



Office of Inspector General Small Business Administration

February 2002 Update

Agency Management

Agency Financial Statements Audit Issued. On February 27, 2002, OIG issued an audit report on SBA's FY 2001 financial statements, which received an unqualified opinion. The independent auditors determined that the financial statements **present fairly, in all material respects, the financial position of SBA** as of September 30, 2001, and 2000, and its net costs for the years then ended, and the changes in net position, budgetary resources, and financing for the year ended September 30, 2001, were in conformity with generally accepted accounting principles.

The independent auditors determined that there were **four reportable conditions involving SBA's internal control and its operation**. The reportable condition related to the financial reporting process was deemed a material weakness, as SBA continued to experience difficulties in producing complete, accurate, and timely financial statements. The other three reportable conditions were: (1) SBA's cash flow models used for determining subsidy re-estimates continued to contain errors that remain undetected by SBA; (2) SBA used a small non-representative sample to estimate the amount of excess of the Master Reserve Fund investment earnings over payments to certificate holders from those earnings; and (3) SBA's information system control environment continued to need improvements. OIG made recommendations to correct these conditions. SBA management generally agreed with the findings and recommendations. The reportable condition involving the information system control environment will be addressed in detail in a separate report titled *Audit of SBA's Information Systems Controls – FY 2001*.

Further, the auditors determined that SBA's financial management systems did not substantially comply with the Federal Financial Management Improvement Act because: (1) SBA's core financial system was not able to provide complete, reliable, timely, and consistent financial management information for external reporting and managing current information; and (2) significant errors and misstatements were made in SBA's initial financial statements.

Business Loan Programs

Audit of SBA-Guaranteed Loans. OIG initiated an audit of all SBA-guaranteed loans originated by a single lender purchased by SBA between January 1996, and February 2000. The objective of the audit was to determine if the lender processed the loans correctly. The audit resulted in the identification of multiple loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. The following two audit reports address two of those loans.

On February 27, 2002, OIG issued an audit report on an SBA-guaranteed loan. The **lender did not secure the loan with all available collateral** as required by the standard operating procedure (SOP). According to Agency policy, when there is a shortfall of business assets, the lender must secure worthwhile available assets owned by the principals. The loan was under secured by \$74,202. The principal, however, had personal assets with an estimated liquidation value of \$83,202 that could have reduced SBA's loss. We recommended that the district office seek recovery of SBA's guaranty percentage of \$62,501.50. The district office agreed with the recommendation and suggested a repair in the guarantee by the amount

recommended. The lender did not provide comments to the draft report in time for inclusion in the final report.

On February 27, 2002, OIG issued an audit report on a second SBA-guaranteed loan. OIG found that the **lender approved the loan to an ineligible borrower**. Pursuant to the SOP, a lender must verify the resident alien status of an applicant to ensure that the principal is authorized to remain in the United States for at least half of the maturity of an approved loan. According to the lender's loan file, the principal was only authorized to remain in the United States for 2 months after loan approval, instead of the 11 years required for the 22-year maturity. We recommended that the district office seek recovery of \$308,228. The district office agreed with the recommendation and stated that action would be taken to recover the amount from the lender. The lender did not agree with the finding because the principal's resident alien status did not cause the business to fail. OIG did not agree with the lender's position, because the lender had ample information that the applicant was not eligible for the loan. By obligating SBA to guarantee an ineligible loan, the lender inappropriately placed SBA at unnecessary risk.

Preferred Lender Agrees to Release SBA from \$8.2 Million Guaranty Liability. An SBA preferred lender agreed on February 13, 2002, to **release SBA from guaranty liability** on 16 defaulted business loans. This action resulted in an SBA cost savings of more than \$8.2 million. An investigation by OIG and the Federal Bureau of Investigation (FBI) identified the 16 loans in question as part of an alleged fraudulent scheme. The preferred lender's decision to release SBA from liability resulted from the joint investigation and the diligent efforts of SBA's Houston District Office.

Ohio Real Estate Agent and Business Broker Sentenced to Prison. A licensed real estate agent and business broker in the Cleveland, Ohio, area was sentenced on October 30, 2001, to 2 years imprisonment, 2 years probation, and \$46,500 restitution to SBA. A jury previously found her guilty of **making false statements to SBA and conspiracy to defraud the Government**. She and three others had been indicted in connection with a scheme to facilitate a \$326,000 SBA-guaranteed loan to a man for his

purchase of a forklift-sales and -service business in Parma, Ohio, from a couple. The scheme to fraudulently provide the purchaser with the funds for his required capital injection prior to the loan closing enabled all the defendants to benefit from the completion of the transaction. It essentially provided him with 100 percent financing and resulted in inflation of the contract sales price, thereby exposing SBA and the participating lender to additional loss and reduced recovery potential. The benefit to the couple was the sale of their business; the benefit to the real estate agent/business broker was her commission. This scheme to defraud SBA and the participating lender was also facilitated by each of the subjects' concealment of the transfer of funds from the couple to the purchaser, and their supporting false statements to the participating lender and SBA. OIG initiated its investigation based on a referral from SBA's Cleveland District Office.

Four Illinois Men and Defunct Corporation Indicted. On January 15, 2002, four Illinois men (a restaurateur and three attorneys) and a defunct Illinois corporation were indicted as a result of OIG's joint investigation with FBI. The indictment charged the defendants with two **conspiracies, mail fraud, wire fraud, bankruptcy fraud, making material false statements, and obstruction of justice** in connection with the sale of an Antioch, Illinois, restaurant and bar financed, in part, with a \$1.25 million SBA-guaranteed loan. OIG initiated this investigation based on referrals from SBA's Illinois District Office and an anonymous complainant.

President of Kentucky Construction Company Pleads Guilty to Conspiracy. The president of a construction company in Louisville, Kentucky, pled guilty on January 31, 2002, to one count of **conspiracy to defraud the Government with respect to claims**. As part of his plea agreement, the Government will dismiss the other counts on which he was previously indicted. He and a guarantor obtained \$250,000 in SBA-guaranteed bank loans in 1997. The 12-count November 2001 indictment of the president, the guarantor, and the president's brother alleged that they conspired to defraud SBA. Purportedly, the guarantor and the president submitted five fraudulent and falsified invoices claiming that they purchased office furniture, computer equipment, and a backhoe to induce disbursement of the loans. They then falsely negotiated the joint payee loan checks. In addition,

the guarantor and the president allegedly allowed a company vehicle to be individually titled to the president's brother and proceeds from sale of the vehicle to be retained for personal use. Proceedings continue as to the guarantor and the president's brother. OIG initiated this investigation based on information received from SBA's Kentucky District Office.

Executive Director of New Hampshire Microlender Sentenced. The former executive director of a microlender of SBA funds in Manchester, New Hampshire, was sentenced on January 30, 2002, to 4 years probation, 150 hours community service, and \$28,336 restitution to SBA. He previously pled guilty to one count of **submitting material false statements**. This was the first conviction in the 10-year history of SBA's Microloan Program, which provides short-term small (under \$25,000) loans to entrepreneurs via SBA-approved, nonprofit intermediaries known as microlenders. As executive director, he was required to report to SBA on a quarterly basis the balances of the bank accounts established to manage the microloan funds. SBA uses these reports to monitor the microlender's performance and liquidity. According to his indictment, between November 1996 and March 1997, he knowingly submitted false material statements to SBA by vastly overstating the actual balances of the microloan accounts. In reports he submitted for the quarters ending in June and December 1996, he claimed combined account balances of \$325,678 and \$409,486; however, the actual balances totaled only \$15,900 and \$67,071, respectively. The indictment also charged that he converted to his personal use \$13,042 in microloan funds when he withdrew these funds from the microloan accounts and deposited them into his private accounts. In June 1997, the microlender became insolvent and SBA took over administration of its loan portfolio. OIG initiated this investigation based on information provided by SBA's Office of Financial Assistance and New Hampshire District Office.

Iowa Meat Distribution Company President/Owner Sentenced. The president and owner of a now-defunct meat distribution business in Cumming, Iowa, was sentenced on February 12, 2002, to 63 months in prison, 5 years on probation, and \$1.23 million restitution to SBA's participating lender bank. A Federal jury previously convicted him on one count each of **concealing a material fact from SBA, bank**

fraud, embezzlement, and money laundering. In connection with a \$1.4 million SBA-guaranteed loan he received from the bank in 1997 to purchase the company, the defendant wrote an insufficient-funds check and perpetrated a check kite to make it appear he had made a required \$300,000 equity injection. In 1998, he criminally converted (from the company's ownership to his own) four vehicles pledged to the bank on this same loan. In 1999, he embezzled nearly \$500,000 from the pension plan of another meat distribution business he owned. Then he laundered the money he had embezzled. Both meat distribution companies failed and he defaulted on his SBA-guaranteed loan. Following the jury's verdict, the judge ordered that the \$468,934 that he feloniously obtained from the meat distribution company pension plan be forfeited to the United States. OIG initiated this investigation conducted jointly with FBI, the Pension and Welfare Benefits Administration, and the Customs Service based on a referral from SBA's Des Moines District Office.

Co-Owner of Texas Dry Cleaners Indicted for Bank Fraud and Making False Statements. A co-owner of a dry cleaning business in Dallas, Texas, was indicted on February 13, 2002, on one count of **bank fraud** and one count of **making a false statement to SBA**. Allegedly, he submitted a false personal financial statement, in which he concealed personal debt that understated his liabilities, to a bank to obtain a \$77,500 SBA-guaranteed loan. Subsequently he purportedly falsely certified that there had been no substantial adverse change in his financial condition to induce disbursement of loan funds. OIG conducted this investigation jointly with FBI and the Postal Inspection Service.

Virginia Chiropractor Sentenced. A Virginia Beach, Virginia, chiropractor was sentenced on February 20, 2002, to 5 years probation (the first 6 months under home confinement with electronic monitoring) and \$136,617 restitution (more than 70 percent to SBA, almost 30 percent to the participating non-bank lender). He previously pled guilty to one count of **making a false statement under oath in bankruptcy**. He had submitted false equipment invoices and a false building lease in support of his application for a 1996 SBA-guaranteed loan of \$337,000 to purchase equipment. Upon receiving the two-payee disbursement checks for the loan, he forged the endorsement of the equipment company and deposited

the checks into his personal account. He subsequently defaulted on the \$136,617 balance of the loan. His scheme was revealed when he filed bankruptcy in 1999. OIG's joint investigation with FBI was based on a referral from the U.S. Bankruptcy Trustee in Norfolk, Virginia.

Disaster Loan Program

New York Man Pleads Guilty to Wire and Bank Fraud. A North Haven, New York, man pled guilty on February 19, 2002, to a criminal information charging him with one count of **wire fraud** and two counts of **bank fraud**. The charges related to a scheme to defraud SBA of disaster loan funds. He had assisted a physician practicing in California, who rented a New York City apartment from him, with the care of her elderly mother during 1999 and 2000. When the elderly lady's home in Cortland Manor, New York, was damaged by a hurricane in late 1999, she applied with the help of her daughter for an SBA disaster loan. The defendant became involved in the details of the loan when the physician had to return to California. He submitted altered invoices for work purportedly performed on the elderly woman's home. His false statements led SBA to lend the elderly woman \$78,300. He then fraudulently wrote and endorsed checks from the elderly woman's bank account and used loan proceeds to pay for repairs at his residences and other personal expenses. The joint OIG/FBI investigation was initiated based on a complaint by a member of the public.

Small Business Investment Companies

Board Member of Defunct New York Small Business Investment Company Pleads Guilty to Conspiracy and Mail Fraud. A former board member of a defunct specialized small business investment company (SSBIC) in Rockland County, New York, pled guilty on January 23, 2002, to one count each of **conspiracy** and **mail fraud**. The charges relate to his participation in schemes to defraud the Government of tens of millions of dollars from various Federal programs, including SBA's SSBIC program. The plea resolved his 1997 indictment (along with six other defendants including his son) on 21 counts of **conspiracy, embezzlement of Federal program funds, making material false statements, mail fraud, wire fraud, mortgage fraud, and money laundering**. As an SSBIC board member, the board member

misappropriated SBA funds by extending loans to small businesses affiliated with the SSBIC's officers and directors and concealed these improper loans by submitting fraudulent documents to SBA. He also loaned SBA funds to enterprises that were not independently controlled by private business owners but instead were affiliated with a religious school, a not-for-profit entity ineligible to receive SBA funds. The SSBIC also made loans to small businesses that, in turn, improperly paid a portion of the loan proceeds to the religious school or to related entities. When he failed to appear in court to face the charges in his 1997 indictment, a warrant was issued for his arrest. After an extensive search, he was located in Israel, where he had obtained Israeli citizenship, and was arrested by Israeli police in February 1999, in response to a formal request submitted by the U.S. Department of Justice. After extensive legal proceedings, the Supreme Court of Israel ordered his extradition, and he was returned to the United States in November 2001. He was one of the first fugitives to be extradited to the United States under an Israeli law enacted in April 1999, which permits the extradition of Israeli citizens. SBA/OIG's investigation was based on information received from the Internal Revenue Service (IRS) and was worked jointly with IRS and OIGs of the U.S. Departments of Education and Housing and Urban Development.

Surety Guarantees

Audit Report Issued on Preferred Surety Bond Company. On February 28, 2002, OIG issued an audit report on a **preferred surety bond company**. The audit found that the surety correctly calculated and timely remitted fees to SBA. The audit also found that the surety **did not always comply with SBA regulations for underwriting and servicing bonds and processing claims**. More specifically, the company: (1) did not request and maintain status reports for one bond; and (2) made a duplicate claim payment on one bond that was reimbursed by SBA. As a result, the auditors recommended that SBA take appropriate actions to recover \$2,837.01 and advise the company to review, revise, and adhere to policies and procedures to correct the deficiencies. SBA management agreed to implement the recommendations upon completion of the audit.

Second Audit Report Issued on Preferred Surety Bond Company. On February 28, 2002, OIG issued an audit report on a second **preferred surety bond company**. This audit found that the surety correctly calculated and timely remitted fees to SBA. The audit also found that the surety **did not always comply with SBA regulations for underwriting and servicing bonds and processing claims**. More specifically, the company did not: (1) maintain copies of required SBA forms for one bond; and (2) notify SBA of default for one bond in a timely manner. As a result, the auditors recommended that SBA advise the company to implement and enforce policies and procedures to correct the deficiencies. SBA management agreed to implement the recommendations upon completion of the audit.

Government Contracting and Business Development Program

President of Defunct Pennsylvania Construction Company Indicted for Making Material False Statement. The president of a defunct Hunting Valley, Pennsylvania, construction company was indicted on January 31, 2002, on one count of **making a material false statement** to SBA. He allegedly represented in his SBA Section 8(a) Annual Update form and attachments that he had relocated to Pennsylvania along with his Section 8(a) certified business and that he controlled the day-to-day operations of the company. The indictment charges that he never relocated to Pennsylvania from Michigan and that he had a friend run the daily affairs of the business. The identity and role of his friend was not made known to SBA. The friend who controlled the business was not eligible to participate in the Section 8(a) program because he had already graduated from the program and would not be considered disadvantaged. SBA/OIG is continuing this joint investigation with the Naval Criminal Investigative Service, the Department of Veterans Affairs OIG, the Defense Criminal Investigative Service, and the Customs Service.

Office of Inspector General

OIG has established an e-mail address (oig@sba.gov) that we encourage the public to use to communicate with our office. We welcome your comments on our publications, suggestions for possible audits, or referrals of possible incidents of waste, fraud, or abuse.

The activity Update is produced by SBA/OIG,
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Comments or questions concerning this Update or request for copies of OIG audits, inspections, and/or other documents should be directed to:

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