

ERIN McDONNELL

SMALL BUSINESS ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

SEMI-ANNUAL REPORT ON AUDIT AND INVESTIGATIVE
ACTIVITIES FOR THE PERIOD OCTOBER 1, 1978
THROUGH MARCH 31, 1979

REPORT 1-79

APRIL 30, 1979

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Background and Introduction

Public Law 95-452, commonly referred to as "The Inspector General Act of 1978", mandates that the Inspector General prepare semi-annual reports summarizing the results of activities during the six month periods ending March 31 and September 30. These reports are to be furnished to the head of the establishment involved not later than April 30 and October 31 of each year and shall be transmitted by agency head to the appropriate committees of Congress within thirty days after its receipt, together with any comments thereon which the agency head deems appropriate.

Pursuant to these provisions, I am forwarding the initial report of the Office of the Inspector General for your review and transmittal to Congress. It provides a summary of the activities of the Office during the period from October 1, 1978 - March 31, 1979. In all likelihood, this report will be atypical of reports you will receive in the future. This fact is due to the Office's heavy involvement in a nationwide effort related to our Section 8(a) Contracting program. During this reporting period, more than 60% of the audit and investigative resources of the Office have been devoted to this major undertaking. A vast proportion of the remainder of our resources was devoted to our statutorily imposed regulatory audits of Small Business Investment Companies (SBIC's). Superimposed upon the foregoing was the fact that some of our resources were utilized to effect a transition to an operational status under the new Inspector General law, to orient our first Inspector General nominee to the programs and operations of SBA, and to participate in structured training courses sponsored by the Department of Justice on the new Inspector General concept.

Notwithstanding the unique demands levied upon this Office during this reporting period, I believe we did maintain our ability to respond to those needs viewed as most critical to the operations of the Small Business Administration. Admittedly, the factors referred to above did cause a substantial deviation from our audit and investigative plans. This was a necessary tradeoff, however, when one considers the importance of our 8(a) investigation and the substantial interest shown in this area by Congressional oversight committees and members of the private sector. Once this special effort has been concluded, the resources of the Inspector General's Office will be targeted on a prioritized and selective basis at those programs and operations which are shown to be the most vulnerable to fraud, abuse, mismanagement and waste based on an analysis of SBA programs and operations now being undertaken in this Office.

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The following is a summary of audit and investigative activities by program and functional areas.

SECTION 8(a) PROGRAM

Review of Business Development Expenses (BDE) Funds for Section 8(a) Contractors Audit Report 1-79

The purpose of the review was to (1) determine the extent of compliance by field personnel with existing procedures relating to BDE and (2) ascertain whether SBA is employing BDE in an effective, efficient and equitable manner consistent with 8(a) program objectives. The review was made on a selective basis in five SBA regions.

Our review showed that BDE could be used more effectively, if existing procedures were followed more closely by program personnel and if further criteria were developed for control over approval and disbursement of BDE for the purchase of capital equipment. In addition, further guidance should be given to program personnel in determining the reasonableness of BDE awarded for price differential compared to the initial price of the contract.

The following is a summary of the findings identifying areas where corrective action should result in greater effectiveness:

1. Contractors' Costs Justifying Price Differential Payments Not Supported

8(a) contractors' cost proposals which resulted in approval of Business Development Expense (BDE) for price differential payments were not, in many cases, supported and the analyses of the proposals required to be made by SBA personnel were inadequate and not well documented.

Recommendations

Associate Administrator for Operations (AA/O)

Assure that field offices follow Agency procedures by:

- a. Requiring 8(a) contractors to prepare bid proposals with sufficient support to allow independent verification of costs.
- b. Requiring SBA Cost Analysts to prepare adequate analyses of 8(a) contractors' costs.

Corrective Action Taken

On January 2, 1979, the Acting AA/O sent a copy of this finding to all Regional Directors for review, action and follow-up as needed.

2. Need for Capital Equipment Purchased with BDE Funds Not Justified

BDE funds were approved to purchase capital equipment without documentation justifying that it was essential to the performance of the contract as required by Agency procedures.

3. BDE Used for Capital Equipment Without Evidence That Alternate Fund Sources Were Not Available

BDE funds were approved for the purchase of capital equipment without documentary evidence that 8(a) contractors could not obtain funds from conventional or SBA financing or from company or private resources. Agency procedures permitted the use of BDE for capital equipment only when alternate funds were not available to the 8(a) firm. In some cases, there were indications that fund sources other than BDE were available. Therefore, funds appropriated for legitimate BDE purposes may have been diverted for ineligible uses.

4. BDE Approvals for Purchase of Capital Equipment or Other Front End Uses Not Properly Controlled

BDE funds disbursed to 8(a) contractors for capital equipment and other front end uses were not adequately controlled because SBA did not have written procedures to insure that items approved for BDE purchases were not actually purchased by the contractor.

Recommendation for Corrective Action

Recommendations made for each of the above three findings are not being shown since the action taken by the Administrator eliminated the need for these actions.

Alternative Corrective Action Taken

By memorandum dated November 9, 1978, the SBA Administrator advised all Regional Directors that "BDE will be utilized solely for the purpose of paying price differential in the 8(a) Program. The use of BDE for any other purpose is

no longer authorized. Any requirement that an 8(a) contractor may have for equipment, inventory or for other purposes which may have been permissible previously will be the responsibility of the 8(a) contractor through the use of the contractor's own assets and/or SBA's lending programs or other authorized programs".

5. Contract Negotiations With Procuring Agencies Not Held or Properly Documented

Contract negotiations between SBA and procuring officials were not held as required in some instances; in others, the results of the negotiations were not properly documented, or were not documented at all. Consequently, there was no assurance that prices proposed by the procuring agencies were fair and that resulting BDE was justified.

Recommendation

Associate Administrator for Operations (AA/O)

Take action to assure that:

- a. Contract negotiations are held with procuring agencies before contract approval, particularly when BDE is contemplated.
- b. Memoranda of negotiation are prepared in all instances and in accordance with SOP requirements including, in particular, the rationale for the FMP and the justification for BDE.

Corrective Action Taken

On January 2, 1979, the Acting AA/O sent a copy of this finding to all Regional Directors for review, action and follow-up if needed.

6. Business Development Expense Approval Documents Not Properly Prepared, Signed or Filed

Two SBA forms required for approving BDE were not in many instances properly prepared, signed or filed. These forms were needed by reviewing officials to ascertain the completeness of required documentary support and to evaluate the justification for the purpose of the BDE. As a result, BDE was not approved by officials having proper approval authority and/or approvals were decided upon without correct or sufficient information.

Recommendation

Associate Administrator for Operations (AA/O)

Take action to see that SBA Forms 1014 and 1014A are properly prepared, signed and filed.

Corrective Action Taken

On January 2, 1979, the Acting AA/O sent a copy of this finding to all Regional Directors for review, action and follow-up if needed.

7. Guidelines Needed for Defining Reasonableness of BDE as a Percent of Fair Market Value

SBA had not developed standards to guide business development specialists in determining the maximum amount of BDE that can reasonably be approved for individual 8(a) contracts. As a result, BDE awards have exceeded the fair market price (FMP) of the contract for which they were approved.

Recommendation

Associate Administrator for Minority Small Business and Capital Ownership Development

Establish standards on the maximum amount of BDE that can be approved relative to contract prices in order to guide business development specialists in ascertaining reasonableness of BDE awards.

Corrective Action Taken

Pending

Evaluations of Section 8(a) Firms for Eligibility

During this reporting period, the subject evaluation of the approximately 1500 8(a) firms has been in process. The object of this review is to evaluate the eligibility of 8(a) firm owners as to whether they are socially or economically disadvantaged and to establish the state of ownership and control of their firms' operations.

We expect this evaluation to be completed by July 31, 1979. To complete this evaluation, the Agency has assigned 40 to 50 of its own personnel in addition, starting in March of 1979, 50 detailees from other government agencies and an equivalent of 60 auditors from the Defense Department are participating in this review.

Review of Advance Payments to Section
8(a) Contractors

As a result of the Interim Inspector General's review of program surveillance reports concerning outstanding advance payments, the Interim Inspector General reported, as required by Public Law 95-452 "The Inspector General Act of 1978" section 5(d), to the SBA Administrator on November 7, 1978, that a potential serious problem may exist. This report was forwarded to the Congress by the Administrator as required by the Act.

Based on the above, a preliminary audit survey was initiated by the Office of Inspector General in Region II on November 14, 1978. This survey indicated a need to expand the nature and scope of our audit to include five additional SBA regions. It is anticipated that this audit will be completed in April 1979 and that any significant findings and recommendations will be reported in the October 31, 1979, semi-annual report.

Investigations of Section 8(a) Program

As a result of information developed during the above reviews of the Section 8(a) Program, eight (8) cases have been referred to the Department of Justice for further investigation and/or prosecution. These referrals were based on false statements and misuse of government funds. All cases are still pending at the Department of Justice.

SMALL BUSINESS INVESTMENT COMPANY PROGRAM

Section 310(b) of the Small Business Investment Act of 1958, as amended, requires examinations, at least annually, of all Small Business Investment Companies (SBIC's) licensed by SBA, except where the examination is waived for specific reasons.

The examinations are made to establish whether the licensee operations are in compliance with SBA Rules and Regulations, the legislation, and SBA policies and procedures. For the six-month period, October 1, 1978 through March 31, 1979, 186 SBIC's were examined. These examinations disclosed 333 violations of the SBA Rules and Regulations, 111 of which were in the six significant categories which are detailed below. The Agency has taken appropriate action on 176 examinations. Action is pending on ten (10) examinations. Sixty of the 333 violations, which primarily involved failure to file reports and other advices with SBA, were corrected as a result of, and during the examinations.

Conflicts of Interest

Conflicts of interest are prohibited by Section 107.1004 of the SBA Rules and Regulations. They occur most frequently when a licensee insider is in a position to benefit either directly or indirectly from a financing or related transaction with a small business concern in other than an arms length manner. The conflicts frequently involve management services contracts and legal services. There were 30 of these violations.

Prohibited Uses of Funds

Prohibited uses of funds involve Section 107.1001 of the SBA Rules and Regulations. A violation occurs whenever a licensee finances an activity which cannot be considered representative of a continuing small business or which is otherwise prohibited such as relative to certain real estate and other transactions. There were 19 of these violations.

Excessive Interest Rate

A violation occurs whenever the stated interest rate for the financed small business concern exceeds the maximum 15 per cent per annum permitted by SBA or lower amount permitted by law. Other costs imposed either directly or indirectly are subject to inclusion in the interest rate computation depending upon SBA Rules and Regulations. There were 16 of these violations.

Activities Not Contemplated

Section 107.803 of the SBA Rules and Regulations is cited for any significant activity of the licensee which is not apparently intended by the Act. These violations may deal with financing of concerns which are not small as defined by SBA size standards. In addition, activity not in the public interest may be reported. There were 10 of these violations.

Control Over Portfolio Concerns

A violation of Section 107.901 of the SBA Rules and Regulations occurs whenever the licensee assumes control over a portfolio concern such as through stock ownership or board of director representation. SBA must approve temporary licensee control over portfolio concerns. There were 16 of these violations.

Lending Limitation Exceeded

The lending limitation, Section 107.301(d) of the SBA Rules and Regulations, is exceeded whenever the licensee makes a financing to a small business concern in an amount in excess of a prescribed percentage of the licensee's private capital. There were 14 of these violations.

Investigations of SBIC's

During the reporting period, seven (7) investigations of SBIC's were completed. Six of these were initiated as a result of findings disclosed by the annual examination and one by a complaint received by program officials.

As a result of these investigations, five (5) have been referred to the Criminal Division, Department of Justice. The principal basis for the referrals were false statements, misuse of government funds and misrepresentation regarding private capital injection. All are in the investigatory stage at the Department of Justice and no indictments have been obtained to date. However, administrative actions have been taken as follows: four (4) of these SBIC's have been placed in liquidation and debts due SBA accelerated and one (1) has surrendered its license and has been removed from the program.

Administrative action is pending against the remaining two licensees. Also, during the reporting period, there have been seven (7) convictions and four (4) indictments of SBIC principals. These convictions and indictments were the results of investigations made previous to this reporting period.

The investigation of one of the SBIC's listed above resulted in the Agency cancelling the disbursement of \$1.1 million.

SECTION 7(a) BUSINESS LOAN PROGRAM

During the six-month period ended March 31, 1979, a summary report of 360 compliance audits of 7(a) Loans was issued to the Associate Administrator for Operations and to the Associate Administrator for Finance and Investment for their consideration and appropriate action. Action on this report has not been finalized. These audits were made by two CPA firms under contract with SBA. The audits were made of borrowers and participating banks for the purpose of evaluating their compliance with the terms of the loan authorizations and loan agreements. The loans for audit were selected from Regions II, IV and IX. Separate reports were prepared on each borrower and were forwarded to the responsible SBA district office for appropriate action and response. Satisfactory responses have been received on each of these reports.

The audits disclosed approximately 1,100 findings which were grouped into 18 categories.

Generally, the most significant findings were included in categories described as (1) improper use of loan proceeds, (2) violations of collateral provisions, (3) required equity not invested or maintained, (4) bank loan servicing violations, and (5) financial reporting deficiencies. These five categories of findings, reported on in the 360 audit reports, represent over one-half of all reported findings. The following is a summary of these categories of findings:

1. Improper Use of Proceeds

A certain use of loan proceeds is specified by the loan authorization. An improper use occurs whenever a small business concern uses the proceeds of the loan for purposes other than that stated in the loan authorization. The improper use of proceeds ranged from \$5,000 to over \$100,000, and included some instances of use of loan proceeds for non-business purposes. Some of the findings also included possible false statements by borrowers.

2. Required Equity Not Invested or Maintained

An investment of equity in the business is required to help secure the loan. An amount of equity may be required to be maintained in the business by the loan authorization. The decrease in the required equity investment results in increased risks to SBA.

3. Violations of Collateral Provisions

Violations of collateral provisions are prohibited by the loan authorization. A violation occurs whenever the borrower sells, assigns or transfers collateral without SBA approval. In some cases, a bank will approve a sale, transfer or assignment without the approval of SBA, in violation of the loan authorization. These violations resulted from lack of follow-up on the part of the lender and SBA. They can weaken the position of SBA and the bank in the event of default.

4. Bank Loan Servicing Violations

Bank loan servicing is a requirement of the loan authorization. The violations included a lack of required documentation, guaranty fees or "points" paid by borrower, and also, lender modification of loan conditions without SBA approval. These violations resulted from a lack of follow-up on the part of SBA. In cases, missing or incomplete documents could cause the collateral position of the bank and SBA to be impaired in the event of default or liquidation. Incorrect and incomplete settlement sheets prevented SBA from assuring proper use of loan proceeds.

5. Financial Reporting Deficiencies

SBA's financial reporting requirements are contained in the loan authorization. The violations include misleading financial statements, insufficient financial statements, financial statements not prepared in accordance with generally accepted accounting principles, and no submission of audited statements. Thus, it could not be determined that the financial statements submitted by the borrowers accurately represented financial conditions at the time of the loan applications.

Currently, there is another contract in effect with a CPA firm which provides for 360 audits of selected 7(a) business loans. The loans for audit were selected from Regions IV, VI and VIII.

As of March 31, 1979, 132 of these audit reports have been completed and reports issued. Responses to these reports are pending or are being evaluated. More definitive information will be available at the next reporting period.

In addition, six (6) other 7(a) Loans were audited by SBA's auditors. These audits reported on the issue of improper passing on of fees by participating bank to the borrowers amounting to \$17,500. Of this amount, \$1,200 has been refunded to the borrower. The balance should be refunded in the near future.

Also as a result of an investigation, three participating banks were found to have improperly passed on fees to borrowers amounting to \$13,450. The entire amount of these fees was refunded to borrowers at the direction of SBA.

Investigations of 7(a) Loan Program

During the reporting period, ten (10) investigation reports were issued concerning 7(a) loans. Five (5) of these reports were referred to the Department of Justice for their consideration. These referrals were made because of possible false statements and misuse of loan proceeds.

Administrative actions were taken on two (2) other reports as follows: (1) the participating bank increased its exposure from 10% (\$6,000) to 50% (\$30,000) because of the likely loss resulting from the bank's handling of the loan; and (2) the district office is recommending to the Administrator denial of liability (90% of \$200,000) on a bank guaranteed loan.

On three (3) other investigations, no action was required.

In addition to the above, based on information received from SBA's Regional and District Offices, the following referrals were made to the Department of Justice:

7(a) Direct Loans	33
7(a) Guarantee Program	61

The above referrals were made based on false statements in applications for assistance, removal of SBA collateral, fraud against the government, violations of the Federal Reserve Act by participating banks and conspiracy to defraud SBA.

We also received information from the Department of Justice that ten (10) convictions and two (2) indictments were reported during the reporting period from previous referrals of cases involving 7(a) loan borrowers.

MINORITY LOAN PROGRAM

During the reporting period, fifty-four (54) referrals were made to the Department of Justice concerning borrowers in this program. These were made for various reasons such as false statements, conversion of collateral and misuse of loan proceeds. Also during this period, four (4) convictions were reported as a result of previous referrals to the Department of Justice.

DISASTER LOAN PROGRAM

Investigations were initiated with regard to two (2) disaster loans during the reporting period. In one case no action was required and in the other case, the loan was placed in liquidation and was also referred to the Department of Justice for investigation and/or prosecution.

In addition to the above, 55 additional disaster loan related referrals were made to Justice for further investigation and/or prosecutions. These involved 30 business loans, 20 home loans and five farm loans. These referrals were based on such reasons as false statements, misuse of loan funds, etc. The referrals were made based on information received from our field offices.

Also during this period, the Department of Justice reported one (1) indictment and two (2) convictions on disaster loan borrowers.

SURETY BOND GUARANTEE PROGRAM

During the reporting period, one (1) referral was made to the Department of Justice. We also have been informed that one (1) indictment was made on a previous referral.

SIZE STANDARD

Two (2) investigations were initiated concerning size standards. Only one of the investigations required action and this action is pending final determination. This investigation involved the possible affiliation of a small business seeking timber "set-asides," with a conglomerate business in the timber products industry.

Also during the first six months of this fiscal year, the Office of Inspector General has maintained active liaison with the Air Force Office of Special Investigations and the Army Criminal Investigation Command in a joint effort targeted at the detection of firms attempting to obtain small business set-aside contracts which are not legitimate small businesses. We have received from the U. S. Army CIC a report which has identified a number of businesses which should be evaluated as to their present qualifications to obtain small business set-aside contracts under present SBA regulations.

HANDICAPPED ASSISTANCE LOANS

Three (3) referrals were made to the Department of Justice during the reporting period for further investigations and/or prosecution. These referrals were based on false statements and conversion of collateral.

CONTRACT AUDITS

Two contract audits were completed during the reporting period. These audits questioned cost of \$16,700 and \$13,500 was sustained with appropriate reduction in contract price.

APPLICANT REPRESENTATIVES

Eight (8) applicant representative investigations were completed during the reporting period. Applicant representatives are private individuals or companies who are in the business of assisting borrowers in obtaining loans from SBA.

As a result of these investigations, in five (5) cases the privilege to represent loan applicants was revoked by the Administrator. One case was referred to the Department of Justice for further investigation and/or prosecution.

SBA NAME CHECK PROGRAM

All recipients of SBA assistance are screened for the purpose of determining present or past criminal records. This function is performed by the Office of Inspector General. The following are the results of this program for the reporting period:

SBIC Principals Checked through Indices of FBI and SEC	416
Loan Applicants Checked through FBI Indices	63,146
Loans Declined for Policy Reasons	1
Loans Declined for Parole/Probation/ Pending Criminal Charges	27
Dollar Volume of Declined Loans	\$1,535,044

INVESTIGATION OF SBA PERSONNEL

During the reporting period, thirty-eight (38) investigations involving SBA personnel were completed. As a result of these investigations, the following personnel actions were taken: two resignations, one demotion, three reprimands and two admonishments.

Possible administrative action on twenty (20) completed investigations is still pending. The investigations of ten (10) cases did not disclose any basis for administrative or any other action.

In addition to the above, eleven (11) cases have been referred to the Department of Justice for its consideration of further investigation and/or prosecution. These referrals were based on possible bribery, false travel vouchers, false time and attendance records and conflict of interest.

Also during the reporting period, the Department of Justice reported one (1) indictment and one (1) conviction of SBA personnel.

SUMMARY OF
REFERRALS, INDICTMENTS AND CONVICTIONS
FOR THE PERIOD OCTOBER 1, 1978 THROUGH MARCH 31, 1979

<u>PROGRAM</u>	<u>DEPARTMENT OF JUSTICE REFERRALS</u>	<u>INDICTMENTS</u>	<u>CONVICTIONS</u>
8(a) Contractors		0	0
Small Business Investment Co.	6	4	7
Section 7(a) Business Loans	94	2	10
Minority Loan	54	0	4
Disaster Loan	55	1	2
Surety Bond Guarantee	1	1	0
Handicapped Assist- ance Loans	3	0	0
Applicant Represen- tatives	1	0	0
Investigations of SBA Personnel	11	1	1
Forgery	0	0	1
Impersonation of SBA Personnel	1	0	0
Employee Murdered by Borrower	<u>0</u>	<u>0</u>	<u>1</u>
TOTALS	<u>234</u>	<u>9</u>	<u>26</u>