



Office of Inspector General U.S. Small Business Administration

March 2003 Update

Business Loan Programs

OIG Issues Two Reports on Section 7(a) Business Loan Guaranty Purchase Process. The audit concluded that SBA has taken several actions in recent years to improve the guaranty purchase process, including making periodic quality assurance reviews and issuing Policy Notice 5000-831, “7(a) Loan Guaranty Purchase Policy,” on October 2, 2002. While these actions should improve the purchase process, additional measures are needed to strengthen purchase decisions and protect SBA from making erroneous guaranty payments to lenders that do not originate, service, and/or liquidate loans in accordance with SBA rules and regulations. Prior to SBA issuing Policy Notice 5000-831, the Section 7(a) guaranty loan purchase process did not always identify material lender non-compliance with SBA rules and regulations and protect SBA from making erroneous guaranty purchase payments. The purchase procedures in effect at the time the audit work was performed had not been updated since 1983. Consequently, the purchase process did not incorporate the necessary controls to offset the increased risk of delegated lending authority under the Preferred Lenders Program with reduced oversight by SBA.

Material lender non-compliance involved loan origination and closing, servicing, and liquidation actions in seven areas. The most significant deficiencies, by dollar amount, occurred in repayment ability, equity injection, and use of loan proceeds. By not identifying the material deficiencies, SBA paid \$7.6 million in erroneous payments on 30 of 153 loans reviewed.

The Guarantee Purchase Review (GPR) process was established primarily to assess the accuracy of prior

purchase decisions and identify areas for improvement. The GPR process did not identify all inappropriate purchase decisions because the GPR teams did not get the lender’s loan files and the sampling methodology did not include loans that represented the population because statistical sampling techniques were not used. As of September 30, 2002, approximately 4,000 loans with guarantees totaling \$675 million were excluded from the GPR process because the loans were not purchased and charged-off within the specified time frame. Consequently, SBA could not use the results of the GPR to estimate within an acceptable level of confidence the erroneous payments made.

OIG recommended that SBA: (1) establish criteria for obtaining the entire lender’s loan files to ensure all deficiencies are detected and the GPR teams request lender loan files on a sampling basis; (2) establish timeframes for completing the training for all individuals involved with the guaranty purchase process; (3) use valid statistical sampling techniques to select loans for GPR reviews; and (4) revise the loan selection criteria for GPR reviews by deleting the requirement that loans must be purchased and charged-off within a specific time frame. SBA management indicated it would evaluate the benefits of obtaining the lenders loan files and that a timeline for training staff responsible for making purchase determinations has been established. Management did not agree to implement the recommendations for improving the GPR process, i.e., obtain the lenders loan files on a sample basis or change the method used to select loans for review by using valid statistical sampling techniques and eliminating the requirement that a loan be purchased and written off within a specific time frame. OIG believes that implementation of the recommendations to improve the GPR process would improve the evaluation of prior purchase decisions and allow SBA to reliably estimate and report erroneous payments.

As a companion to the audit report, the Inspection and Evaluation Division conducted two surveys, one completed by district directors and branch managers and one by SBA loan officers and other employees who are the primary processors of guaranty purchase requests, to determine field office personnel's experience with the guaranty purchase process. The resultant report presents an analysis of the results.

The directors' survey focused on: (1) workload; (2) management; and (3) the purchase process. Directors' responses indicated that most offices receive three or fewer purchase requests per week; about half of the respondents reported a small backlog. A slight majority of the respondents indicated their decisions to deny purchase requests were supported by Headquarters, although a vocal minority disagreed. An overwhelming majority reported that their offices had found it simpler to ask the lender to repair or withdraw the guaranty request. They also reported using different criteria for various lenders and loans.

The loan officers' survey focused on: (1) workload; (2) management; (3) the review process; (4) individual experience; (5) documentation; (6) training; (7) risk assessment; (8) monitoring; and (9) communication. A majority of loan officers indicated that the SOP needs to be strengthened and, conversely to the directors, did not believe their denial recommendations were supported by SBA Headquarters. Most loan officers specified that they use different criteria for different lenders, largely due to poor performance by the particular lender. A majority of loan officers also reported they had not received formal training, and although not specifically asked in the general comments section, many offered unsolicited requests for formal training.

OIG Analyzes Past Work to Determine Why Equity Injection Continues to Be an Issue in Section 7(a) Loans. OIG conducted a study involving an analysis of numerous audits and investigations where equity injection was identified as a prominent problem in Section 7(a) loans. The purpose of the study was to synthesize past OIG work to identify patterns of problems indicative of systemic program weaknesses and suggestions for solutions to these weaknesses. Analysis of this previous OIG work, and of SBA's guidance and forms, revealed that SBA guidance

regarding equity injection is unclear. To remedy this inadequacy, OIG recommended that SBA revise SOP 50 10 4, the Loan Authorization, and loan application forms. These revisions should provide detailed guidance on amounts of injection the Agency requires, documentation the lender should provide to prove that the injection took place, as well as what the Agency will accept as evidence that the borrower's injection is not encumbered. In addition, standardized training for all Agency and lender employees as well as an Application Checklist should be developed.

The Agency did not agree with the recommendation that addressed the establishment of a firm minimum quantifiable equity injection level. SBA's concern was that the Agency needs flexibility and that the amount of equity injection would vary from industry to industry as well as case to case. The OIG response indicated that the report findings and recommendations regarding equity injection amounts speak to the issue of clarification of guidance for the lenders and SBA. The Agency may take corrective action using any of several approaches to resolve the lack of information that currently exists. In its initial response, SBA did not address the remaining four recommendations. OIG will continue to seek implementation and resolution of the five recommendations through SBA's follow-up process.

Disaster Loan Program

Guam Man Pleads Guilty to Making Material False Statement. A man from Yona, Guam, pled guilty to an Information on March 11, 2003, charging him with one count of **making material false statements**. He applied for a disaster home loan after Super Typhoon Paka. His application was denied initially because of his inability to repay the loan based on his income. He subsequently submitted additional information including pay stubs and W-2's that falsely indicated he was employed. Based on the additional information provided, his request for a \$51,400 SBA disaster loan was approved. It was later learned that he only worked at the job for approximately 6 weeks before being terminated. This investigation was initiated based on a referral from the Guam Branch Office. SBA/OIG conducted this investigation jointly with the Federal Bureau of Investigation (FBI).

OIG Issues Report on Economic Injury Disaster Loans. The SBA Disaster Loan Program is the Federal Government's primary method for funding the recovery of small business disaster victims. When such victims need to borrow funds to repair or replace uninsured damages, SBA's low interest rates and long terms make recovery more affordable. Under the authority of the Small Business Act, SBA provides physical and economic injury assistance to business owners, individuals, and non-profit organizations to rebuild, replace personal property, and overcome economic injury.

Economic injury disaster assistance is available only to small business owners who have suffered a substantial economic injury and are unable to obtain credit elsewhere. In addition, economic injury assistance is available to disaster victims who are designated a major source of employment in an area affected by a disaster.

The audit disclosed that borrowers obtained low-interest, taxpayer-subsidized economic injury disaster loans despite having net assets available to use directly to alleviate their economic injury or to provide them credit elsewhere. This conclusion stemmed from a statistical sampling of borrowers where OIG identified cases where loan recipients had at least \$10 in available net assets for each \$1 borrowed. As a result, for loans of \$150,000 or less approved during fiscal years 1997 through 2000, taxpayers subsidized an estimated \$114 million in loans at an estimated taxpayer cost of \$25 million for individuals and businesses that had the means to alleviate their economic injury. This occurred because SBA procedures provided 2 months of economic injury benefits automatically and deemed borrowers eligible by concluding they were unable to obtain credit elsewhere even though they had available net assets of up to \$750,000. In addition, SBA did not consider the relationship of available net assets to the economic injury sustained by the borrower, when the available net assets were below this threshold.

OIG recommended that the Agency:

1. Define available net assets.
2. Establish a ratio that identifies reasonably available net assets relative to the economic injury loan amount.

3. Use empirical data to determine: (1) the appropriateness of using the \$750,000 threshold of total net available assets, and (2) the blanket application of the 50 percent equity rule to ascertain available net assets that could be used to alleviate economic injury or obtain credit elsewhere.

The Agency disagreed with the finding presented in the report and non-concurred with each of the recommendations. Management stated that OIG's finding is based upon a narrowly defined formula developed by OIG during the audit. Further, the formula appears to assume all "available net assets" of the small business were available to offset the economic injury and/or damage caused by the disaster, but did not consider the overall financial condition (debt to asset levels, validity/accuracy of asset values, liquidating values of working capital requirements to maintain operations until the business returns to normal) of the small business and/or its ability to alleviate the economic injury from their own resource without undue hardship. The Agency believed SBA-established thresholds filter out those applicants who would have undue hardships in financing their own "economic injury" or obtaining credit elsewhere at reasonable terms and conditions.

OIG believes this standard automatically qualifies more than 80 percent of the applicants for taxpayer subsidized economic injury disaster loans and assumes that an applicant with net worth of up to \$1.5 million would suffer undue hardship if they had to use their own assets to cover the disaster related losses.

Small Business Investment Companies

OIG Issues Advisory on Small Business Investment Company Licensing Procedures. OIG issued an audit advisory memorandum report on March 20, 2003, that addressed a complaint by a Small Business Investment Company (SBIC) license applicant. The applicant alleged that its application to obtain an SBIC license was not properly evaluated. OIG's review determined that the Investment Division's (Division) evaluation of the application and their resultant decision to deny the application were not accomplished in accordance with existing SBA procedures and criteria. There were five instances during the evaluation process where the Division did not comply with appropriate guidance and

one instance where additional criteria were added to the process. Additionally, we noted that the applicant was not initially given a formal notification letter with explicit reasons for the denial. A formal letter was sent in July 2002 after the start of our audit and after the applicant complained to SBA and members of Congress. We recommended that: (1) the applicant's re-submission be evaluated using appropriate policies, procedures, and criteria; (2) a formal denial letter be provided in the event the re-submission is denied; and (3) standard operating procedures include a requirement for a formal, written letter stating the specific reasons for application denials. The Associate Administrator for the Investment Division agreed with the recommendations, but disagreed with the report conclusions.

Entrepreneurial Development Programs

OIG Issues Audit Report on Women's Business Center. OIG issued an audit report on grants made to a women's business center in Texas, on March 20, 2003. The audit was conducted based on a referral received in August 2002 stating that grant funds had been misused by the center. OIG's audit disclosed that: (1) the center's financial management system permitted unsupported disbursements and the accounting records did not properly reflect numerous checks cleared by the bank; (2) payroll and unemployment taxes in excess of \$70,000 were delinquent; (3) the former Executive Director used a Center automobile for personal purposes; and (4) questionable costs of \$38,073 were charged to the grant. As a result of inadequate SBA oversight, the Center's management of the grant operations was ineffective. OIG recommended the Associate Administrator for the Office of Women's Business Enterprise take action to ensure the center implements appropriate internal controls, ensure trained examiners perform future monitoring of the center, require the center to remit timely payments to the Internal Revenue Service, and consider debarring the former Executive Director from future grant program participation. The OIG also recommended the Assistant Administrator for Administration take action to recover \$30,478 of unsupported costs and \$7,595 for costs of vehicle provided for former Executive Director's personal use.

Government Contracting and Business Development Programs

Missouri Section 8(a) Contractor and Corporation Execute Settlement. The president of a Poplar Bluff, Missouri, contracting corporation and the corporation executed a \$500,000 civil fraud lawsuit settlement on March 7, 2003. Under the terms of the settlement, the president and the corporation admitted no fault but repaid the U.S. Government \$303,010 and agreed to forgo \$196,989 in payments otherwise due from the U.S. Army Corp of Engineers on a contract the Government alleged was obtained by fraud. The United States Attorney's Office, Eastern District of Missouri, filed this lawsuit alleging that he and his corporation made false statements to SBA concerning his claim of social and economic disadvantage in order to be certified as an SBA Section 8(a) contractor, and thereby inappropriately received about \$17 million for 17 Federal contracts. The president and the corporation were previously sentenced on June 24, 2002, in a related criminal case, after pleading guilty to three counts of mail fraud involving insurance claims. The president was placed on probation for 3 years, ordered to pay approximately \$140,000 in fines and restitution; the corporation was placed on probation for 5 years, and ordered to pay a similar amount. A joint investigation with the U.S. Department of Labor Office of Inspector General (DOL OIG) and FBI had resulted in a 12 count indictment against him and the company alleging illegal kickbacks, mail fraud, false statements to SBA, and major contract fraud. All counts other than mail fraud were dismissed as part of the criminal plea agreement at sentencing. He and the corporation remain suspended by the Department of Defense from receiving all new Government contracts. This case was initiated based on information received from the DOL OIG.

Agency Management

OIG Issues Audit Report on SBA's Due Diligence Contract for Asset Sales 3 and 4. An audit of SBA's due diligence contract for the sale of SBA loans in Asset Sales 3 and 4, found that SBA improperly modified the contract through an oral modification that resulted in \$2.2 million of increased costs. Also, SBA's oversight of the contractor was not sufficient to preclude acceptance and payment of unauthorized invoices.

SBA paid the contractor \$2.2 million in excess of what should have been paid according to the terms of the contract for “drive-by” appraisals provided for Asset Sale 3 and over \$23,000 for duplicate or upgraded third party reports for Asset Sale 4. The payments occurred because: (1) the contracting officer significantly modified the terms of the contract through an oral agreement; and (2) SBA did not closely review invoices and supporting documentation. OIG recommended that the Agency seek recovery of the \$2,181,125 overpayment from the contractor or ratify, if justified, the verbal modification of the contract in accordance with SBA and applicable Federal requirements and ensure that all future contract changes are made using a properly signed written contract modification.

OIG also recommended that the Agency: (1) ensure SBA’s oversight responsibilities of due diligence contracts awarded to the contractor for Asset Sales 1, 4, and 6 are accomplished by obtaining reconciliation data detailing all third party reports billed against each loan; (2) recover amounts paid for unwarranted duplicate and upgraded third party report costs identified as a result of the above reconciliation from the contractor; (3) require the due diligence contractor to conduct an analysis to verify the accuracy of invoicing for third party reports against its reports database to identify and adjust payments for any unwarranted duplicate or upgraded third party reports; and (4) contract with a recovery audit firm to identify and recover any erroneous payments, i.e., unwarranted, duplicate, or upgraded third party report costs if SBA is not satisfied with the contractor analysis.

OIG Determines Controls Over Financial Management Systems Need Improvement. As part of the annual financial statement audit, the independent auditors reviewed general and application controls over SBA’s financial and information management systems to determine compliance with various Federal requirements and issued a report. The independent auditors concluded again, as they did for FY 2001, that SBA made progress toward implementing an agency-wide systems security program, however, improvements are still needed. In the general control areas the Agency needs to improve: (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; (6) service continuity controls; (7) review of mainframe operations; and (8) Joint Accounting and Administrative Management System (JAAMs) application controls. In application control areas the Agency needs to improve: (1) authorization controls; (2) completeness controls; (3) accuracy controls; and (4) controls over the integrity of application processing.

Agency management agreed with 19 of the 25 recommendations and partially agreed with the remaining 6 recommendations.

The activity Update is produced by SBA/OIG,
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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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