight.

**Challenge 5.** Field offices do not consistently apply guaranty purchase requirements.

OIG audits have shown that SBA field offices do not consistently follow Agency requirements when purchasing guaranties from lenders after loan defaults, resulting in purchases that may not be justified and are unnecessary expenditures for the Agency. In response to this concern, SBA reports that it has taken steps to establish a purchase review and follow-up process mechanism, a guaranty repair tracking system, an early warning system, and improved procedures and training. The Agency needs to: (1) ensure that it denies liability or reduces the guaranty when a lender fails to comply with SBA requirements; and (2) continue to develop a reporting process for guaranty repairs.

**Challenge 6.** SBA needs to continue improving lender oversight.

As SBA becomes increasingly dependent on private lenders to perform business loan functions, an effective lender oversight program is critical for ensuring that lender activities serve Agency objectives and comply with all rules and procedures. SBA has established OLO, completed the second round of PLP reviews and started the third, completed the second cycle of safety and soundness examinations of the non-depository SBLCs, and begun development of a comprehensive loan monitoring system (LMS). The Agency needs to ensure that all non-PLP lenders are reviewed periodically on a consistent basis, fully implement the LMS, establish baseline goals and measures for lender processing errors, and compare actual performance to goals.

### Section 8(a) Business Development

**Challenge 7.** More participating companies need access to business development and contracts in the Section 8(a) BD program.

The bulk of the dollar value of Section 8(a) BD contracts goes to a relatively

SBA needs to increase access to business development and contracts, provide clearer standards to determine economic disadvantage, and clarify rules that deter participants from passing procurement activity to non-Section 8(a) BD firms.

small number of companies in the program. SBA is participating in a recently formed interagency task force designed to, among other things, improve business development initiatives, including access to contracts. The Agency needs to give greater emphasis to business development assistance and ensure a more equitable distribution of contracting opportunities to program participants.

**Challenge 8.** SBA needs clearer standards to determine economic disadvantage.

New standards for determining economic disadvantage should be established to effectively measure diminished capital and credit opportunities–the definition included in the law. SBA anticipates issuing procedural guidance on the definition of "economic disadvantage" based on revisions to be made by a new interagency task force (see Challenge 7). The Agency should: (1) redefine "economic disadvantage" using objective, quantitative, qualitative, and other criteria that effectively measure capital and credit opportunities; and (2) provide sufficient training to SBA staff responsible for evaluating companies.

**Challenge 9.** SBA needs to clarify its rules intended to deter Section 8(a) BD participants from passing through procurement activity to non-Section 8(a) BD firms.

SBA's rules, while restricting the amount of a contract that a Section 8(a) BD firm may pass through to a non-Section 8(a) BD firm, allow many non-participating companies to receive substantial financial benefit. SBA intends to include value-added resellers as a legitimate industry under North American Industry Code. SBA needs to tighten the definition of "manufacturing" to preclude the pass-through practice of making only minor modifications to the products of other manufacturers.

### Fraud Deterrence and Detection

OIG recommends that the Agency obtain legislative authority to conduct background checks to deter and detect fraud.

**Challenge 10.** Preventing loan fraud requires additional measures, including the necessary legislative authority and funding.

Fraud in the business loan program could be reduced by obtaining criminal background information on prospective borrowers and on loan packagers and other for-fee agents. SBA submitted a proposal for the legislation necessary to conduct the background checks, but it was excluded from the reauthorization bill by the congressional conference committee. The Agency needs to resubmit the legislative proposal, establish a loan agent registration process, and track loan agent association with individual loans.

The next section of this chapter details significant OIG accomplishments in the five areas of strategic focus.

## Financial Management Systems

**FY 2000 Financial Statements**

SBA's FY 2000 financial statements received an unqualified opinion for the fifth consecutive year.

SBA's FY 2000 financial statements received an unqualified opinion for the fifth consecutive year. The opinion also noted that there were no material weaknesses this year, and that SBA is in substantial compliance with the Federal Financial Management Improvement Act. The independent auditors determined that the financial statements presented fairly, in all material aspects, the financial position of SBA as of September 30, 2000, and its net costs, changes in net position, budgetary resources, and financing for the years then ended were in conformity with generally accepted accounting principles. The independent auditors determined that there were two reportable conditions involving SBA's internal control and its operation that were not material weaknesses. Recommendations were made to correct these reportable conditions. In its response to the audit findings, the Chief Financial Officer (CFO) stated that SBA is working to eliminate the reportable conditions. The financial statements audit is discussed further in the OIG Activities chapter.

## Information Systems and Computer Security

**Presidential Decision Directive (PDD) 63 Audit**

OIG issued an audit report titled, "SBA's Planning and Assessment for Protecting SBA's Critical, Physical Infrastructure." PDD 63 calls for a national effort to ensure the security of the United States' critical infrastructures. OIG found that SBA has made some progress toward implementing PDD 63 requirements. OIG recommended that SBA revise its Critical Infrastructure Protection (CIP) Plan to include milestones and responsibilities for identification of physical Mission Essential Infrastructure (MEI), performance of vulnerability assessments, development of remedial plans, determination of resource requirements, and updating of policies and procedures as necessary. The Chief Information Officer (CIO) agreed with OIG's recommendations. This audit is further discussed in the OIG Activities chapter.

**Loan Monitoring System (LMS) Advisory Memorandum**

OIG makes suggestions for improving the Agency's loan monitoring system.

As part of an ongoing evaluation of the development of SBA's LMS, the first phase of the SBA's SMI, OIG released the first of a series of reports it plans to issue as project milestones are reached or significant concerns arise.

The advisory memorandum report addresses the need to: (1) update the LMS Project Plan; (2) expand the LMS security risk assessment as systems assets are defined; (3) document and distribute project status reports and the results of meetings and reviews; (4) strengthen the quality assurance function; and (5) strengthen acquisition planning. The Chief Operating Officer agreed with OIG's recommendations.

**FY 2000 SBA Information Systems Control Audit**

OIG issued an audit report on SBA's information systems controls. The report was based on the review of general controls over SBA's financial management systems, as part of the audit of SBA's FY 2000 financial statements. The report concluded that while SBA has continued to make significant progress in implementing its information systems security program, further improvements are still needed. The CIO generally agreed with the findings and recommendations. This audit is further discussed in the OIG Activities chapter.

## Lender Oversight

OIG recommends that OCA suspend disbursement of 31 loans to possible ineligible borrowers.

**Ineligible Borrowers Advisory Memorandum**

OIG conducted an audit that identified possible ineligible borrowers in the Section 7(a) business loan program and found 180 loans made during fiscal years 1998, 1999, and 2000, to applicants whose principals had previously defaulted on SBA loans. SBA regulations prohibit making new loans to borrowers who previously defaulted on a Federal loan, or federally-assisted financing, resulting in a loss to the Government. Of the 180 loans, 31 were loan commitments where proceeds were not yet disbursed. OIG recommended that OCA suspend loan disbursement until a determination is made that the principals are the same, that they declared the prior default, and that a waiver was granted. In the event a waiver was not granted, OIG recommended the loan commitment be cancelled. OCA concurred with our recommendations. This advisory audit is discussed further in the OIG Activities chapter.

OIG identifies $760,000 of funds recommended for better use when conducting early default audits.

**Early Default Audits**

OIG has an ongoing program to audit early defaulted SBA-guaranteed loans. An early default is a loan that is charged off or transferred to liquidation within 36 months of origination. Two early default audit reports were issued from October 2000, through March 2001. In both audits, OIG found that the lender did not comply with SBA regulations and procedures, and in the first audit, the borrower did not comply as well. The audits identified over $760,000 for possible recovery. As a result of both audits, SBA is taking appropriate action to correct the situations. Both audits are discussed further in the OIG

Activities chapter.

## Other Selected High-Risk Issues

Over the years, OIG investigations of fraud in SBA's loan programs have identified trends or types of fraud. Three major trends in recent years are: (1) fraud involving borrowers who do not disclose criminal histories; (2) fraud involving loan agents; and (3) fraud involving false tax returns. The first two trends correspond to SBA's Management Challenge 10 described above.

**Fraud Involving Borrowers Who Do Not Disclose Criminal Histories**

OIG reports that borrowers who fail to disclose criminal histories are more likely to default on their loans.

A series of investigative projects known as Operations Cleansweep I, II, and III have disclosed that borrowers who fail to disclose criminal histories have higher rates of default on SBA loans than those who either disclose their records or have no criminal histories. To address this problem and reduce the loss to the Government, SBA has requested legislative language strengthening the Agency's authority to require the information needed to run background checks on all loan applicants. During this period, OIG investigations of criminal-record fraud in connection with SBA's programs yielded: four indictments, two convictions, two arrests, and more than $5 million in court-ordered restitution to SBA and other victims. Examples of these investigations are described further in the OIG Activities chapter.

Operation Cleansweep III was designed to extend the scope and update the results of earlier proactive investigations by examining a sample of 3,000 loans randomly selected from the population of 9,038 non-canceled, non-SBA*Express*, Section 7(a) loans approved between October 1, 1998, and December 31, 1998. The report on Operation Cleansweep III was finalized in March 2001, and will be issued in early April. The findings disclosed that 9.1 percent of the loans had borrowers who failed to fully disclose his/her criminal record. OIG believes the results of this study support the need for SBA to obtain the authority to conduct criminal history checks on all borrowers. OIG is working with SBA to request legislative authority for this purpose.

**Fraud Involving Loan Agents**

OIG focuses on fraudulent schemes devised by loan agents that have resulted in losses to the Agency and the taxpayer.

Loan agents provide referral and loan application services to prospective borrowers or lenders for a fee. Some agents, particularly loan packagers, have been involved in a variety of fraudulent schemes, such as submitting false tax returns or other financial data, charging the borrower excessive fees, using fictitious names on SBA forms, exaggerating the borrower's ability to gain loan approval, acting in illegal collusion with officials of lending institutions, conspiring with borrowers to submit false loan packages, and performing other illegal acts. These schemes, which have been copied from one fraudulent agent to another, have resulted in loan purchases and losses by SBA and, ultimately, the taxpayers.

During this reporting period, OIG investigations of this type of fraud resulted in four indictments, one conviction, and almost $130,000 in restitution. Details of such cases are discussed further in the OIG Activities chapter.

**Fraud Involving False Tax Returns**

OIG continues to investigate allegations of fraud involving false tax returns.

Over the last 10 ½ years, OIG has received nearly 500 allegations that false tax returns were submitted in support of SBA applications (over 98 percent for business or disaster loans). These fraud referrals involved loan applications totaling approximately $130 million that were submitted to 57 SBA offices. To date, 167 individuals have been indicted on criminal charges, 145 have been adjudicated guilty, 7 indictments were dismissed, 1 defendant was acquitted, and 14 others have not yet gone to trial. Because of the implicit credibility of Federal tax returns, SBA has traditionally relied heavily on information they contain in making its credit-related decisions, so falsification of "copies" of returns can have a significant impact on SBA's consideration of those applications.

Significant results of investigations of this type of fraud during the last 6 months include 1 arrest, 7 indictments, 4 convictions, and more than $1.1 million in restitution. Summaries of OIG investigations related to the use of altered or fictitious tax returns can be found in the OIG Activities chapter.

## Agency Initiatives

**Performance Results Act Audits**

OIG continues to focus attention on the Agency's implementation of the Government Performance and Results Act (GPRA). During the last 6 months, OIG issued three GPRA-related audit reports. The objectives of the audits were to determine whether the GPRA goals for the programs reflected the statutory missions, were consistent with the strategic plan, included efficiency and effectiveness measures, had measurable performance measures, and are supported by reliable data. SBA's former Office of Policy had overall responsibility for directing and coordinating the implementation of the GPRA for all SBA program offices. Performance measures were developed by the program offices based on direction provided by the former Office of Policy. The three audits found that SBA had not fully implemented the performance measurement requirements of GPRA for the programs. In addition, some of the performance data in each of the three programs audited was unreliable. The audits are discussed further in the OIG Activities chapter.

# OIG Profile

There are five divisions of SBA/OIG.

SBA/OIG was established by the Inspector General (IG) Act of 1978. OIG provides nationwide coverage of SBA's programs and activities. In addition to the Immediate Office of the IG, OIG's five divisions work together to perform the missions mandated by the Congress.

- **Auditing Division** provides comprehensive audit coverage of SBA's operations through program performance reviews, internal control assessments, and financial and mandated audits to promote the economical, efficient, and effective operation of SBA programs. Audits give SBA managers an objective and systematic assessment of how well their offices are carrying out their programs and operations. Financial audits examine the presentation of financial information, internal controls, and adherence to financial requirements. Performance audits assess operations in terms of economical and effective use of resources.

- **Investigations Division** manages a nationwide program to prevent and detect illegal and/or improper activities involving SBA programs, operations, and personnel. The criminal-investigative staff carries out a full range of traditional law enforcement functions, including (in the last 2 years) executing 24 arrest warrants, 2 search warrants, and 3 electronic monitorings. The security operations staff ensures that all Agency employees have the appropriate background investigations and security clearances for their duties. The name check program provides SBA officials with character-eligibility information on loan applicants and other potential program participants.

- **Inspection and Evaluation Division** conducts assessments of the effectiveness of SBA programs and activities, analyses of critical program issues, best practices studies, and research on matters concerning SBA performance.

- **Counsel Division** is an in-house legal staff that provides legal advice and assistance to all OIG components, represents OIG in litigation arising out of or affecting OIG operations, processes Freedom of Information and Privacy Act requests, and manages OIG legislative/regulatory review functions.

- **Management and Policy Division** provides planning, information systems, budgetary, administrative, personnel, and communications services.

# OIG Profile

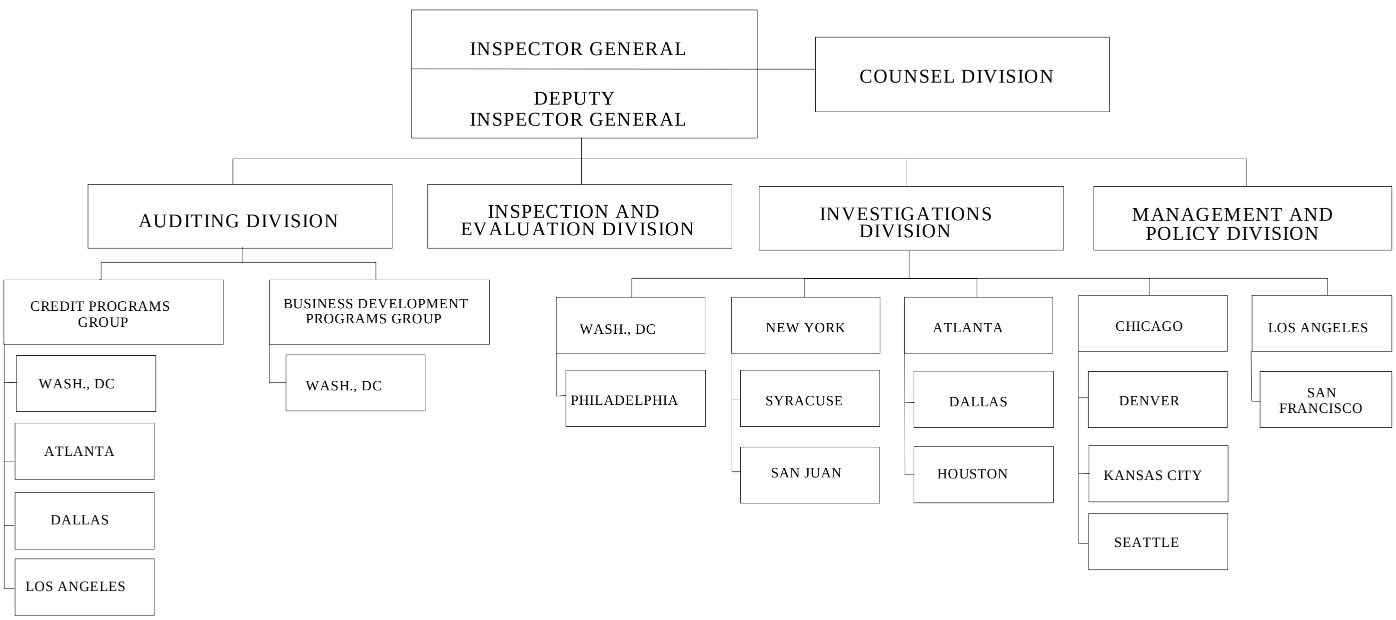
**SBA/OIG has offices nationwide.**

OIG is headquartered in Washington, D.C. and has field audit and investigation offices in Atlanta, Chicago, Dallas, Denver, Houston, Kansas City, Los Angeles, Philadelphia, New York, San Francisco, San Juan, Seattle, and Syracuse.

**SBA/OIG resources.**

As of March 31, 2001, our on-board strength was 108. The OIG FY 2001 appropriation was $11.9 million (less a .22% rescission of $26,297), and $500,000 transfer for disaster assistance oversight activities.

## OFFICE OF INSPECTOR GENERAL
## SMALL BUSINESS ADMINISTRATION



This chapter includes details of audits, investigations, and inspections summarized in the Significant Activities and Management Challenges chapter, as well as other significant OIG activities that do not fall under the strategic plan's five focus points. The material in this chapter is organized by major SBA program area.

## Business Loan Programs

**Section 7(a) Business Loan Program's Compliance with GPRA**

OIG examines the Section 7(a) Loan program's compliance with GPRA.

OIG issued an audit that evaluated the Section 7(a) business loan program's compliance with GPRA. The audit found that the program did not have indicators to determine the extent to which it was accomplishing its mission under the Small Business Act. Most indicators measured outputs rather than outcomes. The program did not have performance indicators to address each of the FY 2000 Annual Plan's performance goals. Also, some of the program's performance data were not reliable due primarily to a lack of effective validation and verification strategies and methods. Lastly, loan quantity indicators were not a valid measure of loan output. The program was reporting loans approved rather than actual loans made. OCA acknowledged problems related to its 7(a) program indicators and data limitations and availability, and is working on specific short-term and long-term approaches to addressing these issues.

**Early Defaulted SBA-Guaranteed Loans**

OIG issues audits on early defaulted SBA-guaranteed loans.

OIG has an ongoing program to audit early defaulted SBA-guaranteed loans. An early default is a loan that is transferred to liquidation or charged off within 36 months of origination. Two early default audit reports were issued from October 2000, through March 2001. The first report was on an $830,000 defaulted loan for which OIG found that both the lender and the borrower did not comply with SBA regulations. The lender neither ensured that over $299,000 of equity was injected into the business, as required, nor followed its own policy for monitoring collateral. Also, the borrower provided misleading information to the lender regarding equity injections and use of loan proceeds. The district office concurred with the audit findings and recommendations and agreed to send the lender a letter demanding remittance to SBA of $641,944, the guaranteed amount. The lender did not provide a response to the draft report. The second report was on a $200,000 SBA loan that was placed in liquidation status 14 months after approval. OIG found that the lender's noncompliance with SBA policy contributed to the loan default. The lender neither evaluated the credit history of the borrower nor informed SBA of adverse credit information. In addition, the lender did not disburse the loan proceeds prudently, report the disbursements accurately, or ensure the proceeds were used for authorized purposes. At the date of default the outstanding principal balance of the loan was $200,000. The lender disagreed with our conclusions. The district office agreed that the lender did not comply with SBA's policies and procedures when making and disbursing this loan, but did not believe the lender's actions warranted a denial of liability by SBA. Instead, SBA stated that it will pursue appropriate action.

**Field Perspective on Preferred Lender Review Process**

OIG asks the SBA field offices for their perspective on the preferred lender program review process.

An inspection advisory memorandum on ***District Office Perspectives on SBA's Preferred Lenders Program Review Process*** reported the views of district officials on the PLP review process. Over half of the survey respondents were either "slightly dissatisfied" or "very dissatisfied" with the current PLP review process, while nearly 40 percent reported being "fairly satisfied" or "very satisfied." As revealed in various comments, much of the dissatisfaction stems from the lack of participation by district offices and the high cost of the reviews, particularly for small volume lenders and locally owned banks. Survey results further indicated that district officials believed PLP oversight could be strengthened by shifting the review process' emphasis from a compliance checklist to more thoroughly examining a lender's credit underwriting practices and procedures for loan servicing and liquidation. It should be emphasized that the survey results were provided exclusively by district officials. OCA found the report informative and stated that certain changes it is implementing are consistent with district officials' opinions; however, it did not concur with all of the issues presented.

**Review of Timeliness of Character Determinations on Loan Applicants**

An inspection advisory memorandum on the ***Timeliness of Formal Character Determinations on Loan Applicants*** examined the Office of Financial Assistance's (OFA) efforts to prevent fraud and monetary loss by making any loan applicant who discloses a prior or pending criminal record subject to a formal character determination. Some district office officials have expressed concern that delays in this process can slow the processing of loan applications and thus place some prospective borrowers' businesses at risk. Minimizing the time needed for this process requires prompt action by all parties involved, including the local SBA field office, OIG, the Federal Bureau of Investigations (FBI), and OFA. Accordingly, OIG recommended that OFA and OIG jointly prepare a procedural notice outlining: (1) all participating offices' responsibilities in terms of timeframes and required documentation; and (2) how e-mail will be used to provide advance notice of OFA's final decisions. OCA concurred that this report addresses its concerns.

**Agency Response to Ineligible Borrowers Advisory Memorandum**

While conducting an audit of the PLP oversight process, OIG identified a principal with three current loans who had caused SBA a loss on a prior loan. A subsequent query of the SBA loan accounting system using the SSNs of principals showed that this was not a unique situation. OIG found 180 loans made during fiscal years 1998, 1999, and 2000, whose principals had previously defaulted on SBA loans. Of the 180 loans, 31 were loan guarantees valued at about $10.3 million. A further analysis of the 180 loans showed that because the SSNs for the principals of the committed and defaulted loans were the same, it appeared that the loans may have been inappropriately approved. These commitments involved the FA$TRACK, Section 504, International Trade, and General Business Loan programs using the preferred, express, and regular loan processing procedures.

OIG recommended that OCA suspend loan disbursement until a determination is made that the principals are the same, they declared the prior default, and a waiver was granted. In the event a waiver was not granted, OIG recommended the loan commitment be cancelled. OCA concurred with OIG's recommendations and advised of actions being taken to address OIG recommendations. Additional audit work will be done later this fiscal year to address the remaining 149 loans (180-31).

Summaries of some criminal history fraud investigations involving SBA loan programs are listed below.

The three cases listed in this section give examples of fraud detected by OIG involving SBA loan programs.

- Four residents of the Cleveland, Ohio, area were indicted and charged each with one count of making false statements to SBA. Three were charged with one count of conspiracy. These charges relate to an alleged scheme devised by a business broker to facilitate a $325,000 SBA-guaranteed loan to purchase a forklift sales and repair business in Parma, Ohio, from two of the defendants. The scheme essentially provided the borrower with 100 percent financing and resulted in inflation of the contract sales price. This was also facilitated by each of the subjects' concealment of the transfer of funds from the two sellers to the borrower, and their supporting false statements to the participating lender and SBA.

  In addition, the borrower was charged with one count of making material false statements for allegedly certifying in the loan application that he had no criminal history when in fact the investigation revealed that he had a substantial criminal history. He had been arrested and charged with various crimes; these charges resulted in four convictions prior to his loan application, including one felony conviction for first-degree burglary. OIG initiated this investigation based upon a referral from SBA's Cleveland District Office.

Operation Cleansweep reveals that a loan recipient failed to disclose his extensive criminal history that included convictions for three robberies, weapons possession, and possession of stolen property, arrests for assault with intent to injure, possession of dangerous drugs, and possession of a forged instrument.

- A borrower who received a $200,000 SBA-guaranteed loan (which he defaulted on less than 9 months after receiving it) to start a Central Islip, New York, restaurant was arrested pursuant to a 1995 warrant based on a complaint charging him with making a false statement to a federally-insured lender on an SBA Personal History Statement in support of a loan application. Allegedly, the defendant failed to disclose his criminal history that included convictions for robberies, weapons possession, and possession of stolen property, and arrests for assault with intent to injure, possession of dangerous drugs, and possession of a forged instrument. The case, which originated from OIG's "Operation Cleansweep," received national attention when it was featured on NBC's televised news segment, "The Fleecing of America," by Tom Brokaw. After learning that he would be criminally charged, the defendant became a fugitive, living under a false name, SSN, and date of birth. He was recently traced when OIG learned that he had applied for a New York State Realtor's license under his alias.

- The president of a residential real estate company in Santa Fe Springs, California, was sentenced to 88 months in prison, 3 years supervised release, $103,100 in fines, and $571,888 in restitution to SBA for conspiracy, wire fraud, making material false statements, money laundering, and bankruptcy fraud. The firm's corporate secretary was sentenced to 46 months in prison, 3 years supervised release, and a $1,900 fine for conspiracy, wire fraud, making material false statements, and money laundering. The real estate company obtained a $550,000 SBA-guaranteed loan by using a false SSN, fraudulent checks, and false financial statements, and by omitting the secretary's criminal record from the SBA application. SBA/OIG joined the investigation at the request of the U.S. Attorney's Office for the Central District of California.

The following cases illustrate OIG investigations of fraud involving loan agents.

OIG has identified fraud involving loan agents as a high-risk issue for the Agency. These cases illustrate investigations of this type.

- A husband and wife who ran a business-brokerage firm in Phoenix, Arizona, were each indicted for submitting fraudulent documents to SBA lenders. The couple allegedly came up with a "no money down" plan for clients to purchase a business at 100 percent financing contrary to SBA requirements. The scheme inflated the purchase price to cover the selling price plus the down payment. To cover up the scheme, the brokers arranged for the buyer to obtain a real estate license and listed as an asset on the borrower's SBA paperwork the commission that the borrower would be earning for the sale of the business, which equaled their required down payment. For the scheme to work, the brokers also arranged for third parties to loan, just before closing, the required down payment. The records indicated that the buyer had supplied the down payment funds. After the loan closed, the brokers received an inflated commission and paid the loan back to the third party.

Another client who obtained a $900,000 loan to purchase six fast-food franchises in Arizona recently pled guilty to one count of making material false statements. At the direction of the brokers, this client submitted false financial information to obtain the SBA-guaranteed loan.

In total, the couple brokered approximately $2.9 million in loans to small business owners throughout Arizona and to date, $2.5 million appears to be uncollectable, resulting in losses to SBA and the participating lenders. OIG's investigation was based on a referral from SBA's Arizona District Office.

- A former principal of an Inglewood, California, loan brokerage firm was sentenced to 5 months incarceration, 5 months home detention, 5 years supervised release, and $60,000 restitution for aiding and abetting the submission of false income tax returns that had been altered to overstate a borrower's adjusted gross income. The loans applied for totaled $1.85 million.

  Also, the former head of an SBA division of a bank was sentenced to 15 months incarceration, 5 years supervised release, and $6,000 restitution. He previously pled guilty to accepting a gift for procuring a loan and fraudulently receiving money from a loan transaction. This individual was a former SBA district director who left SBA in 1984. He accepted a $24,000 automobile from a loan brokerage, received money both directly and indirectly from the proceeds of a $1 million SBA-guaranteed loan, and failed to disclose that either he owned 50 percent of the business or he was going to receive at least $65,000 of the loan proceeds for his personal use. According to his plea agreement, from 1989 through 1992, he received approximately $2 million in incentive bonuses and commissions from the bank's secondary-market sale of SBA-guaranteed loans plus a base salary that eventually reached $250,000. During his years at the bank, at least 17 borrowers submitted fraudulent documents, including falsified "copies" of tax returns, seeking SBA-guaranteed loans, resulting in 25 individuals being charged. Of these, 22 have pled guilty, 1 was acquitted, and the trial of the other 2 is pending. OIG initiated the investigation based on allegations from an anonymous complainant.

Some investigations reveal not only fraud involving loan agents, but fraud involving tax returns and criminal histories.

- An Internal Revenue Service (IRS) employee, a certified public accountant (CPA)/SBA-loan package preparer, and six others were indicted for involvement in schemes that utilized falsified tax returns to obtain SBA-guaranteed loans. Two other individuals who had been indicted previously were adjudicated guilty, one at trial and one by plea, and one of them was sentenced during this period as well.

The IRS employee and three principals of an Irving gas station were indicted on 1 count of conspiracy and 14 counts of making material false statements to induce a lender and SBA to fund a $200,000 SBA-guaranteed loan. One of the principals and his wife allegedly posed as borrowers intending to purchase the gas station from another principal who posed as sole proprietor. The three principals allegedly submitted numerous fraudulent documents (including their required $60,000 capital injection into the business) in support of the loan. (Charges against the wife have been dismissed.) The IRS employee allegedly used his position to produce bogus tax verifications for three false tax returns by manipulating the use of IRS's Integrated Data Retrieval System.

In a related case, a Federal jury found an employee of an Irving auto body shop guilty of one count of conspiracy and nine counts of making material false statements to induce a lender to fund a $350,000 SBA-guaranteed loan. He was sentenced to 37 months incarceration and ordered to pay $506,203 in restitution to the lender and SBA.

Two persons associated with another gasoline station/convenience store in Grand Prairie acknowledged their involvement to fraudulently induced a lender to fund a $256,000 SBA-guaranteed loan, purportedly for one defendant to buy the store from a group that included the second. Both defendants were previously indicted on 1 count of conspiracy and 11 counts of making material false statements. The purchaser pled guilty to one count of making material false statements in return for dismissal of the other counts against him. Since he is a convicted felon, he posed as his brother and used his brother's credit identifiers to qualify for the loan. The seller signed a pretrial diversion agreement; if he complies with its terms, his record will be expunged in 1 year. Both were involved in the submission of falsified copies of tax returns in support of the loan.

Three Dallas businessmen were indicted on one count each of conspiracy and seven counts each of making material false statements relating to a $293,000 SBA-guaranteed loan for the purchase of a restaurant from one of them. The three businessmen allegedly devised a scheme whereby the purported buyer (who has subsequently been dismissed from the indictment) would apply for the loan in place of the actual buyer (the third businessman), at an inflated selling price. They also submitted falsified copies of tax returns, fraudulent IRS tax return verifications, and numerous other fraudulent documents in support of the loan.

Two principals of a Dallas service station and the CPA/SBA-loan

Two indictments issued that charged four individuals and two corporations with fraud against SBA and violations of environmental laws.

OIG has found several examples of falsified tax returns submitted with SBA loan applications.

package preparer were indicted on 1 conspiracy count and 25 counts of making material false statements for fraudulently inducing a lender to fund a $355,000 SBA-guaranteed loan. They allegedly falsified Federal tax returns, IRS tax verifications, leases containing forged signatures of the fuel company's regional and district managers, and an $85,000 capital injection. The indictment also charges the three with fraudulently inducing a $200,000 SBA-guaranteed loan to the Irving gas station mentioned above.

The following cases illustrate OIG's work on fraud involving false tax returns.

- The owner of a clothing manufacturer in Dallas, Texas, was sentenced to serve 54 months in prison, 3 years supervised release, and $656,955 restitution for SSN fraud and making material false statements to obtain a $675,000 SBA-guaranteed loan. In her application, she gave a false name and SSN to conceal that she defaulted on another SBA loan and previously filed for bankruptcy. She also submitted false tax returns and supporting IRS documentation, falsified financial statements, and other fraudulent documents to obtain the loan. She then failed to purchase the equipment pledged as collateral and spent most of the loan proceeds for unauthorized purchases. She immediately defaulted on this loan. This investigation was based on a referral from the lender.

- The president of a defunct Kansas City, Missouri, dry cleaning business in Oklahoma pled guilty to one count of making false statements to a federally-insured bank that related to his SBA loan. He had been indicted on 10 counts of the same charge and using false SSNs. The dry cleaning business had received a $98,235 SBA-guaranteed loan and immediately defaulted. The businessman defaulted on a total of six loans, resulting in total lender losses of about $197,000.

The following cases illustrate OIG investigations involving fraud to obtain business loans.

- Two associates of an equipment manufacturer in San Diego, California, pled guilty to one count of misappropriation of SBA collateral and one count of mail fraud, respectively. The company had obtained an $833,000 Export Working Capital loan to finance production of mining conveyors. The indictment charged that the defendants submitted false documentation to obtain the SBA-guaranteed loan disbursements, transferred property of the company to conceal it from the U.S. Bankruptcy Court, and made material omissions on the company's Statement of Financial Affairs to the U.S. Bankruptcy Court. SBA's net chargeoff on the loan was $175,051. OIG joined the investigation at the request of the U.S. Attorney's Office for the Southern District of

> Owner of a die cutting company pled guilty to one count of bankruptcy fraud and was sentenced to 4 months incarceration, 2 years supervised release, and a $10,000 fine. He had received a $940,000 SBA-guaranteed loan.

California.

- A New Jersey State grand jury issued two indictments charging four individuals and two corporations with fraud against SBA and violations of environmental laws. In the first indictment, an East Rutherford, New Jersey, plating and finishing company and three of its principal officers were charged in connection with a $500,000 SBA-guaranteed loan. The company was charged with theft by failure to make required disposition and four counts of uttering a forged instrument. The three principals were each charged with theft by failure to make required disposition and misconduct by a corporate official. Two were also indicted on four counts of uttering a forged instrument, while the third was indicted on three counts of uttering a forged instrument. The indictment alleges that the defendants failed to purchase equipment as required in the loan agreement; provided a forged landlord waiver in applying for the loan; and passed three checks to banks knowing that endorsements were unauthorized. The investigation also resulted in a second indictment naming the same four defendants plus a second plating and finishing company and its owner for discharging chemical and industrial waste into a county sewer line and unlawfully storing and abandoning toxic pollutants and hazardous waste. The first company ceased operating under its name in 1996; by then the fourth man was its owner, and he established the second plating and finishing company at that site. The State of New Jersey's Division of Criminal Justice requested SBA/OIG's assistance.

- Two persons associated with the sale of a pet store acknowledged that they induced a bank to make a $150,000 SBA-guaranteed loan. Both defendants were previously indicted on one count of conspiracy and one count of making false statements to SBA. The president of a Millstone Township, New Jersey, franchising company pled guilty to making a false statement to SBA; as part of the plea agreement, the conspiracy count was dismissed. He was sentenced to 2 years incarceration, 1 year supervised release, and $650,000 restitution to an investor in his company. The seller signed a pretrial diversion agreement; if he complies with its terms, his record will be expunged in 6 months. He had allegedly signed and submitted a bill of sale that indicated a total price of $225,000 and verified that he had received a $75,000 cash injection from the buyers. The franchiser's president admitted submitting a letter to the bank corroborating the $75,000 cash injection. In fact, the buyers had made a cash injection of only $25,000. An undisclosed note between the seller and the buyers made up the difference. OIG conducted this investigation based a referral from SBA's South Florida District Office.

- The former president of a wholesale meat company in Cumming, Iowa, was indicted on one count each of concealing a material fact from SBA and bank fraud in connection with a $1,400,000 SBA-guaranteed loan he received from a bank to purchase the business. Allegedly, the businessman wrote an insufficient-funds check and perpetrated a check kite to make it appear the required equity injection was made, and concealed an undisclosed promissory note to the seller. The second charge alleged that he subsequently converted vehicles pledged to a successor to the bank on this same loan. His business failed and he defaulted on the SBA-guaranteed loan, leaving an unpaid balance of about $1,258,000. OIG initiated its investigation based on a referral from SBA's Des Moines District Office.

OIG audit finds that SBA had not fully implemented the performance measurement requirements of GPRA for the Disaster Assistance program.

The following cases illustrate OIG investigations involving fraud after business loan default.

- The owner of a die cutting company in Fairfield, New Jersey, that had received a now-defaulted $940,000 SBA-guaranteed loan pled guilty to one count of bankruptcy fraud. He was sentenced to 4 months incarceration, 2 years supervised release, and a $10,000 fine. In connection with his personal bankruptcy petition, he claimed to own no real property. The investigation uncovered a deed and mortgage that revealed that he took ownership of a condominium the year before the bankruptcy plus tax records showing his ownership continuing to the present. The case was referred to OIG by SBA's New Jersey District Office.

- The president of a southwest Ohio real estate business was convicted on 36 of the 40 counts on which he was previously indicted. Two of the 36 counts charged him with aggravated theft by deception over $100,000 and forgery utterance over $100,000 in connection with a $439,000 SBA-guaranteed business loan. The businessman deposited funds associated with a $5 million bad check to an escrow account, then induced the title company to issue a $427,074 check from that account, in the name of his Section 504 lender, asserting that these funds were to pay down the SBA loan. He then forged an endorsement on the check and deposited the money to his business account. The county prosecutor's request that OIG join this investigation was facilitated by SBA's Columbus District Office.

The following narrative illustrates investigations of cases involving SBA's business-lending partners.

- The former president of a Keystone, Nebraska, bank pled guilty to a one-count information that charged him with submitting a false statement to SBA. He was sentenced to 3 years probation, $14,640 restitution to a borrower, and a $5,000 fine. OIG's investigation found that the defendant requested and received $1,750 in cash payments from two local small businessmen applying for SBA-guaranteed loans from the bank. Although he told the businessmen he needed these sums for expenses, the defendant falsely reported on an SBA settlement sheet that the bank collected no additional fees. The defendant actually misappropriated the money he received.

# Disaster Loan Program

**Disaster Assistance Program's Implementation of GPRA**

OIG issued an audit report on the Disaster Assistance program's performance measurement requirements of GPRA that found that SBA had not fully implemented them. Specifically, the program did not have performance indicators to determine the extent to which it accomplished its mission under the Small Business Act. Furthermore, disaster home loan currency and delinquency rates were misleading since they excluded a large portion of disaster loans and the indicator for effective field presence was not consistently applied. As a result, program officials could not measure the extent to which the program helped businesses and families recover from disasters, and whether the products and services were cost-effectively delivered.

President of New York SBIC sentenced to 1 year of incarceration, 5 years supervised release, and $770,000 restitution to SBA for bank fraud and making material false statements.

OIG recommended that the Office of Disaster Assistance: (1) develop an outcome indicator to measure results aligned with the statutory mission; (2) develop an indicator to gauge program delivery costs; and (3) consistently report disaster field staff presence. In addition, OIG recommended that the Office of Disaster Assistance revise the disaster loan currency/delinquency performance indicator. SBA management officials concurred with three of OIG's recommendations. Their response included both short-term and long-term plans to implement the recommendations. The action SBA management proposed for the last recommendation was not fully responsive. OIG has outlined the actions SBA needs to take before this recommendation is considered resolved.

The following cases illustrate OIG investigations of fraud to obtain disaster loans.

- A Reno, Nevada, man was indicted on one count of making material false statements to SBA and one count of mail fraud. He obtained a $213,600 disaster home loan following floods in Washoe County, Nevada, based on his loan application, on which he claimed he was employed at a restaurant for 10 months in that year and earned $60,000. However, the investigation disclosed that he was employed at the business for 3 months and had earned only $2,060. OIG initiated this case based on a referral from the Nevada Attorney General's Office.

- An Albuquerque, New Mexico, woman was indicted on three counts of mail fraud, one count of wire fraud, one count of filing false claims, one count of impersonation of a Federal employee, one count of making material false statements, and one count of false representation of an SSN. The charges relate to her attempt to obtain post-disaster assistance from SBA and the Federal Emergency Management Agency (FEMA), including a $40,000 SBA disaster home loan using the name and SSN of a deceased acquaintance, submitting false documents in support of her damage claim, and attempting to obtain information about her claim and the investigation by posing as a representative of the U.S. Attorney's Office. The investigation determined that neither the defendant nor the person whose name she falsely used ever resided at the address claimed in the disaster-assistance application.

## Small Business Investment Companies

The following narratives illustrate OIG investigations of fraud by principals of Small Business Investment Companies (SBIC).

- The president of a New York, New York, SBIC was sentenced to 1 year of incarceration, 5 years supervised release, and $770,000 restitution to SBA for bank fraud and making material false statements. During a 1-year period, he fraudulently obtained over $750,000 in loans from the SBIC, as well as over $250,000 in salary advances, while drawing an annual salary of $150,000. He caused the SBIC's vice president to cosign the salary advance and loan checks by falsely representing that the loans were permissible under SBA regulations. He falsely claimed that the SBIC's loan committee had approved the loans and advances and subsequently made the same false representations to SBA on several occasions, seeking the Agency's retroactive approval for the monies already received. He then used the fraudulently-obtained funds for unauthorized purposes, including repayment of his personal gambling and other debts to the two other members of the SBIC's loan committee. His actions caused a loss to SBA of over $900,000 and forced the Agency to liquidate the SBIC. The SBIC's vice president recently settled for $170,000 the SBA receiver's civil suit. This investigation originated from a referral from SBA's Office of SBIC Operations.

- The president of another New York City SBIC pled guilty in February 2001 to an information charging him with embezzling and misapplying funds belonging to the SBIC. He had caused the SBIC to overpay, to the advantage of two private companies affiliated with him, approximately $71,176 more than its rightful rent obligations at the site they jointly occupied. The president's actions delayed SBA's seizure of control of the SBIC and significantly contributed to the Agency's loss, which exceeded $2,229,000. This investigation originated from a referral from SBA's Office of General Counsel (OGC).

## Surety Bond Guarantees

OIG continues to audit surety companies and identifies a total of $432,242 in questioned costs in three of the five audits.

At the request of the Office of Surety Guarantees (OSG), OIG continues to conduct audits of surety companies participating in SBA's SBG program. During the reporting period, OIG issued five audit reports on five surety companies. The Small Business Investment Act requires OIG to conduct audits of preferred sureties. One of the five audited sureties was a preferred surety. OIG found that the surety companies did not always comply with SBA regulations and requirements for underwriting and servicing bonds and processing claims. OIG recommended that the surety companies implement and maintain written underwriting and servicing policies and procedures for SBA-guaranteed bonds. OIG also found that all of the surety companies correctly calculated fees and four remitted them timely. For four of the five surety companies, OIG found that they did not maintain complete underwriting documentation for one or more bonds. In one of the audits, OIG found that the surety: (1) issued one bond after work under the contract had begun without obtaining SBA approval; (2) failed to obtain the required certifications for five bonds; (3) input bond information for one bond into the Preferred Surety Bond system prior to the bond effective date; (4) submitted inadequately supported legal expenses for one bond; and (5) remitted salvage to SBA in an untimely manner for one bond. In two audits the surety companies did not notify SBA of bond default in a timely manner. OIG identified a total of $432,242 in questioned costs for three of the audits and recommended that the surety companies implement policies and procedures to correct the problems. OSG agreed with OIG's recommendations in all five audits.

## Government Contracting and Business Development Program

President of a Long Island City, New York, Section 8(a) general contractor sentenced to 5 years of supervised release and $259,369 restitution for conspiracy, bank fraud, and lying.

OIG issued an audit report that reviewed the Section 8(a) BD program's compliance with GPRA. OIG found that SBA has not adequately implemented performance measurement requirements of GPRA for the Section 8(a) BD program. SBA's definition of success for the Section 8(a) BD program contained in its FY 2001 Results Act Annual Performance Plan (Performance Plan) omitted the measures of success. OIG found that: (1) the performance plan lacked effectiveness and efficiency performance indicators for the Section 8(a) BD program; (2) the data contained in the SBA database for the program were generally accurate concerning the fiscal year in which Section 8(a) BD program participants left the program; and (3) some performance data were unreliable or incorrectly described. OIG recommended that: (1) SBA define Section 8(a) BD program success in accordance with the law; (2) include indicators in the Performance Plan that allow for a determination of how effectively and efficiently the Section 8(a) BD program is operating; (3) accurately describe and report performance goals and data; and (4) implement a system that ensures that termination requests of Section 8(a) firms are tracked through final resolution. The Acting Associate Deputy Administrator for Government Contracting and Business Development and the Associate Administrator for Business Development took no exception to the audit results presented in the draft report.

Summaries of some criminal history fraud investigations involving the Section 8(a) BD program are listed below.

- A defunct Philadelphia, Pennsylvania, Section 8(a) construction company pled guilty to 1 count of conspiracy to defraud the Government, 12 counts of filing false claims, and 1 count of major fraud against the United States for schemes to defraud SBA, the Department of the Navy, and the United States Department of Agriculture (USDA) subcontractors. The vice president was convicted of conspiracy, false claims, and major fraud against the United States. The false statement claims counts related to his denying in the company's Section 8(a) application that he had a criminal history. In fact, he had been arrested seven times and convicted three times. The other charges related to the schemes to defraud SBA, the Navy, and USDA.

- The president of a Long Island City, New York, general construction contractor was sentenced to 5 years supervised release and $259,369 restitution for conspiracy, making material false statements and bank fraud. During the application process for the Section 8(a) program, he falsely stated that he had never been arrested or charged with a crime, when in fact he had been arrested on theft charges. He also admitted submitting documents containing inflated income information to induce a federally-insured financial institution to extend a $50,000 line of credit to the company, and that he and others conspired to defraud the Government by submitting fraudulent bonds and falsified payroll reports in connection with a Section 8(a) contract.

  One of his co-conspirators was sentenced to 1 year and 1 day of incarceration, 3 years of supervised release, and restitution of $45,375 for conspiracy. As a condition of the contract, the construction company was required to obtain payment and performance bonds to cover any cost resulting from its failure to perform adequately and/or pay its subcontractor. The co-conspirator submitted counterfeit payment and performance bonds and the altering of other records. OIG initiated its case based on a referral from Federal Bureau of Prisons.

OIG reviews legislation designed to improve the operations of the SDB program and makes several recommendations.

The following narratives illustrate OIG investigations involving other types of fraud in connection with Section 8(a) contractors.

- A Newark, New Jersey, general construction company and its president pled guilty to informations charging them with one count of major fraud against the United States and two counts of making material false statements to obtain more than $8 million in Section 8(a) contracts. The president also pled guilty to an information charging him with three counts of mail fraud to obtain more than $3 million in contracts from the Port Authority of New York and New Jersey. The president had submitted a Section 8(a) program application to SBA with false documents claiming to identify employees and equipment of the company. He then submitted a Section 8(a) business plan representing that the company was equipped to handle construction work in 26 different specialties. However, the company was really a storefront operation that never had the employees, equipment, or experience necessary to be a viable construction company. To perform the company's contractual obligations, the president brokered the contracts to non-minority-owned companies in return for a percentage of the contract value, which progressively got larger. Eventually, the company defaulted on four of its seven Section 8(a) contracts, causing a loss of approximately $800,000 on one contract alone.

- The president of a defunct construction company in Huntingdon Valley, Pennsylvania, pled guilty to one count of mail fraud for falsely-reported payments to subcontractors and false progress payment certifications on a $1.6 million contract and one count of making a material false statement for representing that he was the 100 percent owner of the company on his Section 8(a) program application when he only owned 40 percent. A principal condition of the plea agreement is that the defendant will make restitution (pursuant to a stipulated $3.2 million judgment) to his surety-bonding company before he is sentenced.

OIG reviewed a proposed regulation to improve the operations of SBA's SDB program based on SBA's gained experience in the certification process. The proposed regulation stated that the presumption of economic disadvantage might be rebutted "if SBA finds that the individual is not economically disadvantaged due to his or her access to capital and credit." OIG recommended that the proposed regulation define what access to capital and credit is needed to overcome economic disadvantage, and what factors SBA will look at in making this determination. The proposed regulation also stated that the "disadvantaged individual must devote sufficient time to the concern to enable SBA to conclude that such individual controls the day-to-day operations of the concern…." OIG recommended that "sufficient time" be defined in the regulation rather than only discussed in the preamble section discussing the proposed changes to the regulations. Additionally, OIG recommended that safeguards be added to the proposed regulation ensuring that private certifiers do not certify any companies that they have or will have business dealings with. Lastly, the proposed regulation provides that when the Agency has evidence that a firm may not be eligible for the SDB program, it may take action to decertify the firm. OIG recommended that this language be changed to require SBA to take action to decertify rather than leaving it as an option.

## Agency Management

**FY 2000 Financial Statements Audit**

SBA's FY 2000 financial statements received an unqualified opinion for the 5th consecutive year. The opinion also noted that there were no material weaknesses this year, and the SBA is in substantial compliance with the Federal Financial Management Improvement Act. The opinion was issued in an audit report dated February 28, 2001. The independent auditors determined that the financial statements presented fairly, in all material aspects, the financial position of SBA as of September 30, 2000, and its net costs, changes in net position, budgetary resources, and financing for the years then ended were in conformity with generally accepted accounting principles.

SBA's information systems controls reviewed during OIG audit.

The independent auditors also determined that there were two reportable conditions involving SBA's internal control and its operation that were not material weaknesses. This is the first time that the independent auditors did not find any material weaknesses in SBA's internal control and operation. More specifically the independent auditors reported that: (1) SBA's financial reporting processes and procedures were not adequately documented and a fully effective quality assurance process was not in place; and (2) SBA's security-monitoring program was not fully implemented. Recommendations were made by the independent auditors to correct these reportable conditions. In its response to the audit findings, SBA management stated that they are working to eliminate the reportable conditions. The reportable condition involving the security-monitoring program is addressed in detail in a separate report titled Audit of SBA's Information Systems Controls-FY 2000.

**Presidential Decision Directive (PDD) 63 Audit**

OIG issued an audit report titled, "SBA's Planning and Assessment for Protecting SBA's Critical, Physical Infrastructure." PDD 63 calls for a national effort to ensure the security of the United States' critical infrastructures. Critical infrastructures are the physical and cyber-based systems essential to the minimum operations of the economy and Government. SBA has made progress toward implementing PDD 63 requirements, but its focus has been on protecting the Agency's critical, cyber-based infrastructure. To fully comply with PDD 63, the Agency needs to expand its infrastructure protection efforts to address its critical, physical infrastructure. SBA's current CIP Plan does not require protection of the Agency's physical MEI. We recommended that the plan be revised to include milestones and responsibilities for identification of physical MEI, performance of vulnerability assessments, development of remedial plans, determination of resource requirements, and updating of policies and procedures as necessary. PDD 63 and related guidance call for agencies to establish effective CIP coordination with other applicable entities. To avoid duplication of key functions, we recommended that SBA coordinate its CIP efforts with the General Services Administration, which is responsible for the security of the Federal and leased buildings in which SBA operates. The CIO agreed with our recommendations and stated that his office has already taken steps to address the issue.

**SBA's Information Systems Controls for FY 2000**

OIG investigates criminal conduct by SBA employees.

OIG issued an audit report on SBA's information systems controls. The report was based on the review of general controls over SBA's financial management systems as part of the audit of SBA's FY 2000 financial statements. General controls are the policies and procedures that apply to all or a large segment of an entity's information systems to help ensure their proper operation. They impact the overall effectiveness and security of computer operations, rather than specific computer applications. The objective of the review was to determine if those controls complied with various Federal requirements. The report concludes that while SBA has continued to make significant progress in implementing its information systems security program, further improvements are still needed. The report describes areas where controls can be strengthened, such as, (1) monitoring, assessing, and measuring security program effectiveness; (2) restricting physical access to network servers; (3) documenting application development and software changes; (4) controlling changes to operating system configurations; (5) segregating incompatible duties; and (6) testing disaster recovery plans. The CIO, CFO, and Assistant Administrator for Disaster Assistance generally agreed with the findings and recommendations.

**FY 1999 Cost Allocation Study Advisory Memorandum**

OIG issued an advisory memorandum on the FY 1999 Cost Allocation Study used by SBA to determine all costs attributable to each SBA program. OIG found that the costs identified through the study overstated SDB certification expenses by $3.9 million. It reported SDB expenses as $14.6 million rather than $10.7 million. Additionally, since the Cost Allocation Study was based on obligations that included unliquidated balances on closed obligations, the model did not show actual SDB expenditures. The Economy Act, which applied to cost reimbursements from other agencies, requires SBA to determine the actual cost of the SDB certification program. Lastly, SBA did not clearly document the model, as required by the Office of Management and Budget (OMB) Circular A-127.

The auditors recommended that SBA's CFO implement internal controls to verify the accuracy of future surveys and models, enforce procedures for immediate de-obligation of unliquidated obligations on completed projects/contracts, and document the logic and methodology behind the cost allocation model. While Office of the Chief Financial Officer (OCFO) officials stated that procedures for the FY 2000 cost study included internal control improvements that should address OIG's concerns, they did not address verifying the model to detect and correct potential errors. OCFO agreed to the recommendations in the report, and the FY 2000 cost study process included procedures to verify the model and correct potential errors.

The following cases involve OIG investigations of criminal conduct by SBA employees.

- The former coordinator of SBA's BIC in Itta Bena, Mississippi, pled guilty to filing a false claim when relocating from Texas to Mississippi, and was sentenced to 4 years probation and to pay SBA $8,779 in restitution and was also fired. As part of the plea agreement, the Government agreed to dismiss the three false claims counts on which she had also been indicted. The investigation was initiated based on a referral from SBA's Mississippi District Office.

- A former SBA time-and-attendance keeper pled guilty to one count of Theft II and she was sentenced to pay $5,430 in restitution to SBA, serve 1 year of probation, and undergo weekly drug testing. She admitted to submitting falsified time sheets to be paid more than $5,400 in overtime that she did not work. She retired from the Government during the investigation, which OIG initiated based on a referral from SBA's OGC.

OIG reviews two proposed standard operating procedures: 1) the Agency's Equal Employment Opportunity program, and 2) SBA's advisory committees.

OIG reviewed and commented on H.R. 4181, the "Debt Payment Incentive Act of 2000." OIG supported the proposed legislation, but recommended that the provision requiring a prospective contractor to enter into a repayment plan within 6 months following the award of a contract be changed to require the contractor to enter into a repayment plan with the Federal agency to which the delinquent outstanding debt is owed beginning not later than the contract award date. OIG believed there is no justification to postpone the entry into a repayment plan following the award of a

OIG works with SBA to identify the 10 most serious management challenges facing the Agency and submits its findings to Congress.

contract. If the deadline is delayed for 6 months and the party fails to enter into a repayment plan, then substantial contract performance may have already occurred. Additionally, termination and appeal expenses would already have been incurred as opposed to the much more economical and efficient method of handling Federal debt repayment as either a responsiveness or responsibility issue before award. The proposed legislation also provided that partners or shareholders owning more than 25 percent of an applicant for financial assistance or a contractor would certify that they have not been assessed a penalty under section 6672 of the Internal Revenue Code. OIG recommended these certifications be extended to include delinquencies on any Federal debt owed. Further, if the individuals certified they are delinquent on a Federal debt, then they should also be required to enter into a repayment plan before Federal financial assistance is granted or a Federal contract is awarded.

OIG reviewed the Agency's draft of standard operating procedure (SOP) 90 54 5, on SBA's advisory committees established pursuant to the Federal Advisory Committee and Small Business Acts. Among its comments, OIG recommended that the advisory role of district advisory councils (DAC) be emphasized. OIG considered the some of the language referring to DAC authority contained in the SOP to be too broad, taking into consideration the significant non-advisory activities of at least one DAC revealed by a recent OIG audit. See Audit of Rhode Island District Advisory Council, Audit Report No. 0-28, September 29, 2000), available at http://www.sba.gov/ig/audits.html. OGC generally agreed with OIG comments and is making the requested changes.

OIG reviewed a proposed revision of SOP 37 13, that would amend the Agency's Equal Employment Opportunity (EEO) program to include new regulations promulgated by the EEO Commission and introduce the Agency's alternative dispute resolution program. OIG recommended changes to ensure that employees and managers involved in the EEO process for the first time would be able to understand what to expect from the process and their respective rights and responsibilities during that process. SBA's Office of Equal Employment Opportunity and Civil Rights Compliance agreed with the recommended changes and the final version of the SOP was published in December 2000.

OIG reviewed and commented on the Agency's draft FY 2000 Performance and Accountability Report. OIG suggested that the proposed transmittal letter by the head of the Agency include a more comprehensive assessment of data completeness and accuracy as required by the Reports Consolidation Act of 2000, as codified at 34 U.S.C. § 3516(e). Additionally, OIG recommended that the Agency improve its description of OIG's list of the most serious management challenges facing SBA, provide

SBA's progress on resolving those challenges, and describe any areas of remaining concerns and how and when the Agency plans on addressing or overcoming them.

## Office of Inspector General

### Top Ten Management Challenges Submitted to Congress

In response to a congressional request, OIG submitted its assessment of the 10 most serious management challenges facing SBA in FY 2001. The current list identifies three new challenges and updates and/or consolidates those submitted last year. The first four focus on agency-wide issues for modernizing the Agency. The second two discuss loan program challenges. The third three deal with Section 8(a) BD challenges. The final challenge focuses on preventing loan fraud. The full assessment of the 10 most serious management challenges is detailed in the Significant Activities and Management Challenges chapter.

### OIG Fraud Awareness Briefings

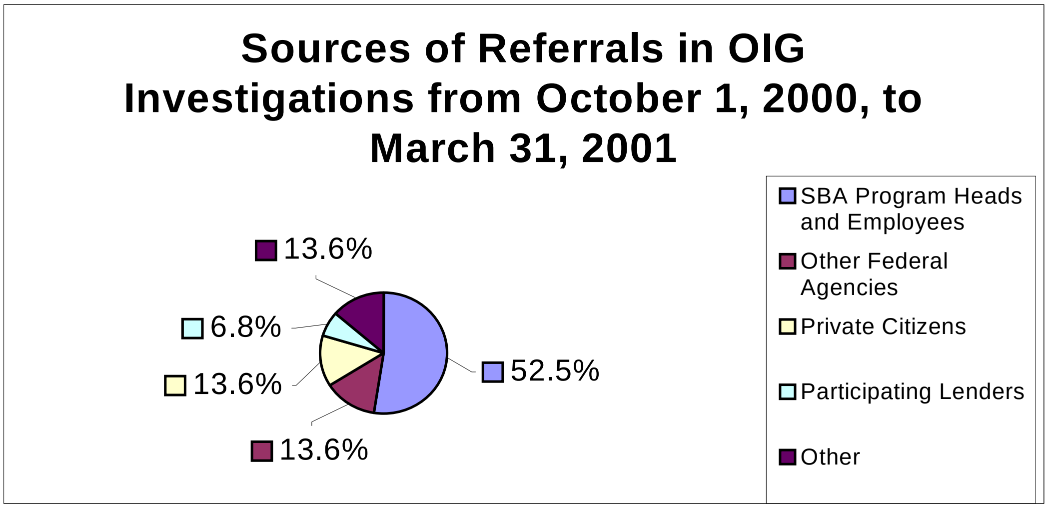
OIG conducted several briefings for SBA's employees, lenders, and other resource partners as part of its mission to educate its customers on identifying waste, fraud, and abuse. During this reporting period (as the chart below illustrates) over 50 percent of the investigations initiated by OIG originated from within the Agency in the form of referrals either from program heads or other SBA employees. This cooperation indicates the strong commitment of SBA employees to reducing waste, fraud, and abuse in Agency programs and improving the Agency's management and control of its programs. However, we have recognized the shift in SBA's role from primarily reviewing and processing loans to increasingly providing oversight of lending practices; accordingly, we have changed our briefing strategy. Much of our past success resulted from referrals from conscientious SBA employees; our continued successes will depend more on lender referrals. OIG has expanded its integrity-awareness briefing program to include participating lenders and other interested parties. During this reporting period we conducted the following briefings.

- OIG staff gave a presentation to 40 attendees at a New York Bank Clearinghouse Committee meeting.

- OIG staff gave presentations to 72 attendees at disaster-fraud awareness meetings in California conducted jointly with special agents from FEMA. The meetings were held for State and local law enforcement officers.

- OIG staff gave a presentation to 10 attendees at a Section 8(a) marketing seminar sponsored by SBA's Houston District Office.

- OIG staff presented integrity awareness briefings to a total of 68 Agency employees in Puerto Rico, the Virgin Islands, and Kansas City.




* Due to rounding, the total of the above percentages is 100.1 percent.

OIG continues to make referrals that result in SBA declining loans in both the business loan and disaster loan programs. OIG also continues to perform background checks and security clearances for Agency employees.

**Office of Security Operations**

Pursuant to provisions of the Small Business Act and the Small Business Investment Act, SBA requires applicants for assistance to meet certain character standards before participating in Agency programs. OIG's Office of Security Operations (OSO) helps SBA ensure that Agency program participants meet the standards by processing name checks and, where appropriate, fingerprint checks on applicants. To make character eligibility determinations, OSO makes use of its on-line connection with FBI's Machine Readable Data system. When program applicants appear to be ineligible for assistance based on character, OSO makes referrals to program officials for adjudication. During this reporting period, OSO made referrals that resulted in SBA's business loan program managers declining 36 applications and disaster loan program officials declining 3 applications, totaling $7,468,700 and $7,583, respectively, for character reasons. Those declinations made available that amount of credit for applicants in whom SBA can have confidence of repayment. In addition, officials of SBA's Section 8(a) program declined five applications for certification. Almost $185 million in loans have been declined during the last 10 years due to character eligibility.

OSO also performs background checks to comply with Federal regulations that require Agency employees to have security clearances appropriate for their positions. During this reporting period, OSO initiated 84 background investigations and issued 14 security clearances. OSO also reviewed and adjudicated 101 background investigative reports in accordance with Executive Order 10450 and OMB Circular A-130, and coordinated with SBA's Office of Disaster Assistance to ensure the timely adjudication of 45 derogatory background investigative reports forwarded for review and appropriate action.

**Direct Audit Time by Program Area**
**October 1, 2000, to March 31, 2001**

| Program Area | Direct Time % | Number of Audits | |
|---|---|---|---|
| | | Issued | In Progress |
| Capital Access | 65% | 9 | 7 |
| Disaster Assistance | 1% | 1 | 0 |
| Government Contracting and Business Development | 12% | 1 | 1 |
| Agency Management | 22% | 6 | 10 |
| **Total** | 100% | 17 | 18 |

**Direct Investigation Time by Program Area**
**October 1, 2000, to March 31, 2001**

| Program Area | Direct Time % | Number of Investigations** | |
|---|---|---|---|
| | | Closed*** | In Progress |
| Capital Access | 69% | 17 | 228 |
| Disaster Assistance | 9% | 4 | 110 |
| Government Contracting and Business Development | 9% | 4 | 39 |
| Agency Management | 13% | 4 | 27 |
| Entrepreneurial Development | **** | 0 | 2 |
| **Total** | 100% | 29 | 406 |

** Includes civil cases    *** Includes cases canceled    **** Less than ½ percent

# Statistical Highlights

## FY 2000 Productivity Statistics
## October 1, 2000, through March 31, 2001

| Officewide Dollar Accomplishments | Totals |
|---|---|
| A. Potential Investigative Recoveries and Fines | $8,004,382 |
| B. Loans Not Made as Result of Investigations and Name Checks | $7,534,002 |
| C. Disallowed Costs Agreed to by Management | $3,371,798 |
| D. Recommendations that Funds Be Put to Better Use Agreed to by Management | $1,454,258 |
| Total | $20,364,440 |

**Auditing Division Activities**

| | |
|---|---|
| A. Audit Reports Issued | 17 |
| B. Audit Recommendations Issued | 61 |
| C. Dollar Value of Costs Questioned | $432,242 |
| D. Dollar Value of Recommendations that Funds Be Put to Better Use | $11,061,994 |

**Audit Followup Activities**

| | |
|---|---|
| A. Audit Recommendations Closed | 82 |
| B. Disallowed Costs Agreed to by Management | $3,371,798 |
| C. Dollar Value of Recommendations that Funds Be Put to Better Use Agreed to by Management | $1,454,258 |
| D. Unresolved Audit Recommendations | 37 |

**Inspection and Evaluation Division Activities**

| | |
|---|---|
| A. Reports Issued | 2 |

**Legislation/Regulations/SOP/Other Review**

| | |
|---|---|
| A. Legislation Reviewed | 1 |
| B. Regulations Reviewed | 22 |
| C. Standard Operating Procedures Reviewed | 7 |
| D. Other Issuances Reviewed** | 85 |

* Includes the recommended loan guarantees cancelled
** This includes policy notices, procedural notices, Administrator's action memoranda, and other communications, which frequently involve the implementation of new programs and policies.

# Statistical Highlights

**Investigations Division Activities**

| | |
|---|---|
| A. Total Cases | 435 |
| B. Closed Cases | 29 |
| C. Pending Cases | 13 |
| D. Open Cases | 393 |
| E. Subjects Under Investigation | 1,600 |
| F. Cases Referred to FBI or Other Agencies for Investigation | 9 |

**Summary of Indictments and Convictions**

| | |
|---|---|
| A. Indictments from OIG Cases | 32 |
| B. Convictions from OIG Cases | 28 |

**Summary of Recoveries and Management Avoidances**

| | |
|---|---|
| A. Potential Recoveries and Fines as a Result of OIG Investigations | $8,004,382 |
| B. Loans Not Approved as a Result of OIG Investigations | $57,719 |
| C. Loans Not Approved as a Result of the Name Check Program | $7,476,283 |
| Total: | $15,538,384 |

**SBA Personnel Actions Taken as a Result of Investigations**

| | |
|---|---|
| A. Dismissals | 1 |
| B. Resignations/Retirements | 1 |
| C. Suspensions | 1 |
| D. Reprimands | 0 |

**Program Actions Taken as a Result of Investigations**

| | |
|---|---|
| A. Suspensions | 0 |
| B. Debarments | 0 |
| C. Removals from Program | 0 |
| D. Other Program Actions | 0 |

**Summary of OIG Fraud Line Operation**

| | |
|---|---|
| A. Total Fraud Line Calls/Letters | 559 |
| B. Total Calls/Letters Referred to Investigations Division for Evaluation | 9 |
| C. Total Calls/Letters Referred to Program Offices or Other Federal Investigative Agencies | 95 |
| D. Total Other Calls/Letters | 455 |

# Inspector General Act Statutory Reporting Requirements

The specific reporting requirements prescribed in the Inspector General Act of 1978, as amended by the Inspector General Act Amendments of 1988, are listed below.

| Source | | Pages |
|---|---|---|
| Section 4(a)(2 ) | Review of Legislation and Regulations | 26-27, 30-31 |
| Section 5(a)(1) | Significant Problems, Abuses, and Deficiencies | 3-33 |
| Section 5(a)(2) | Recommendations with Respect to Significant Problems, Abuses, And Deficiencies | 3-33 |
| Section 5(a)(3) | Prior Significant Recommendations Not Yet Implemented | 42 |
| Section 5(a)(4) | Matters Referred to Prosecutive Authorities | 43-48 |
| Section 5(a)(5) And 6(b)(2) | Summary of Instances Where Information Was Refused | None |
| Section 5(a)(6) | Listing of Audit Reports | 39 |
| Section 5(a)(7) | Summary of Significant Audits | 7-29 |
| Section 5(a)(8) | Audit Reports with Questioned Costs | 40 |
| Section 5(a)(9) | Audit Reports with Recommendations that Funds Be Put to Better Use | 40 |
| Section 5(a)(10) | Summary of Reports Where No Management Decision Was Made | 41 |
| Section 5(a)(11) | Significant Revised Management Decisions | None |
| Section 5(a)(12) | Significant Management Decisions with Which OIG Disagreed | None |

# TABLE OF APPENDICES

**Appendix** **Page**

## APPENDIX I
## Audit Reports Issued
## October 1, 2000, to March 31, 2001

| TITLE | NUMBER | ISSUE DATE | QUESTIONED COSTS | FUNDS FOR BETTER USE |
|---|---|---|---|---|
| **Capital Access** | | | | |
| GPRA – 7(a) Business Loans | 1-01 | 12/4/00 | | |
| American Contractors Indemnity | 1-02 | 12/27/00 | | |
| Identification of Possible Ineligible Borrowers | A1-02 | 1/11/01 | | $10,300,000* |
| Ranger Insurance | 1-03 | 1/18/01 | $180,762 | |
| National American Insurance | 1-04 | 1/22/01 | | |
| St. Paul Surety | 1-05 | 2/1/01 | $250,771 | |
| Indemnity Insurance | 1-07 | 2/22/01 | $709 | |
| MVP Sports Café | 1-10 | 3/9/01 | | $641,994 |
| Alexander's Auto Salvage | 1-13 | 3/27/01 | | $120,000 |
| Program sub-total | 9 reports | | $432,242 | $11,061,994 |
| | | | | |
| **Disaster Assistance** | | | | |
| GPRA Disaster Assistance | 1-06 | 2/15/01 | | |
| Program sub-total | 1 report | | | |
| | | | | |
| **Government Contracting and Business Development** | | | | |
| GPRA 8(a) | 1-11 | 3/27/01 | | |
| Program sub-total | 1 report | | | |
| | | | | |
| **Agency Management** | | | | |
| Cost Allocation Study | A1-01 | 12/7/00 | | |
| Loan Monitoring System | A1-03 | 2/23/01 | | |
| SBA FY 2000 Financial Statements | 1-08 | 2/28/01 | | |
| Verification of FACTS Data | A1-04 | 3/8/01 | | |
| PDD 63 | 1-09 | 3/26/01 | | |
| Information System Controls | 1-12 | 3/27/01 | | |
| Program sub-total | 6 reports | | | |
| **TOTALS (all programs)** | 17 reports | | $432,242 | $11,061,994 |

*Represents the recommended loan guarantees cancelled

## APPENDIX II - Part A
## Audit Reports with Questioned Costs
## October 1, 2000, to March 31, 2001

| | | REPORTS | RECs* | COSTS** | |
|---|---|---|---|---|---|
| | | | | QUESTIONED | UNSUPPORTED |
| A. | For which no management decision had been made by September 30, 2000 | 4 | 6 | $4,046,779*** | $558,950 |
| B. | Which were issued during the period | 3 | 6 | $432,242 | 0 |
| | Subtotals (A + B) | 7 | 12 | $4,479,021 | $558,950 |
| C. | For which a management decision was made during the reporting period | 5 | 8 | $3,743,199 | $558,950 |
| | (i) Disallowed costs | 6 | 8 | $3,371,798 | $201,642 |
| | (ii) Costs not disallowed | 2 | 2 | $580,752 | $357,308 |
| D. | For which no management decision had been made by March 31, 2001 | 2 | 4 | $735,822 | $112,316 |

* Recommendations.
** Questioned costs are those which are found to be improper, whereas unsupported costs may be proper but lack documentation.
*** Difference from September 2000 SAR ending balance cause by prior reclassification of prior dollar finding from questioned cost to funds for better use.

## APPENDIX II - Part B
## Audit Reports with Recommendations that Funds Be Put to Better Use
## October 1, 2000, to March 31, 2001

| | | REPORTS | RECs* | RECOMMENDED FUNDS FOR BETTER USE |
|---|---|---|---|---|
| A. | For which no management decision had been made by September 30, 2000 | 3 | 3 | $1,603,345*** |
| B. | Which were issued during the period | 3 | 3 | $11,061,994** |
| | Subtotals (A + B) | 6 | 6 | $12,665,339 |
| C. | For which a management decision was made during the reporting period | 3 | 3 | $1,603,345 |
| | (i) Recommendations agreed to by SBA management | 2 | 3 | $1,454,258 |
| | (ii) Recommendations not agreed to by SBA management | 0 | 1 | $149,087 |
| D. | For which no management decision had been made by March 31, 2001 | 3 | 3 | $11,061,994 |

* Recommendations.
** Includes the recommended loan guarantees cancelled
*** Difference from September 2000 SAR ending balance cause by prior reclassification of prior dollar finding from questioned cost to funds for better use.

## APPENDIX II - Part C
## Audits Reports with Non-Monetary Recommendations
## October 1, 2000, to March 31, 2001

| | | REPORTS | RECOMMENDATIONS |
|---|---|---|---|
| A. | For which no management decision had been made by September 30, 2000 | 12 | 49 |
| B. | Which were issued during the period | 17 | 52 |
| | Subtotals (A + B) | 29 | 101 |
| C. | For which a management decision was made (for at least one recommendation in the report) during the reporting period | 20 | 71 |
| D. | For which no management decision (for at least one recommendation in the report) had been made by March 31, 2001 | 9 | 30 |

## APPENDIX II – Part D
## Issued Audit Reports with Overdue Management Decisions
## March 31, 2001

| **TITLE** | **NUMBER** | **ISSUED** | **STATUS** |
|---|---|---|---|
| Dixieland Events/Tamingo Farms | 0-05 | 2/16/00 | Awaiting conclusion of further lender audit. |
| GPRA – SBIC | 0-25 | 9/7/00 | Program office seeking legal guidance on one recommendation. |

## APPENDIX II - Part E
## Significant Audit Reports Described in Prior Semiannual Reports Without Final Action as of March 31, 2001

| Report Number | Title | Date Issued | Date of Management Decision | Final Action Target |
|---|---|---|---|---|
| 43H006021 | 8(a) Continuing Eligibility | 9/30/94 | 10/30/94 | 6/30/01 |
| 53H004006 | Loan Servicing and Debt Collection | 3/31/95 | 4/30/95 | 12/31/01 |
| 75H011026 | Business Loan Guarantee Purchases | 9/30/97 | 8/15/00 | 12/31/01 |
| 88H002017 | NOAA Computer Contracts | 6/18/98 | 3/1/99 | 9/30/01 |
| 86F008023 | Defaulted Loan by Arkansas Capital Corp | 7/31/98 | 3/31/99 | 6/30/01 |
| 9-11 | Non-Tax Delinquent Debt | 7/28/99 | 8/13/99 | 7/1/01 |
| 9-15 | Disaster Home Loan Servicing Centers | 8/3/99 | 9/20/99 | 4/30/01 |
| 9-23 | Survey of Electronic Records Management | 9/15/99 | 11/30/99 | 6/30/01 |
| 0-05 | Dixieland Events/Tamingo Farms | 2/14/00 | * | * |
| 0-06 | FY 1999 Financial Statements | 2/29/00 | 3/29/00 | 9/30/01 |
| 0-11 | NADI Manufacturing, Inc. | 3/28/00 | 6/13/00 | 12/30/01 |
| 0-14 | 7(a) Service Fee Collections | 3/30/00 | 8/22/00 | 10/31/00 |
| 0-15 | Systems Development Methodology | 3/30/00 | 9/29/00 | 9/30/02 |
| 0-17 | Stop One Convenience Store | 4/28/00 | 10/26/00 | 9/1/01 |
| 0-19 | SDB Business Certification Program | 6/30/00 | *** | ** |
| 0-20 | SBA Financial Reporting | 7/11/00 | 2/2/01 | 9/30/03 |
| 0-25 | GPRA – SBIC | 9/7/00 | * | ** |
| 0-26 | GPRA – Surety Bond Program | 9/26/00 | 1/30/01 | 5/1/01 |
| 0-27 | PDD 63 Planning & Assessment | 9/26/00 | 11/22/00 | 9/30/01 |
| 0-28 | Rhode Island District Advisory Council | 9/29/00 | *** | 6/30/01 |
| 0-29 | MBELDEF Cosponsorship | 9/29/00 | *** | ** |
| 0-30 | SBA Administration of MBELDEF | 9/30/00 | *** | ** |
| 0-31 | Boscart Construction Inc. | 9/30/00 | *** | ** |

* At least one recommendation remains open.

** Target dates vary with different recommendations.

******* Management decision dates vary with different recommendations.

## APPENDIX III
## Six Month Arrested/Indicted/Convicted Summary

| State | Program | Alleged Violation(s) Prosecuted | Arrested/ Indicted/ Convicted/ | Investigated Jointly With. . . |
|---|---|---|---|---|
| AZ | BL | Business brokers submitted fraudulent documents to private lenders to obtain 100-percent financing for clients seeking business acquisition loans guaranteed by SBA; inflated purchase price to cover actual selling price plus cash injection; arranged for buyer to obtain real estate license and listed as asset commission that borrower would earn for sale of business; arranged for third party injectors to loan required down payment as cash injection received inflated commission and arranged for a portion of commission that was loaned by the third party injectors (plus fee) to be wired back to third party. At brokers' direction, client submitted false financial information to obtain $900,000 SBA-guaranteed loan; in plea agreement he admitted knowing that he did not have cash injection needed to close loan and being aware that brokers had obtained temporary cash injection from third party so he could obtain loan. * | Brokers: Both indicted<br><br>Client: Charged and pled guilty | FBI |
| CA | BL | Equipment manufacturer obtained $833,000 SBA-guaranteed Export Working Capital loan by president, associate, and employee participating in scheme utilizing false invoices and faxes; concealed property from bankruptcy court; president omitted significant information from financial statements. * | President and associate pled guilty Employee dismissed | FBI |
| CO | BL | To obtain $100,000 SBA-guaranteed LowDoc loan, painting company owner failed to disclose $250,000 in business debts and two pending lawsuits on application; used some loan proceeds for personal expenses instead of authorized business debts; failed to list numerous assets during bankruptcy. | Indicted | FBI |
| IA | BL | To obtain $1,400,000 SBA-guaranteed loan to purchase business, former president of meat company wrote insufficient-funds check and perpetrated check kite to make it appear that required equity injection was made; concealed undisclosed promissory note to seller; converted vehicles pledged to bank on same loan. * | Indicted | FBI |
| KY | 8aBD | Former Ohio Section 8(a) contractor participated in fraudulent conspiracy to circumvent program graduation rules, using sons to establish Section 8(a) companies in other states to surreptitiously maintain participation in program. | Father pled guilty | EPA/OIG, DCIS |
| MD | BL | On documents to obtain $260,000 SBA-guaranteed loan, listed name/date of birth/SSN of son in place of own; also failed to disclose he owed approximately $3 million to IRS and others. * | Convicted | None |

| State | Program | Alleged Violation(s) Prosecuted | Arrested/ Indicted/ Convicted/ | Investigated Jointly With. . . |
|---|---|---|---|---|
| MS | DL | Assistant minister of church that received $257,600 disaster loan to repair hurricane damage misappropriated $75,000 of loan proceeds; submitted numerous false invoices to SBA in support of request for loan disbursements. | Charged and pled guilty | None |
| MO | BL | To receive $98,235 SBA-guaranteed loan, president of defunct dry cleaners made numerous false statements, including providing false tax return for business; also used false SSNs and false tax returns to obtain five personal loans, resulting in total lender losses of about $197,000. * | Arrested; pled guilty | USSS, SSA/OIG, PIS |
| MT | BL | Owners of hot tub company obtained $170,000 SBA-guaranteed Women's Pre-Qualification loan using inflated invoice; used most of extra $13,000 generated by scheme to pay off undisclosed $8,000 business debt, and pocketed $5,000 remainder. | Both pled guilty | None |
| NE | BL | Former president of participating lender bank requested and received $1,750 in cash payments from two local small businessmen applying for SBA-guaranteed loans; falsely reported to SBA that bank collected no additional fees; actually misappropriated money he received. * | Charged and pled guilty | None |
| NV | DL | To obtain $213,600 disaster home loan, man claimed he was employed 10 months and earned $60,000; actually, he was employed for 3 months and earned only $2,060. * | Indicted | State attorney general |
| NJ | BL | To obtain $500,000 SBA-guaranteed loan, plating/finishing company and three principal officers failed to purchase machinery and fixtures as required in loan agreement, provided forged landlord waiver, and passed three checks to banks knowing that endorsements had not been authorized by endorsing party. Same four defendants plus second plating/finishing company and its owner committed environmental crimes. * | Two corporations and four individuals indicted | EPA/OIG, state enforcement agency |
| NJ | 8aBD | To obtain more than $8 million in Section 8(a) contracts, construction company and president included, in program application to SBA, resumes for individuals falsely purported to be key employees of company, bogus documents purported to be corporate minutes of company containing signatures of officers, and other false documents claiming to identify employees and equipment of company. President submitted Section 8(a) business plan representing that company was equipped to handle construction work in 26 different specialties, but company was really storefront operation that never had employees/equipment/ experience necessary to be viable. President brokered contracts to nonminority-owned companies in return for percentage of contract value. * | Both charged, both pled guilty | ACIC, DCIS, NCIS, VA/OIG, USPS/OIG |
| NM | DL | Using name and SSN of deceased acquaintance, woman obtained post-disaster assistance, including $40,000 SBA home loan; submitted numerous false documents; also attempted to obtain information about claim and investigation by posing as representative of U.S. Attorney's Office. Neither she nor deceased acquaintance ever resided at address claimed in disaster-assistance application. * | Arrested and indicted | FEMA/OIG |

| State | Program | Alleged Violation(s) Prosecuted | Arrested/ Indicted/ Convicted/ | Investigated Jointly With. . . |
|---|---|---|---|---|
| NY | BL | Photo studio owner in applying for $260,000 SBA-guaranteed loan, lied to conceal that: 1) he had been convicted of alien smuggling and was Federal fugitive; and 2) he was resident alien facing deportation proceedings. * | Convicted | SSA/OIG |
| NY | BL | To obtain $200,000 SBA-guaranteed loan purportedly to start restaurant, president failed to disclose extensive criminal history. * | Arrested | SSA/OIG, USSS |
| NY | SBIC | SBIC president embezzled and misapplied its funds, causing SBIC to overpay, to advantage of two private companies affiliated with him, $71,176 more than rightful rent obligations at site they jointly occupied; delayed SBA's seizure of control of SBIC and significantly contributed to Agency's loss of more than $2,200,000. * | Charged and pled guilty | FBI |
| OH | BL | Four individuals formed conspiracy to defraud Government, devised by licensed real estate agent/business broker to facilitate $325,000 SBA-guaranteed loan for purchase of forklift sales/repair business; fraudulently provided funds for required capital injection prior to loan closing; inflated contract sales price; concealed transfer of funds between defendants. One defendant concealed his substantial criminal history. * | Four indicted, one arrested | None |
| OH | BL | Real estate salesman induced title company to issue $427,074 check from escrow account, in name of his Section 504 lender, based on his representations that funds were designated for paying down outstanding balance on SBA loan; then forged endorsement on check and deposited money to his business account instead. * | Convicted | County prosecutor |
| PA | 8aBD | Construction corporation and executive conspired to improperly obtain 8(a) contracts; executive also denied in his SBA 8(a) application that he had criminal history; in fact, he had seven prior arrests and three convictions. * | Corporation pled guilty, executive convicted | USDA/OIG, DOL/OIG, NCIS, ACIC, DCIS |
| TX | BL | To obtain $293,000 SBA-guaranteed loan (purportedly for purchase of restaurant), businessmen devised scheme whereby purported buyer would apply for loan in place of actual buyer, and they would inflate selling price of business by $110,000. They also submitted falsified copies of three tax returns, three bogus IRS tax return verifications, and numerous other fraudulent documents. * | Three indicted; one a fugitive, one dismissed | TIGTA |
| TX | BL | To obtain $355,000 SBA-guaranteed loan, two principals of service station and CPA/SBA-loan packager falsified nine Federal tax returns, six IRS tax verifications, two leases containing forged signatures of fuel company's regional and district managers, and $85,000 capital injection. Indictment also charged all three defendants in connection with $200,000 loan described below. * | One completely new defendant indicted | TIGTA |

| State | Program | Alleged Violation(s) Prosecuted | Arrested/ Indicted/ Convicted | Investigated Jointly With. . . |
|---|---|---|---|---|
| TX | BL | To obtain $200,000 SBA-guaranteed loan, one principal of gas station and wife posed as borrowers intending to purchase gas station from another principal who posed as sole proprietor. They submitted six falsified copies of tax returns, three fraudulent IRS tax return verifications, and numerous other fraudulent documents (including required $60,000 capital injection into business). IRS employee improperly used position with IRS by producing bogus tax return verifications for three tax returns by manipulating use of Integrated Data Retrieval System. * | Four indicted; wife dismissed | TIGTA |
| TX | BL | Three sellers of gas station, and buyer (convicted felon), used buyer's brother's identifiers, false tax returns, and false documentation of capital injection to obtain $256,000 SBA-guaranteed loan. * | Buyer pled guilty, one seller signed pretrial diversion, others dismissed | TIGTA |
| TX | BL | Convenience-store leasehold owner cashed $54,211 SBA loan disbursement check payable jointly to him and financial institution by forging endorsement of financial institution. | Pled guilty | FBI |

* This case is further discussed in the narrative section of this report.

Program codes: BL=business loans, DL=disaster loans, 8aBD=Section 8(a) business development, SBIC=small business investment companies

Joint-investigation Federal agency acronyms: ACIC=Army Criminal Investigation Command; DCIS=Defense Criminal Investigative Service; DOL/OIG=Labor Department OIG; EPA/OIG=Environmental Protection Agency OIG; FBI=Federal Bureau of Investigation; NCIS=Naval Criminal Investigative Service; PIS=Postal Inspection Service; SSA/OIG=Social Security Administration OIG; TIGTA=Treasury Department Tax Administration OIG; USDA/OIG=Agriculture Department OIG; USPO= U.S. Probation Office; USPS/OIG=Postal Service OIG;VA/OIG=Veterans Affairs Department OIG

## APPENDIX IV
## Six Month Sentencing Summary

| State | Program | Alleged Violation(s) Prosecuted | Confinement Time and Dollar Results (Criminal Restitution/Fines/Etc.) | Investigated Jointly With. . . |
|---|---|---|---|---|
| CA | BL | Former banker accepted $24,000 automobile from SBA-loan broker; received share of proceeds of $1 million SBA-guaranteed loan. Broker caused submission of false tax returns in support of $1,850,00 in SBA-guaranteed loan applications. * | Banker: 15 months incarceration, $6,000 restitution<br><br>Broker: 5 months incarceration, 5 months at home, $60,000 restitution | FBI |
| CA | BL | Telemarketing agency owner concealed criminal history in applying for $430,000 and $135,000 SBA-guaranteed loans. | 9 months in halfway house | USPO |
| CA | BL | Real-estate company president and corporate secretary obtained $550,000 SBA-guaranteed loan by using false SSN and fraudulent checks, submitting false financial statements, and omitting corporate secretary's criminal record from SBA application. * | President: 88 months in prison, $103,100 fine, $2,676,329 restitution<br>Secretary: 46 months in prison, $1,900 fine, $2,104,441 restitution | HUD/OIG, FBI, IRS |
| DC | EC | Former SBA timekeeper submitted time sheets to be paid $5,441 in overtime that she did not work. * | Pled guilty; $5,430 restitution | None |
| FL | BL | President of franchiser submitted letter to bank falsely corroborating that $75,000 cash injection from buyers had been paid. Store's seller allegedly signed and submitted bill of sale that indicated total price of $225,000 and verified receiving $75,000 cash injection from buyers. * | Franchiser: Pled guilty; 2 years incarceration, $650,000 restitution<br><br>Seller: Pretrial diversion | FBI |
| IA | BL | In obtaining $45,000 loan, president of repair shop failed to disclose pertinent negative facts. | $5,000 settlement of civil complaint to prevent discharge in bankruptcy of debt to SBA | None |
| MS | EC | SBA employee, having transferred to SBA office in different region, obtained extra $8,779 in reimbursement of expenses for her two children and her husband when they did not relocate with her as she claimed. * | $8,779 restitution | None |
| NJ | BL | Owner of die cutting company with defaulted $940,000 SBA-guaranteed loan concealed property (condominium) from creditors and bankruptcy trustee. * | Pled guilty; $10,000 fine | FBI |
| NJ | BL | Loan packager whose Internet site offered loan applications allegedly required applicants to pay 5-percent fee plus 1-percent good-faith deposit; allegedly falsely represented his company as authorized to approve consumer loans in New Jersey; allegedly failed to refund advance fees as promised. | Agreed to desist from soliciting mail clients & to repay $62,850 to customers in 11 states | PIS |

| State | Program | Alleged Violation(s) Prosecuted | Confinement Time and Dollar Results (Criminal Restitution/Fines/Etc.) | Investigated Jointly With. . . |
|---|---|---|---|---|
| NY | 8aBD | Project manager of construction company forged bond to defraud Government in connection with $379,079 Section 8(a) contract. Company's president concealed criminal record, obtained line of credit by fraud, conspired in bond fraud. * | Project manager: 1 year + 1 day incarceration, $45,375 restitution<br><br>President: $259,369 restitution | FBI |
| NY | SBIC | SBIC president obtained $750,000 in loans and $250,000 in salary advances by misrepresenting their legitimacy; then used fraudulently-obtained funds for personal debts. SBIC vice president cosigned loan and advance checks. * | President: 1 year incarceration, $770,000 restitution<br><br>Vice president: Settled SBA receiver's civil suit for $170,000 | FBI |
| PA | 8aBD | President of defunct construction company falsely represented he was 100 percent owner on Section 8(a) program application; falsely reported payments to subcontractors; made false progress payment certifications on $1.6 million contract. * | Charged and pled guilty; plea agreement requires restitution (pursuant to stipulated $3,200,000 judgment) to surety-bonding company before sentencing | NCIS, VA/OIG |
| TX | BL | Attorney induced disbursement of $95,000 SBA-guaranteed loan by false invoices and certifications of expenditures; falsely negotiated joint-payee disbursement checks; and used some loan proceeds to purchase another business. | $13,413 restitution | None |
| TX | BL | To obtain $350,000 SBA-guaranteed loan, proprietor of auto repair shop and employee submitted false tax return and falsified capital injections and equipment purchases. * | Employee convicted; 37 months incarceration, $506,203 restitution<br>Proprietor: fugitive | TIGTA |
| TX | BL | To obtain $675,000 SBA-guaranteed loan, owner of clothing manufacturer used false SSN and false name to conceal that her previous business had defaulted on SBA loan and that she had previously filed for bankruptcy; also submitted fictitious tax returns, falsified financial statements, and other documents; then failed to purchase equipment pledged as collateral and spent most of loan proceeds for personal purchases. * | 54 months in prison, $656,955 restitution | TIGTA, SSA/OIG |

* This case is further discussed in the narrative section of this report.

Program codes: BL=business loans, EC=SBA employee conduct, 8aBD=Section 8(a) business development, SBIC=small business investment companies

Joint-investigation Federal agency acronyms: FBI=Federal Bureau of Investigation; HUD/OIG=Housing & Urban Development Department OIG; IRS=Internal Revenue Service; NCIS=Naval Criminal Investigative Service; PIS=Postal Inspection Service; SSA/OIG=Social Security Administration OIG; TIGTA=Treasury Department Tax Administration OIG; USPO= U.S. Probation Office; VA/OIG=Veterans Affairs Department OIG

# MAKE A DIFFERENCE

To promote integrity, economy, and efficiency, we encourage you to report instances of fraud, waste, or mismanagement to the SBA OIG FRAUD LINE.*

## CALL

1-800-767-0385 (Toll Free)
202-205-7151 (Washington, DC, Area)

## Write or Visit

U.S. Small Business Administration
Office of Inspector General
Investigations Division
409 Third Street, SW. ($5^{th}$ Floor)
Washington, DC 20416

Or E-mail Us At OIG@SBA.GOV

*Upon request your name will be held in confidence.