



Office of Inspector General U.S. Small Business Administration

February 2005 Update

Agency Management

OIG Issues Management Challenge on Small Business Contracting. On February 24, 2005, the OIG issued a new management challenge on small business contracting under the report title “*Large Businesses Receive Small Business Awards.*” This challenge provides a concise statement of the problems that have been identified in past OIG, Government Accountability Office, and Office of Advocacy reports, as well as in expert testimony to Congress. One of the most important challenges facing the SBA and the Federal Government is that large businesses are receiving small business procurement awards and agencies are receiving credit for these awards. The report identifies three actions that the Agency needs to take to overcome this challenge. In accordance with the Reports Consolidation Act of 2000, this challenge will be incorporated with other Agency challenges in our Report on the Most Serious Management Challenges Facing the SBA in Fiscal Year (FY) 2006, and Agency progress in addressing this challenge will be re-evaluated at that time. The complete FY 2006 report will be included in SBA’s annual Performance and Accountability Report this fall.

SBA’s FY 2004 Financial Statements Management Letter Issued. Pursuant to the Chief Financial Officers Act of 1990, Cotton & Company LLP’s management letter was issued on February 23, 2005. The purpose of the management letter is to communicate to SBA management “non-reportable conditions” that came to Cotton & Company’s attention during their engagement to audit SBA’s FY 2004 financial statements. The following areas, which were reported last year, are repeated in this report because the conditions, as well as the need for implementing enhanced controls, continue to exist: 1) accountable property controls; 2) Disaster Area Office centrally billed account; 3) Master Reserve Fund (MRF), cash held outside of Treasury; 4) recordation of allotment transactions; and 5) entry to align statement of financing with statement of net cost. The management letter also noted areas for improvement: 1) retention of documentation to support Colson data validation; 2) Surety Bond Guarantee (SBG) liability documentation;

3) monitoring of the Small Business Investment Company (SBIC) participating securities reimbursement assumption; 4) separation of duties within the Office of the Chief Information Officer (OCIO); 5) loan accrual methodology; 6) activity-based costing (ABC) model; 7) enhancements to footnote disclosures; 8) Performance and Accountability Report; 9) budget briefing book; 10) Disaster Loan Program Cohort 1996 Loan Data; and 11) section 504 credit subsidy cash flow model. SBA management generally agreed with the auditors’ findings and recommendations, but requested more information on the specifics of several findings that had not been previously communicated to the Office of the Chief Financial Officer (OCFO). Agency management also questioned whether several findings should be included in the report or could be presented better.

OIG Issues Audit Report on SBA’s Information Systems Controls. On February 24, 2005, OIG issued the audit report on SBA’s Information Systems Controls for FY 2004, which was issued by Cotton & Company LLP as part of the audit of SBA’s FY 2004 financial statements. The auditors reviewed general and application controls over SBA’s financial management systems to determine if those controls complied with various Federal requirements. 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. General controls impact the overall effectiveness and security of computer operations, rather than specific computer applications. Application controls are the structure, policies, and procedures that apply to separate, individual application systems, such as accounts payable, inventory, payroll, grants, or loans. Application controls help ensure that transactions are valid, properly authorized, and completely and accurately processed by the computer. Federal requirements for general and application controls include OMB Circular A-130, Security of Federal Automated Information Resources, and the Computer Security Act of 1987. The auditors concluded that SBA continued to make progress in implementing its information systems security program, but that improvements are still needed. The report describes areas where controls can be strengthened, such as: 1) entity-wide security program controls; 2) access controls; 3) application software development and program change controls; 4) system software controls; 5) segregation of duty

controls; and 6) service continuity controls. The report also provides recommendations for strengthening controls in these areas. SBA generally agreed with the auditors' findings and recommendations, with the exception of finding 3A on application software development and program change controls, and finding 5A on segregation of duty controls for the Loan Accounting System (LAS). Finding 3A and recommendation 3A were modified to better reflect what was found during audit fieldwork. Finding 5A and recommendation 5B were not changed or modified as the Chief Information Officer must adequately ensure that LAS security is enforced agency-wide.

Business Loan Programs

Missouri Boat Propeller Manufacturer Sentenced. On February 3, 2005, the former President of a boat propeller manufacturer located in Ozark, Missouri, was sentenced to 9 years in Federal prison followed by 5 years probation. The business owner was further ordered to repay his victims, including an SBA lender, a non-SBA lender, the Internal Revenue Service (IRS), and various individuals, a total of \$2,442,564, and to pay a \$400 special assessment. The business owner pled guilty last year to **bank fraud, mail fraud, filing a false income tax return, and failure to appear in Federal court.** A joint investigation with the IRS determined that he made false statements to financial institutions to obtain a \$340,000 SBA-guaranteed loan. The business owner failed to disclose numerous personal and corporate liabilities, and also submitted a false income tax return which inflated his personal adjusted gross income by \$100,000 more than what he reported to the IRS. The business owner, who is a disbarred attorney, defaulted on the loan resulting in a principal loss of more than \$224,000. The investigation further determined that he engaged in a fraud scheme in which he induced more than 10 individuals to invest money with him through another company by falsely claiming the company was engaged in the business of factoring accounts receivable in the trucking industry. Through this scheme, he bilked investors out of about \$1.6 million. The business owner was originally indicted on Federal charges in March 2002, but failed to appear for his trial in October of that year. He was located and arrested in Arizona by U.S. Marshals and local authorities in May 2003. This investigation was initiated based on a referral from the SBA Branch Office, Springfield, Missouri.

Texas Convenience Store Owner Indicted. The owner of a Houston, Texas, food mart and a second individual were indicted by a Federal grand jury in the Southern District of Texas on January 31, 2005. The business owner and the other individual were charged with one count of **bank fraud** and three counts of **false statements to a financial institution.** The business owner was also charged with one count of **false claim to U.S. citizenship.** The business

owner fraudulently obtained a \$1 million SBA-guaranteed loan from a financial institution and a \$390,000 companion loan from a bank. The business owner represented that he used personal assets in excess of \$307,000 to purchase real estate for the food mart. Bank records indicate that he received a majority of the money from another individual, who already had an SBA-guaranteed loan in the amount of \$632,000. The business owner also falsely indicated that he was a U.S. citizen. This case was developed from the OIG's Foreign Nationals Project in Houston, Texas.

Former Missouri Business Owner Sentenced. On February 4, 2005, the former owner and a managing member of a lumber company in Annapolis, Missouri, was sentenced to 5 years probation, a \$100 special assessment, and restitution to a financial institution in the amount of \$171,572. The business owner previously waived indictment and pled guilty to an Information that charged her with **falsely representing the amount of equity cash** she injected into the company for the purpose of obtaining an SBA-guaranteed loan. The investigation revealed that the business owner falsely claimed to have injected about \$171,000 equity into the company prior to the disbursement of a \$727,000 SBA-guaranteed loan. The business owner made about five interest-only payments before the company went out of business. The investigation was initiated based on a referral from the SBA District Office, St. Louis, Missouri.

President of Defunct Pennsylvania Business Sentenced. The president of a defunct business in Lancaster, Pennsylvania, was sentenced on February 17, 2005, to 5 years probation and ordered to pay \$437,000 restitution to SBA. The president was previously found guilty on three counts of **mail fraud**, and three counts of **making false statements** to SBA. The business had originally obtained an SBA-guaranteed loan for \$315,000, but the loan balance had increased to \$437,000, including interest due. The president made various offers of compromise to SBA on the defaulted loan, advising that the only payment he could make was the \$60,000 equity in his home. The president was found guilty of a fraud scheme in which he attempted to conceal \$551,000 which he obtained through an unrelated stock sale. The scheme involved the president opening bank accounts in the names of his children and preparing bogus stock certificates to make it appear that he did not actually own the stock. The purpose of the scheme was to induce SBA to accept the \$60,000 and forgive the remaining loan balance. This investigation was based on a referral from SBA's Philadelphia District Office.

Houston Convenience Store Owners Plead Guilty to Conspiracy to Commit Bank Fraud. The owners of a convenience store in Houston, Texas, pled guilty to one count of **conspiracy to commit bank fraud** on January 27, 2005, and February 22, 2005, respectively. Both men were previously indicted for falsely obtaining nine SBA-guaranteed loans for convenience stores located in the Houston area. The

loans totaled \$9,500,000; SBA's guaranteed portion was \$6,566,233. The conspiracy count alleges that they recruited individuals to apply for SBA-guaranteed loans; submitted false and fraudulent documents; artificially inflated certain checking account deposits; submitted false and fraudulent "gift letters"; and used escrowed loan proceeds to purchase cashiers' checks, which were then used as down payments for loans to conceal the fact that the down payments were funded by the loan proceeds. The investigation was based on a referral from the SBA's Dallas District Office. The SBA OIG conducted this investigation jointly with the Federal Bureau of Investigation (FBI).

SBA PLP Lender Cancels Loan to Michigan Restaurant.

On February 11, 2005, an SBA PLP lender canceled a previously approved \$650,000 SBA business loan to a borrower in Ann Arbor, Michigan. The purpose of the loan was to open a restaurant. The lender notified SBA of the cancellation after the SBA OIG received allegations of fraud from a confidential informant and provided documentation to the lender that appeared to support the allegations. The documentation included financial records and testimony that directly contradicted information provided by the borrower during the application process.

Agency Completes Final Actions. The following final actions have been reported as being completed:

- Report – Survey of Risk Management by Industry Code. The Agency reported that it uses industry codes to analyze portfolio performance on a quarterly basis, and reports these to the Portfolio Analysis Committee. This action addresses the recommendation made in the report.
- Action Memorandum – Improvements are needed in the Small Business Lending Company Oversight Process. On September 30, 2004, the Agency issued a policy memorandum clearly establishing lines of authority between the Office of Lender Oversight and the Office of Financial Assistance. The memorandum also established the Lender Oversight Committee to provide enforcement oversight. Two recommendations made in the report remain open.

Government Contracting and Business Development Programs

OIG Issues Audit Report on Cooperative Agreement to HP Small Business Foundation. On February 11, 2005, OIG issued a final audit report "**Review of a Cooperative Agreement to the HP Small Business Foundation.**" The recipient of the cooperative agreement did not have an acceptable accounting system for allocating and supporting costs incurred in accordance with applicable Federal

requirements. As a result, the following problems were identified: 1) the recipient submitted more than \$1 million dollars in expenses which were either incurred prior to the subject cooperative agreement, not properly supported, or lacked approval by SBA; 2) written procedures for screening and allocating costs were inadequate; 3) costs were misclassified; 4) vendor expenses were not addressed to the recipient; 5) contracting actions were not supported by written agreements; and 6) the recipient may have sub-granted the project to a third party in violation of the cooperative agreement. We recommended that the Office of Government Contracting and Business Development (GCBD) require the recipient to develop a financial management system that meets the requirements of OMB Circulars A-110 and A-122. We also recommended that the Office of Procurement and Grants Management (OPGM) request a legal opinion as to whether the arrangement between the recipient and a third party violated the terms of the cooperative agreement regarding sub-granting. SBA officials agreed to implement the recommendations.

OIG Issues Report on Small Business Procurement Awards.

On February 24, 2005, the SBA OIG issued "***SBA Small Business Procurement Awards Are Not Always Going to Small Businesses.***" The objective of the review was to determine whether small business procurement awards reported by the SBA in FY 2001 and 2002 were indeed awarded to companies that were small at the time of the award and to evaluate issues related to small business government contracting. To determine whether small business purchases reported by SBA were indeed purchased from companies that were small at the time of the purchase, we reviewed six of the highest dollar awards in this category made from October 1, 2000, to June 30, 2002. The OIG found that, out of the six companies that received small business purchases, four were not small at the time of purchase. This occurred because SBA utilized multiple award contracts and did not ask contractors for an updated size certification. Regulations provide that a contractor self certify its size when responding to a solicitation. At the time of the procurements under study, that size certification remained valid throughout the life of the contract, unless a procuring agency requested an updated certification. Because contracts can be active for many years, companies may become large, and an agency can still obtain credit for small business procurement. The OIG's research also discovered inconsistent regulations that could affect small business procurement. Additionally, we found that there are several problems with purchasing from small businesses on the GSA Schedules, including size self-certifications that do not follow SBA regulations, the avoidance of small business set-asides and other rules, and the Schedules' data quality. Lastly, we identified some concerns with the Department of Defense's Central Contractor Registration, the Government's central repository of vendor data. Specifically, the small business size self-certifications and the lack of promotion for the "Dynamic Small Business Search" as the official source of

small businesses are problematic. Because part of SBA's mission is to protect the interests of small businesses by ensuring that a fair proportion of government purchases are placed with small businesses, these concerns need to be addressed. The OIG issued recommendations to correct the reported deficiencies to the Associate Deputy Administrator for Government Contracting and Business Development. The Agency agreed with recommendations 1, 2 and 5 and plans to take action in the near future that will address these recommendations. While recommendation 3 refers to small business representations at the establishment of a GSA Schedules contract, the Agency's response focuses on the designation of small business status on task orders. The Agency states, "We agree that SBA and GSA need to discuss the designation of small business status on orders, and possibly initiate a FAR case to clarify how NAICS codes apply to orders from these contract vehicles." With regard to recommendation 4, the Agency disagreed by concluding that "on unrestricted contracts and orders against an unrestricted contract, set-aside provisions do not apply."

Agency Completes Final Action on Audit of Expenses for Meals and Refreshments Incurred by the Latino Coalition Foundation on SBA 7(j) Cooperative Agreement. The Agency reported that it was reimbursed for unallowable costs spent on alcoholic beverage service for a welcome reception. One additional recommendation made in the report remains open.

Statutory/Regulatory/Policy Reviews

In effort to proactively identify and correct potential Agency inefficiency and management problems at the onset of policy and regulatory development, the OIG reviewed, cleared, and/or provided comments, as appropriate, on 13 Agency initiatives, including proposed legislation, Agency Standard Operating Procedures, and Agency notices containing directives to its employees.

This monthly update is produced by the SBA OIG,
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The 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 concerning this update or other OIG publications. To obtain copies of such documents please contact:

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