



U.S. Small Business Administration
Office Inspector General

Memorandum

To: Ana Ma
Chief of Staff

Date: April 30, 2009

From: Debra S. Ritt /s/ **Original Signed**
Assistant Inspector General for Auditing

Subject: Key Unresolved OIG Audit Recommendations in Program Areas Funded by the American Recovery and Reinvestment Act and Related Activities Needed to Safeguard Funds (Report No. ROM-09-1)

Under the American Recovery and Reinvestment Act of 2009 (Recovery Act), the Small Business Administration (SBA) will receive \$730 million to expand the Agency's lending and investment programs and to create new ones that will aid small business owners and revitalize the secondary market for SBA-guaranteed loans. To reduce the risks associated with the extraordinary level of Recovery Act funding, the Office of Management and Budget (OMB) has directed agencies to address weaknesses or deficiencies disclosed by prior audits and investigations in program areas under which Recovery Act funds are authorized. Where recommended final actions have not been completed, agencies are to expedite or explain why such actions cannot or should not be taken in the administration of Recovery Act programs in the Agency's risk mitigation plan.

To aid SBA in this effort, we have identified unresolved audit recommendations from reports we have issued that address weaknesses or deficiencies in (1) programs directly impacted by the Recovery Act, and (2) operational support processes that will impact the disbursement and financial reporting of Recovery Act funds. Final actions are overdue for 10 of the 29 recommendations. Others either did not have a management decision or had identified final actions that should be expedited due to the associated risks. While the Agency is responsible for determining when recommendations can be closed, and the Agency closed 2 of the 10 overdue recommendations, our review found that the problems identified were not corrected. Therefore, we are including those two recommendations in this memorandum. The recommendations address actions that are needed to:

- strengthen oversight of 7(a) lenders;
- identify and recover improper payments;
- develop procedures and performance measures for the Microloan program;
- enhance information technology (IT) systems used to monitor and manage loan activity; and
- improve contract award and administration.

STRENGTHENING OVERSIGHT OF 7(A) LENDERS

Prior audits and investigations have identified material deficiencies in SBA's oversight of lenders participating in the 7(a) Loan Guaranty program. The 7(a) program is SBA's largest lending program and the principal vehicle for providing small businesses with access to credit that cannot be obtained elsewhere. The Recovery Act authorizes \$375 million in funding to temporarily reduce or eliminate fees and increase 7(a) loan guaranties to up to 90 percent. Because the higher guaranties reduce lender risk, which may lead to poor underwriting, a greater potential will exist for losses and fraud.

Excerpted below are audit findings and unresolved recommendations from three reports that are aimed at correcting deficiencies in how (1) SBA monitors lenders, (2) delegates authority to lenders to originate, service, and liquidate loans, and (3) implements enforcement actions to correct unacceptable lender performance.

- ***SBA's Use of the Loan and Lender Monitoring System (OIG Report No. 7-21, May 2007)***. We reported that SBA conducted on-site reviews of lenders with guaranteed loan portfolios of \$10 million or more, but did not review smaller lenders with high-risk ratings. We also reported that SBA had not developed comprehensive policies establishing how lender risk ratings generated by its Loan and Lender Monitoring System would be used to manage lender performance. SBA agreed, but has not completed action to:
 - Develop an on-site review plan or agreed-upon-procedures for all high-risk 7(a) lenders with guaranteed loan portfolios in excess of \$4 million.
 - Implement comprehensive policies and procedures that define: acceptable lender performance and risk tolerance levels, enforcement actions that will be taken when risk tolerance limits are violated, and how lender risk data will be incorporated into agency-wide oversight activities and credit models.

- ***Oversight of SBA Supervised Lenders (OIG Report No. 8-12, May 2008)***. The audit examined SBA's oversight of its supervised lenders. At the time of the audit there were eight lenders that had loan portfolios in excess of \$100 million and were considered to be among SBA's largest lenders. As of September 2007, SBA supervised lenders had a combined portfolio of \$5.6 billion, which represented about 18 percent of SBA's total 7(a) loan portfolio. These lenders presented a higher risk of loss than other 7(a) lenders because they were not regulated by other Federal agencies. We reported that even though these lenders had recurring performance and compliance issues, SBA continued to renew and expand their delegated authorities, allowing them to operate with minimum oversight, and did not take enforcement actions to correct lender performance. We also reported that SBA did not conduct timely reviews of the lenders' defaulted loans, properly scope onsite examinations or schedule them to coincide with delegated authority decisions, or consistently require corrective action plans for problem lenders. While the Agency has begun to address these issues, it has not taken final action to:
 - Establish risk mitigation goals applicable to the 7(a) program and lending portfolio, and performance measures to indicate the progress in achieving the goals.
 - Develop standard operating procedures that will establish a hierarchy of enforcement actions addressing when and under what circumstances specific enforcement actions will be implemented, and require that any deviations from the procedures be justified in writing.
 - Issue guidance requiring that onsite examinations be conducted no earlier than 90 days prior to the delegated lending authority renewal period; and that lender compliance be determined based on a review of a statistical sample of loans.
 - Develop guidance addressing when corrective action plans should be required and ensure that the plans include performance goals and milestones to be achieved by the lenders.
 - Revise SOP 50 10 to include specific criteria for renewals of delegated lending authorities that addresses the normal 24-month renewal periods, any abbreviated renewal periods, and performance benchmarks used in the process.

- *Audit of SBA's FY 2007 Financial Statements – Management Letter (OIG Report No. 8-06, December 2007)*. We reported that SBA did not properly or timely follow-up with lenders on the liquidation of loans eligible for charge-off, potentially resulting in uncollectible loans remaining on SBA's financial statements as a receivable. We found that lenders were not providing the required 180-day liquidation status reports, which delayed liquidation actions on loans. The Agency agreed to address this issue, but has not taken final action to:
 - Implement procedures to evaluate, on a scheduled time frame, lenders who are consistently delinquent in providing reports and documentation to SBA, and consider taking actions against those lenders.

IDENTIFYING AND RECOVERING IMPROPER PAYMENTS

A number of audits over the last several years have been critical of the Agency's ability to identify and collect improper payments of loan guaranties when lenders failed to comply with SBA regulations or did not follow prudent lending practices. We found that SBA's purchase reviews and loan liquidation processes did not adequately identify improper payments. Chief among the factors that contributed to inadequate loan reviews was the lack of management emphasis on oversight based on the placement of these functions under the Office of Financial Assistance (OFA), whose goal of increasing the volume of loans conflicted with holding lenders accountable for unnecessary Agency losses.

During recent audit follow-up efforts related to the recovery of improper payments, we noted that SBA did not timely recover all identified improper payments or to take appropriate actions to mitigate further losses. For example, in May 2003, SBA agreed to recover \$630,224. According to an Office of General Counsel opinion issued in December 2008, we learned that recovery was no longer feasible because SBA did not pursue recovery within the statute of limitations for recovery. Currently, \$4.2 million in improper payments from recent audits have not been recovered. Increases in loan volumes and reduced lender risk under the Recovery Act are expected to lead to higher levels of improper payments. These improper payments and demands for greater accountability over Recovery funds will require that SBA prudently manage 7(a) program losses by taking appropriate action to repair and deny loan guaranties due to lender noncompliance.

To increase management emphasis on improper payments, SBA moved oversight of the guaranty purchase and loan liquidation function to a newly established Office of Financial Program Operations within OCA. The following audit report was issued in January 2009 and final actions on the recommendations are not yet

due. However, to strengthen Agency efforts to identify and recover improper payments, SBA needs to expedite final actions on the following recommendations.

- ***Audit of the Liquidation Process at the National Guaranty Purchase Center (OIG Report No. 9-08, January 2009).*** The audit identified \$4 million of improper payments and uncollected amounts resulting from lender noncompliance that were not addressed during purchase or liquidation. Inadequate contractor training and supervision largely contributed to the Agency's inability to properly identify lender compliance. The most common loan issues were related to unsupported sales of collateral, acceptance of inadequate offers in compromise, and inappropriate repair decisions regarding collateral. The Agency agreed to address these issues, but has not taken final action to:
 - Direct the Center to ensure that charge-off reviews are properly supervised and that all required documentation is obtained from lenders.
 - Revise liquidation recovery rates in SOP 50 51 (2) to reflect the forced sale liquidation values related to the various types of collateral used to secure SBA loans.
 - Perform periodic reviews of non-purchased loans in liquidation to ensure that they are removed from the portfolio when appropriate and their outstanding balances are correct.

DEVELOPING PROCEDURES AND PERFORMANCE MEASURES FOR THE MICROLOAN PROGRAM

The Recovery Act authorizes \$24 million for marketing, management, and technical assistance activities under SBA's Microloan program and \$6 million for new loans. To better ensure the productive use of these funds, SBA will need to address recommendations from a prior OIG report that identified significant internal control weaknesses in the administration of the Microloan program. The Agency also needs to establish program policy and procedures to consistently implement the Microloan program and to meet the expectations of transparency and accountability under the Recovery Act.

- ***Microloan Program: Moving Toward Performance Management (OIG Report No. 3-26, May 2003).*** We reported that oversight activities conducted by SBA district offices significantly varied as the program operated without a set of Standard Operating Procedures. Also, strategies for the outreach and marketing of microloans by district

offices, and internal control plans to monitor the number of Intermediaries and to review non-performing lenders had not been developed. Employees, instead, must rely on unofficial guidance and policy statements, which have been communicated through letters and memoranda. We also reported that SBA could not effectively evaluate the performance of the program beyond microloan volume because the Agency did not collect the appropriate information to develop outcome-based measures. In order to address these issues, SBA agreed, but has not taken, final action to:

- Ensure the development of a comprehensive Microloan Program SOP and a systematic approach for the official dissemination of guidance and information that can be routinely revised or updated as appropriate.
- Ensure that program goals are set and outcome-oriented data, such as information on business status at the time the microloan is paid in full or written off and other data related to the program's legislative and SBA's strategic objectives, is required of all program participants.

ENHANCING INFORMATION TECHNOLOGY SYSTEMS NEEDED TO MONITOR AND MANAGE LOAN ACTIVITY

Prior audits have identified weaknesses in SBA systems used to monitor and manage loan activity, to include (1) inaccurate lender reporting of loan information; (2) inadequate system functionality to effectively manage loan status; and (3) insufficient controls for modifying system enhancements. These weaknesses could impact SBA's ability to adequately and timely manage increases in lending activity and default rates expected under the Recovery Act.

The Agency needs to complete final action on the following recommendations:

- ***Loan Classifications and Overpayments on Secondary Market Loans (OIG Report No. 8-09, March 2008).*** The audit identified weaknesses in the 1502 Reporting Process and the Loan Accounting System (LAS), which the Agency uses to collect data and monitor loan activity for all 7(a) loans. We reported that LAS misclassified some loans as current, even if they were past due. We found that SBA's reliance on the next installment due dates reported by lenders was the major reason why loans were inaccurately classified. These dates should not be relied upon as they can easily be misreported based on partial loan payments and can be improperly altered by lenders without approval from SBA. If loan currency data is not accurate, complete, or timely, SBA cannot

effectively manage the risks associated with the loan portfolio. We also reported that LAS does not have the capability to identify loans with no principal reductions for 60 days or more, further hampering SBA's ability to accurately classify loan currency. SBA did not agree to address the deficiencies noted, but needs to implement:

- Procedures for classifying loans in the Loan Accounting System to ensure that loan currency is not solely based on the next installment due date, and that data from monthly default reports and principal payment information is also considered.
 - Additional actions to ensure lenders comply with the requirements for reporting next installment due dates on 1502 reports to ensure dates are (1) only rolled forward when a full loan payment is received, and (2) left as past due if a payment is missed or only a partial payment is made.
 - A mechanism to identify loans with no principal reduction for 60 days or more, classifying these loans as past due, and regularly monitor them in accordance with the Secondary Participation Guaranty Agreement (Form 1086).
- ***Audit of SBA's FY 2008 Financial Statement (OIG Report No. 9-03, November 2008 and 9-05, December 2008).*** The audit identified inadequate software change controls in several financial applications integral to implementing new SBA loan programs and meeting financial reporting requirements of the Recovery Act. Software change controls are required to ensure that modifications to existing IT systems do not compromise security controls to prevent processing irregularities or malicious code from being introduced into the IT environment. We reported that several software changes were either not tested or approved for LAS and the Electronic Transaction System (E-TRAN) used to process loan applications. In order to control system modifications that will enable SBA to process and report on Recovery Act loan programs, the Agency agreed to, but has not yet completed, actions to:
- Consistently document software change testing results and approvals for all of its critical financial systems and its local and wide-area networks.
 - Monitor all changes to critical financial systems, such as payment systems, and develop comprehensive procedures to test software updates.

- ***Audit of the Liquidation Process at the National Guaranty Purchase Center (OIG Report No. 9-08, January 2009).*** This audit, which was previously discussed, also disclosed that loans in liquidation were not properly monitored or managed because the National Purchase Guaranty Center lacked an automated system to alert managers of liquidation actions needed on loans. The Agency agreed that an automated system was needed, but did not take final action on the following recommendation because it believes such a capability will be provided by the Loan Management and Accounting System (LMAS) that is currently under development. However, because the LMAS project is currently in the planning phase and is not expected to be completed until 2012, we believe the Agency will need to take interim steps to obtain the information needed to manage its liquidation portfolio. Therefore, the audit recommendation is still relevant, and while not overdue, expedited final action is needed to:
 - Further enhance the Center's newly designed portfolio management system to include the appropriate controls and ensure the appropriate resources are assigned to address loans needing action.

IMPROVING CONTRACT/GRANT AWARD AND ADMINISTRATION

Prior audits have demonstrated problems with the award, monitoring, and close-out of SBA contracts and grants, which increases the risk of waste, fraud, and abuse. While the Agency plans to address the identified weaknesses by revising Standard Operating Procedure (SOP) 00 11 1, *Small Purchases, Contracts, Grants, and Cooperative Agreements*, the SOP has been under revision for over 10 years and has yet to be published. With contract and grant activities expected to increase with Recovery Act funding, steps are needed to ensure that such expenditures guarantee the best value to the Agency and are appropriately managed and controlled. Excerpted below are audit findings and unresolved recommendations from a report that addresses deficiencies in how SBA awards and administers contracts and grants:

- ***Audit of SBA's Administration of the Procurement Activities of Asset Sale Due Diligence Contracts and Task Orders (OIG Report No. 4-16, March 2004).*** We reported that SBA did not always follow proper procurement methods in contracting with small businesses to review loan portfolios for SBA asset sales or perform post-award duties in accordance with established procedures. We also reported that asset sale due diligence procurements did not always benefit small businesses

because the Agency did not ensure that limits on subcontracting were adhered to, and that all eligible contractors were solicited in accordance with GSA procedures. Additionally, we reported that use of the Federal Supply Schedule to procure due diligence services was not in the SBA's best interest and did not ensure SBA received the best value with regards to cost and quality of services. SBA agreed, but has not completed action to:

- Revise current procedures to require that offerors for 8(a) and small business set-aside contracts and set-aside Federal Supply Schedule (FSS) contracts clearly support the amount of personnel costs to be subcontracted.
- Ensure the amount of subcontracting is reviewed and documented in the contract file for 8(a) and small business set-aside contracts and task orders to small business set-aside FSS contracts.
- Develop and implement procedures to monitor contractor compliance with the 50-percent rule on subcontracting, when applicable.
- Require FSS contractors classified as small businesses to certify their size for FSS task orders exceeding \$500,000 to ensure the contractors fit within applicable size standards.
- Ensure all sole source requirements of the Federal Acquisition Regulations (FAR) are complied with when only one contractor is solicited.
- Ensure contracting officials provide all potential offerors with any contractor questions and respective SBA answers that clarify ambiguities in the solicitation or contain information necessary for the preparation of proposals in accordance with the FAR and Standard Operating Procedure 00 11 1.
- Develop and implement planning procedures in accordance with FAR Part 7 and issue a procedural notice to ensure that SBA program officials are knowledgeable of procurement planning requirements.
- Finalize SOP 00 11 2 as soon as possible, incorporate policies to address the outstanding items described above, and ensure future directives are cleared and issued within reasonable time frames.
- Ensure contracting officials are reviewing the GSA approved price lists when issuing task orders to FSS contracts to ensure SBA is not being overcharged and that ordered items are on the FSS.