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REPORT TO THE CONGRESS



BY THE COMPTROLLER GENERAL
OF THE UNITED STATES

UNITED STATES
GENERAL ACCOUNTING OFFICE

APR 1 1976



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The Small Business Administration's Local Development Company Loans Are Making Capital Available-- But Other Aims Are Often Subverted

Community participation deemed essential to the program's success often has not been obtained, and the program's economic impact has been substantially less than the Small Business Administration reported. In addition, loans have been made when need for assistance was questionable.

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The agency needs to carry out its requirements fully on creating local development companies and their financial activities to more accurately measure the program's benefits and to assure that loans are made only when other financing is not available on reasonable terms.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report is the sixth in a series to be issued pursuant to Public Law 93-386, which requires us to make a full-scale audit of the Small Business Administration. It discusses the local development company loan program, which often has not obtained essential community participation and has had substantially less economic impact than the agency reported.

We are sending copies of this report to the Director, Office of Management and Budget, and the Administrator, Small Business Administration.

James B. Atchefs
Comptroller General
of the United States

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ABBREVIATIONS

GAO	General Accounting Office
LDC	local development company
SBA	Small Business Administration

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COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE SMALL BUSINESS ADMINISTRATION'S LOCAL DEVELOPMENT COMPANY LOANS ARE MAKING CAPITAL AVAILABLE--BUT OTHER AIMS ARE OFTEN SUBVERTED

D I G E S T

The Small Business Administration needs to improve its management of the local development company loan program. While the program is making capital available to many small businesses, other objectives of the authorizing legislation are often subverted.

The agency had made or guaranteed 5,271 loans valued at over \$1 billion since the program began in 1959. However, many loans were merely substitutes for assistance available to small businesses under other agency programs--and not consistent with the legislation authorizing the local development company loan program.

The Congress intended that the program's initiative come from local citizens organized in local development companies. However, often--~~GAO is unable to estimate overall frequency--~~ the company is a facade allowing a particular small business to obtain benefits of the longer term, lower interest-rate loans available under this program.

Although the agency had set certain eligibility requirements for screening out such companies, it had not exercised strong supervisory control over the program.

Of 95 loans GAO examined, 1 or more eligibility requirements were not met in 36 cases.

--In 23 cases the small business exceeded its allowable contribution toward the local development company's share of the project cost.

--In 20 cases the agency's membership requirements for the local development company were not met.

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--In 11 cases the small business exceeded its allowable ownership, or control, of the company.

For 25 loans the agency's field offices did not follow proper procedures before permitting local development companies to value their contributions of land or land improvements exceeding costs.

The agency's Internal Audit Division has reported similar problems. The agency's corrective actions, if adhered to, should help exclude ineligible companies from program participation.

The agency has been overstating the program's accomplishments, basing its claims on projected, rather than realized, benefits.

Finally, GAO noted that some loans were approved for small businesses whose financial condition was such that credit should have been refused because it was available from other sources.

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The Administrator of the Small Business Administration should:

- Establish a system to monitor local development companies' entry into the program and their financial contributions to the projects.
- Improve the accuracy of reporting program accomplishments.
- Establish criteria for loan approval which relate dollars invested to jobs created.
- Strengthen the agency's controls for assuring that loans are made only to small businesses whose financial condition warrants assistance.

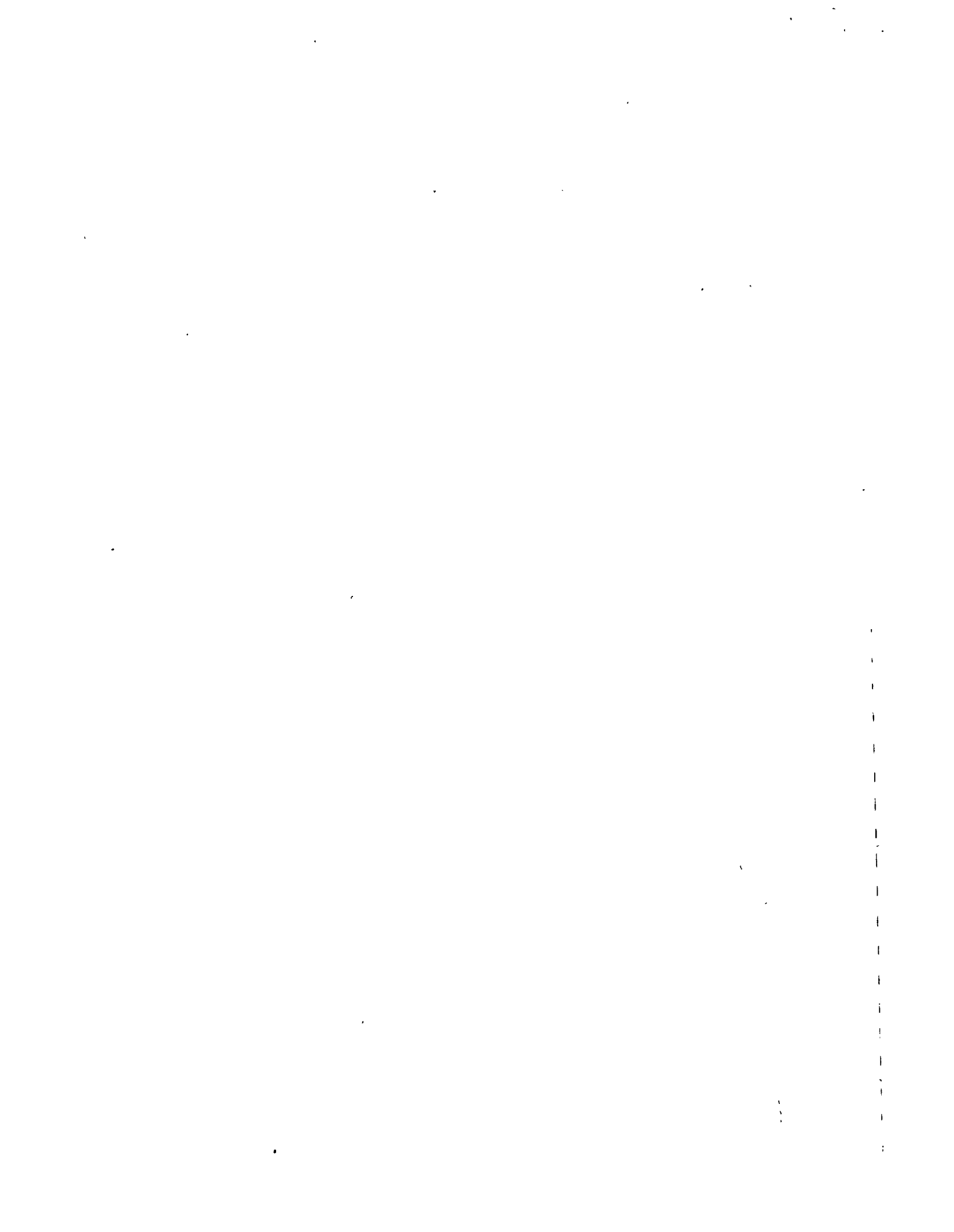
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The Small Business Administration agreed to act on the above recommendations by:

- Restudying membership eligibility and developing requirements to insure community participation.

- Retraining personnel who package and process local development company loans.
- Considering the activation of a system to obtain meaningful historical and current financial and employment data from loan recipients.
- Studying the advisability of establishing job cost-benefit guidelines. (See app. I.)

This report is the sixth in a series under Public Law 93-386, which requires GAO to make a full-scale audit of the Small Business Administration.



CHAPTER 1

INTRODUCTION

The purpose of the Small Business Investment Act of 1958 (Public Law 85-699, approved Aug. 21, 1958) is to improve the national economy in general and, in particular, the small business segment by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small businesses need for soundly financing their business operations and for their growth, expansion, and modernization.) The Small Business Act of 1953 defines "small businesses" as businesses independently owned and operated and not dominant in their field of operation. D.M.K.

LOCAL DEVELOPMENT COMPANY LOAN PROGRAM

Under section 502 of the Small Business Investment Act of 1958, as amended, the Small Business Administration (SBA) makes loans to local development companies (LDCs) for constructing, expanding, or converting plants for use by specific small businesses. By regulation, SBA includes the purchase of machinery and equipment as plant construction. A unique feature of this program, as it relates to other SBA loan programs, is that it makes loans to the LDC rather than directly to the small business.

The Congress conceived the program so the LDC's resources could be used fully to meet the long-term credit needs of small businesses. SBA's philosophy is that, through the LDC, the program attracts local financial and moral support which contributes to the success of loan projects.

In describing the program, SBA says:

"* * * It is a program that works exclusively through a local development corporation made up of local citizens whose primary purpose is to improve their local economy. To become eligible for this kind of loan, these citizens must put up their own personal dollars and, as a corporation, assume the full liability for any project they sponsor. Community interest, not profit, is the motivating force. * * *"

An LDC is a corporation chartered under any applicable State corporation law to operate in a specified area within a State to promote and assist the growth and development of small businesses.

According to SBA procedures and/or regulations, an LDC shall be principally composed of and controlled by (75 percent of voting control) persons residing or doing business in the community. The LDC's primary objective is to benefit the community by increasing employment, business volume, and corresponding factors, rather than monetary profits to LDC stockholders, or members. The LDC must have at least 25 stockholders, or members, and generally must provide about 20 percent of the financing for approved projects. Exceptions for a lesser percentage may be granted in certain hardship cases or where the small business is located in a ghetto or target area. Regardless of the LDC's degree of participation, SBA allows the small business being assisted to provide up to 25 percent of the LDC's financing of a project.

The relationships of SBA, LDCs, participating banks, and small businesses are shown in appendix II.

LOAN PROCEDURES

Section 502 loans can be used to finance construction, expansion, or conversion of plants, including the purchase of land, and to purchase machinery and equipment.

SBA can lend a maximum of \$350,000 for up to 25 years to an LDC for each small business it assists. Four loan plans exist by which SBA can assist an LDC.

- Direct loan plan. SBA funds the entire project cost except for the LDC share.
- Guaranty participation plan. SBA guarantees up to 90 percent of a loan from a lending institution.
- First mortgage plan. The lending institution makes a separate loan secured by a first mortgage on all assets to be acquired for a percentage of the total project cost and SBA obtains a second mortgage for its share of project financing.
- Immediate participation plan. SBA and a lending institution agree that one will purchase from the other a percentage of the loan as funds are disbursed.

The LDC may, in turn, lend the funds directly to a specific small business or may acquire assets and make them available to a specific small business, usually by lease, lease purchase, or sales agreement. The LDC generally retains responsibility for repaying the loan. The small business makes payments to the LDC in an amount necessary

to repay the loan and the LDC's investment in the project, plus applicable interest. The LDC may also charge a fee to cover its administrative costs, pay taxes and maintenance charges, and provide a reasonable reserve for contingencies.

Loans for acquiring plant and equipment are also available from SBA under the business loan program authorized by section 7(a) of the Small Business Act, as amended. The major difference under this program is that the loans are made directly to the small business. Other differences exist in the duration of the loans and the use of the various loan plans. Section 502 loans can be made for 25 years, whereas the maximum term of 7(a) loans is 15 years. Also most of the 502 loans involve some direct, low-interest money, while the 7(a) loans are made primarily under the guaranty participation plan at prevailing interest rates subject to maximums established by SBA. During the 5-year period covered by our review, 76 percent of the 502 loans made were under the direct, first mortgage, or immediate participation plans. SBA's direct participation was usually at 5-1/2 percent interest. In contrast, 89 percent of the 7(a) loans were under the guaranty participation plan. SBA's established maximum guaranty rates during this period ranged from 7-3/4 to 11 percent.

GROWTH OF PROGRAM

From the program's inception in fiscal year 1959 to June 30, 1974, SBA approved 5,271 loans valued at over \$1 billion. During fiscal years 1970 to 1974, the period covered by our review, SBA provided about \$232 million for 2,270 loans. In addition, SBA guaranteed 708 loans for which it assumed a contingent liability of about \$91 million. As of June 30, 1975, SBA's portfolio included 4,009 section 502 loans amounting to about \$400.6 million. The status of these loans was as follows.

	<u>Number of loans</u>	<u>Outstanding balance</u> (millions)
Current	3,536	\$345.2
Past due (30-60 days)	103	9.7
Delinquent (over 60 days)	192	23.8
In liquidation	<u>178</u>	<u>21.9</u>
 Total	 <u>4,009</u>	 <u>\$400.6</u>

INTERNAL AUDIT REVIEW

In 1974 SBA's Internal Audit Division reviewed the program at district offices located in Houston, Birmingham, Denver, New York, and Albuquerque and a branch office in Gulfport, Mississippi. The internal auditors concluded that many of the LDCs had been established without community interest or involvement, as required by legislation and SBA's rules and regulations and standard operating procedures. Internal Audit's review is discussed further on pages 8 and 12.

CHAPTER 2

COMMUNITY DEVELOPMENT NOT ALWAYS THE AIM OF THE LDCs

SBA needs to improve its management of the section 502 LDC program. While the program is making capital available to many small businesses, other objectives of the authorizing legislation are frequently being subverted. We reviewed 95 loans and evaluated the LDCs in 4 SBA field offices. In many instances, loans were merely substitutes for assistance available to small businesses under other SBA programs.

Although SBA had set certain eligibility requirements for screening out those companies applying without community development in mind, it had not exercised strong supervisory control over the program.

SOME LDCs HAVE NOT SERVED THEIR INTENDED PURPOSE

The Congress intended that the program's initiative come from local citizens organized in the LDCs. According to SBA, community involvement is the key to the success and strength of the program. However, often--we were unable to estimate overall frequency--the company was a facade allowing a small business to obtain the benefits of the longer term, lower interest-rate loans available under this program.

In one case, a southeastern development company chartered in February 1972 received SBA's approval for a loan in May 1972. The loan was to help a small business in purchasing land and constructing a warehouse. SBA agreed to provide \$90,000 at 5-1/2 percent, the bank \$90,000, and the LDC \$20,000 for a total project cost of \$200,000.

The LDC president told us that the members did not invest any funds in the LDC and that it had been formed to assist the small business. Moreover, he said the business purchased the required land and transferred the title to the LDC in exchange for its note. The land was then used as the LDC's contribution to the project.

LDC officials told us that they provided no financial or management assistance to the small business, that the LDC is no longer active, and that the small business makes its loan payments directly to SBA and the bank.

In another case, SBA approved a guaranteed loan requested by a southeastern LDC in June 1971. The LDC had been organized

by the small business' president to enable him to qualify for a loan under the program. He obtained LDC members by asking friends and relatives. LDC members owned 85 percent of the small business, and the LDC's and the small business' board of directors were identical. The LDC never invested any funds in the project, no other small business has been assisted, and no additional projects are planned.

In a third case, SBA approved a \$144,500 first mortgage loan in January 1973 for a southeastern manufacturing operation. SBA's portion of the loan was \$65,000 at 5-1/2 percent interest. The participating bank and the LDC funded the balance.

The principal owner of the small business had been primarily responsible for organizing the LDC. Stockholders owning 65 percent of the small business also owned 42 percent of the LDC's stock. An LDC official said that membership had been obtained only to meet SBA requirements. The LDC president said that he had been elected primarily because he had not attended the first meeting and that he really did not know how the LDC had been set up. The LDC has not assisted another small business and has no plans to do so.

In a fourth case, an LDC president told us that an LDC's primary purpose is to serve as "a funnel for SBA funds," and that private financing is sought for only that portion of project costs that SBA will not finance.

SBA officials in one SBA region have recognized this problem. In memorandums dated January 1974, the Chief of the Community Economic Development Division told the regional director and an assistant director that:

"Our slow and tedious job with the LDC as a 'front' for small business projects continues to absorb SBA's manpower. It is estimated that in 85% of case [sic] the LDC is only a means of securing a 90% Government Loan. Only in 15% of the cases is it estimated that this is a true Community Development Project."

* * * * *

"The matter has been largely ignored in the hundreds of loans for millions of dollars that have been made to LDCs * * * in the past five years."

In contrast, we found that community development appeared to be the aim of other LDCs. This was evident in a

loan SBA made to a west coast LDC in March 1972 to purchase land, to construct facilities, and to provide equipment for a market in a shopping center located in a redevelopment area. SBA provided \$240,000, the bank \$120,000, and the LDC \$40,000, totaling \$400,000 for the project's financing. The LDC's share of the project financing came from the sale of capital stock to its 26 members. None of the LDC members associated with the small business had more than 25 percent ownership in the LDC. With financial assistance from SBA, the LDC has also assisted five other small businesses within the shopping center.

SBA REQUIREMENTS GOVERNING LDCs NOT FOLLOWED

SBA has set certain eligibility requirements for LDCs applying for program assistance. For example, an LDC must have a minimum of 25 members. Members of an immediate family (i.e., husband and wife) cannot be individually counted to comply with the minimum requirement. Other requirements cover the small business' contribution of the LDC's share of the project financing and ownership and control of the LDC by the small business.

Of the 95 loans, 1 or more of SBA's eligibility requirements were not met in 36 cases.

--SBA requires that a small business may give a maximum of 25 percent of an LDC's share of project financing. In 23 cases the small business gave more than 25 percent. In 13 cases the LDC's entire share of the financing was given by the small business.

--SBA requires that an LDC have at least 25 stockholders, or members, 75 percent of whom live or do business in the LDC's area of operation. In 20 cases the LDCs failed to meet SBA's minimum membership requirements.

--SBA requires that not more than 25 percent of the ownership, or control, of the LDC may be held by persons having a direct financial interest in the small business being assisted or the project to be developed. For 11 loans, however, persons with more than 25-percent ownership, or control, of the LDC also had a significant financial interest in the project.

Another SBA requirement is that land or related improvement costs of building sites provided by the LDC be

limited to the actual purchase price of the land and paid-for improvements. Appraised values may be used only upon SBA central office written approval. In 25 cases valuations exceeding costs were accepted without central office approval.

For example, in October 1973 SBA guaranteed a loan to construct a southeastern manufacturing plant. The project required a local bank to give \$189,000, or 90 percent, and the LDC to give \$21,000, or 10 percent, of the \$210,000 total investment. As its share of the project, the LDC provided 7 acres of land purchased in May 1969 for \$3,882, to which it assigned a value of \$21,000. SBA's district office accepted the land at this value without obtaining an independent appraisal.

Allowing LDC contributions at valuations exceeding costs without proper approval could reduce local participation below the established minimum, while increasing the total project cost, and SBA's share. It could also permit the LDC to profit at the expense of the small business when repayment schedules are based on the inflated amount.

Adherence to eligibility requirements, in and of itself, does not insure the successful operation of a project. It can, however, increase SBA's assurance that the recipient will operate in the manner intended by SBA. Eight of the loan recipients who violated one or more of the requirements cited above are no longer active. If they had been required to comply with these requirements before their loans were approved, perhaps their problems would have surfaced before SBA funds had been committed.

A detailed listing of the loan violations is included in appendix III.

RESULTS OF SBA INTERNAL AUDIT

In August 1974 SBA's Internal Audit Division issued a report on the section 502 program in which it discussed several weaknesses in carrying out the program, which resulted in several LDCs which did not have community interest or involvement. The internal auditors also found noncompliance with SBA's eligibility requirements. Of the 45 loans they examined, 1 or more eligibility requirements were not met in 13 cases.

Internal Audit recommended certain procedural revisions to provide for more verification and evaluation on SBA's part.

SBA's standard operating procedures were revised in January 1975 to verify LDC membership. If adhered to,

the procedures should help in identifying and excluding ineligible LDCs from the program.

CONCLUSIONS

Some LDCs have been set up to make specific small businesses eligible for low-interest loans rather than to serve as a catalyst for community economic development.

SBA eligibility requirements on LDC creation and financing could help prevent such situations from occurring, but they have not been enforced.

It appears that the availability under the section 502 program of long-term, low-interest loan funds generally not available under the 7(a) business loan program provides an incentive for the types of program abuses described in this chapter. 1/

We believe, therefore, that the program needs stronger supervisory control.

RECOMMENDATION

We recommend that the Administrator of SBA establish a system to monitor LDCs' entry into the program and their financial contributions to projects. Such a system should help verify that the LDC has the community participation deemed essential to the program's success.

AGENCY COMMENTS

In commenting on our report, the Acting Administrator said SBA intends to restudy membership requirements and to develop requirements that will insure community participation essential to the program's success. Also he said that SBA intends to institute retraining programs for those persons who package and process section 502 loans to assure better understanding of the program.

1/See p. 17 for discussion of the subsidy effect of low-interest loans.

CHAPTER 3

PROGRAM ACCOMPLISHMENTS HAVE BEEN OVERSTATED

SBA has identified three factors which contribute to the economic benefit of a community forming an LDC.

1. Creation of jobs.
2. Expansion of tax base.
3. Indirect stimulation of other businesses.

SBA does not have a system to assess the overall economic benefit of the program in terms of these factors. Therefore, it cites the number of jobs created as a barometer for measuring the program's success. We found that SBA's figures on new jobs have been overstated because it uses loan applicant projections rather than actual figures.

Also SBA does not have loan approval criteria which relate dollars invested to jobs created. The expected average investment per job for the loans reviewed ranged from \$1,000 to \$100,000. Developing investment-per-job criteria would help in achieving maximum economic development with limited resources.

PROJECTED EMPLOYMENT LEVELS FREQUENTLY NOT MET

Creating new job opportunities is a principal goal of the program. Loan applicants must give SBA current and projected employment information, including (1) jobs existing on the date of application, (2) new jobs anticipated, and (3) total future employment to be expected if the loan is approved. Applicants are told that the projected increase refers to the number of new full-time jobs that will result from the application's approval at the end of the first 12 months of full production. Frequently, however, no new jobs are created.

For the 95 loans, a total of 3,074 jobs were to be created by small businesses. During our review, 1,751 of the projected additional jobs existed. However, 13 small businesses, in existence at the time of loan application, lost 211 employees after receiving SBA assistance through LDCs. The net jobs resulting from the 95 loans, therefore, were only 1,540, or 50 percent, of the projected jobs. A summary of the success of small

businesses in meeting employment goals is shown in appendix IV.

In the case of 30 loans projecting 658 new jobs, employment goals were achieved or exceeded. For example, in October 1973 SBA approved a loan of \$144,000 to build a new manufacturing plant for an existing midwestern business. The total project cost was \$320,000; the LDC and a participating bank were to provide the balance. The small business had 30 employees, and anticipated 10 new jobs because of the expansion permitted by the new building. In October 1974 the small business had 70 employees, or 30 more than anticipated.

While there are similar success stories, most of the small businesses did not achieve the expected employment goals. During our review businesses assisted by 65 of the 95 loans had fewer employees than the projected levels shown in their loan applications. Although these small businesses had projected 2,416 new jobs, their net increase in employment was only 441, or 18 percent, of that projected. Reasons for not meeting the employment goals included lack of consumer demand, overall economic decline, and overestimated goals. Only eight had reached the projected employment level at any time since loan approval.

For 9 of the 65 loans, lack of project completion or lack of time between project completion and the time of our visit may have been a factor in the failure to achieve the employment goals.

Some businesses had fallen considerably short of achieving their projected levels of employment. For example, in June 1971 SBA approved a \$50,500 immediate participation loan for acquiring land and constructing a building for a midwestern manufacturer. The total cost of the project was \$75,000, the balance of which was to be provided by the LDC and a participating bank. The small business was new and projected creating 75 jobs. By February 1974 the small business had ceased operation. It appears that the primary reason for the business' failure was its late start in a highly competitive industry. By January 1975 the LDC's loan payments had been deferred for 11 months and the building was being used by the local bank president, without charge, to store part of his antique car collection.

In October 1971 SBA approved a participation loan of \$165,375 for a \$367,500 project for expanding a southeastern manufacturer. The small business projected an increase in employment from 65 to 265. In October 1974 only 80 persons, or 185 less than projected, were employed.

According to the small business' president, unfavorable economic conditions were responsible. However, since 1971, the highest employment level achieved by the business was 140, or 125 fewer than projected.

A west coast loan, approved in July 1973 to expand an existing business, was expected to create 75 new jobs. In November 1974 only four additional persons were employed. The LDC president said he had not fully understood the business' employment needs when he prepared the application and, therefore, had guessed. He later realized that the estimate of 75 was considerably higher than could be expected for this type of business and currently anticipates maximum employment of 6 persons when the business is in operation. SBA officials said that the proposed employment figure of 75 had been accepted without question, even though data submitted to SBA indicated that it was unreasonably high.

NEED FOR SYSTEM TO MORE
ACCURATELY MEASURE ACCOMPLISHMENTS

SBA has overstated the accomplishments of the section 502 program by considering the number of jobs anticipated, rather than the number of jobs created, as benefits. SBA reports showing jobs created by the program are based on projections from loan applications. No procedure exists for obtaining data on the actual number of jobs created. As discussed in the preceding section, the loans generally did not create the number of jobs anticipated.

In discussing how effective methods for evaluating the program's economic benefits have not been developed, the report on the 1974 internal audit review stated that:

"Present practices and procedures do not require that economic benefits of 502 loans be determined and evaluated. Some SBA personnel were of the opinion that an operating business and timely loan repayments were adequate as a measure of the success of the program. In our opinion, this does not assure that the program is accomplishing its intended purposes as set forth in statutory provisions. Existing criteria does not provide for a follow-up system whereby data necessary to measure the program's actual benefits and accomplishments will be obtained and evaluated. As a result, SBA is not assured that objectives or projected benefits of the program are successfully accomplished, or whether additional assistance would be beneficial."

The report recommended that SBA:

- Develop expanded guidelines to operating personnel for evaluating the accomplishments and/or failures of the program.
- Compare these guidelines to projections contained in loan applications and loan officers' reports, including projections of the number of employees, gross sales, etc.
- Summarize this data by office and region and for the agency.

Program officials agreed that present statistics on the program's success, including the number of employees, originate from data contained on loan applications rather than from actual experience. They said that an SBA form had been developed that would give factual data but because of the shortage of personnel, there was not sufficient time to obtain this data. They said, therefore, that no corrective action would be taken.

An effective followup system would not only enable SBA to more accurately measure the program's economic benefits, but would also enable SBA to examine the reasons why certain businesses are not achieving the projected rate of success. This information would be useful in evaluating the feasibility of future projects and in identifying businesses needing management assistance.

NEED FOR APPROVAL CRITERIA

Loan applicants are required to estimate the number of new jobs that will be created if the loan is approved. SBA generally requires that there be some expansion; it has no criteria regarding how many dollars should be invested to create one new job. As a result, loan funds are not necessarily applied in a way to create the maximum number of jobs and the greatest economic benefit from the program. The following table categorizes the estimated investment per job, at the time of application, for the loans reviewed.

Average investment per new job	Number of loans	Estimated new jobs	
		Number	Percent
\$ 0 - \$ 10,000	48	2,456	80
10,001 - 20,000	21	401	13
20,001 - 30,000	14	161	5
30,001 - 40,000	3	22	1
40,001 - 50,000	5	26	1
50,001 - 100,000	4	8	-
	<u>95</u>	<u>3,074</u>	<u>100</u>

For example, in June 1973 SBA approved a loan to a midwestern LDC for land and a new building for an existing plumbing supply business. The total project cost was \$100,000; SBA contributed \$67,500. The small business estimated that one additional job would be created. Thus, the investment per new job expected was \$100,000 overall and \$67,500 for SBA's share.

Another loan, approved in November 1972 for a new plant for a midwestern manufacturer, was expected to create two additional jobs. The total project cost was \$146,000; SBA contributed \$92,000. Thus, the investment per job was \$73,000 overall and \$46,000 for SBA's share. In contrast, the same SBA office on the preceding day had approved a loan for another manufacturer which projected 25 new jobs. The total project cost was \$224,200; the investment per job was \$8,968. Since it was a guaranty loan, SBA invested nothing directly.

While the above examples do not represent the norm, they do demonstrate a need for reasonable criteria for approving projects.

CONCLUSIONS

The program's primary objective is economic development. However, despite the fact that many projected jobs did not materialize, SBA's method for reporting program accomplishments continues to show jobs as being created. Thus, the effectiveness of the program is overstated, and decisions concerning continuing the program, level of funding, etc., are being made without accurate and complete program information. A program to monitor progress in achieving projected employment goals could identify businesses needing management assistance, identify the underlying reasons for this need, and help in evaluating the feasibility of future projects.

RECOMMENDATIONS

The Administrator of SBA should:

- Establish a system to more accurately report program accomplishments to give decisionmakers more accurate data on program results. Such a system should monitor small businesses' progress in achieving employment goals.
- Establish criteria for loan approval which relate dollars invested to jobs created.

AGENCY COMMENTS AND OUR EVALUATION

The Acting Administrator agreed that there is a need for more information on the program's accomplishments. He said SBA is considering activating a system discontinued in 1969 which will secure meaningful historical and current financial information and employment data from section 502 loan recipients.

The Acting Administrator said that SBA intends to study the advisability of establishing job cost-benefit guidelines which will relate dollars invested to jobs created. He stated that SBA will consider in its study retaining existing jobs along with the newly created jobs to adequately measure the attendant job cost benefit. Retaining existing jobs was not considered in our review primarily because SBA has administered the section 502 program with heavy emphasis toward creating new jobs.

When SBA undertakes its study, however, some consideration should be given to the fact that by including retention of existing jobs in the job cost-benefit guidelines, cost-benefit calculations could tend to be more favorable for existing businesses than for new businesses. Generally, favorable benefits could occur because existing businesses would be able to project more jobs in loan applications.

CHAPTER 4

LOANS MADE WHEN NEED FOR ASSISTANCE WAS QUESTIONABLE

SBA field offices have approved loans without adequate assurance that the financial assistance applied for was not otherwise available on reasonable terms. As a result, loans have been made to assist persons who, in our opinion, could have obtained all or part of the required financing from other sources.

Also, our examination of 95 loans showed that:

- Bank credit refusals either had not been obtained or did not comply with SBA requirements in 67 cases.
- SBA had not obtained personal financial statements from small business principals in 26 cases.

NEED TO CONSIDER ABILITY OF SMALL BUSINESS PRINCIPALS TO SHARE INVESTMENT RISK

SBA is not entitled to make loans under this program if either the LDC or the small business can provide or obtain, on reasonable terms, the funds required. However, SBA has not adequately considered the credit and resources of the small business principals. Consequently, 16 of the loans were made to persons who should have been able to make their own investment or get other financing.

For example, in April 1973 SBA approved an immediate participation loan of \$108,000 at 5-1/2 percent interest for expanding a midwestern foundry. The total project cost was \$160,846, the balance of which was provided by the LDC and the participating bank. The business was owned by two brothers who also owned several other companies and had a combined personal net worth of about \$2.3 million, including \$125,000 in cash and savings accounts and \$1.4 million in stocks and bonds. In our opinion, this project could have been financed without SBA's assistance.

In July 1973 SBA approved a project for \$167,000, even though 6 stockholders in the west coast small business, controlling 70 percent of the outstanding stock, had a combined personal net worth of \$1.7 million, or more than 10 times the projected amount. Combined assets included more than \$302,000 in cash and savings accounts and more than \$736,000 in stocks and bonds.

In addition, we identified 14 other cases in which small business principals had net worth sufficient for SBA to have explored fully their ability to contribute all or part of the approved loan.

A low-interest loan is a grant or subsidy, the amount of which is measured by the present value of the reduction in interest paid over the life of the loan. For example, three SBA loans for which there appeared to be available alternatives resulted in the following estimated benefits to the recipients, as compared to the benefits from obtaining the same amounts by a conventional loan.

<u>Loan type</u>	<u>Approval date</u>	<u>Amount</u>	<u>Interest rate</u>	<u>Term</u> (years)	<u>Interest saved</u>	
					<u>Total</u> (note a)	<u>Present value</u> (note b)
Guaranty participation	June 1972	\$119,000	8	25	\$ 18,000	\$ 7,758
Immediate participation	April 1973	108,000 (SBA)	5-1/2	15	39,240	22,734
		36,000 (bank)	7-3/4			
Immediate participation	April 1973	187,500 (SBA)	5-1/2	25	132,900	57,278
		62,500 (bank)	7-1/2			

a/Based on estimated interest rate of 8-3/4 percent for conventional loans.

b/Discounted at 8 percent compounded quarterly.

The value of the grant or subsidy depends on the amount, interest rate, and term of the loan, as well as on the level of prevailing interest rates on conventional loans.

The section 502 program provides financing to small businesses which they could not obtain otherwise. The program was not intended to provide risk-free investment opportunities or low-interest subsidies to individuals able to obtain funds from other sources. To the extent that such loans are made, the ability to make loans to fully qualified businesses is reduced.

In February 1971 we reported to the Administrator of SBA that 7(a) business loans were being approved without adequately considering the principals' ability to provide all or part of the financing. We recommended that SBA establish criteria for deciding whether a loan application should be disapproved or modified, based on the personal resources or credit of the applicant's principals.

SBA determined that existing criteria for principals' personal resources were adequate. However, the Administrator directed the regional and district directors and branch managers, in a memorandum dated March 1, 1971, to:

"Please take whatever action is necessary to insure that a proper evaluation is made of the principals' ability to provide funds from personal resources."

As the preceding examples indicated, however, the problem remains.

INADEQUATE CREDIT REFUSALS

SBA regulations require that, before a loan is approved, proof of refusal of the required credit be obtained from a bank or other lending institution whose lending capacity or policy would allow it to cover the loan applied for. Proof of refusal must contain the date, amount and terms requested, and the reason for decline. For 36 loans, bank credit refusals had not been obtained. In addition, refusals obtained for 31 loans were not acceptable by SBA's standards because some required information was omitted.

For example, in March 1970 SBA approved a \$100,000 loan at 5-1/2 percent interest for a southeastern manufacturer. SBA obtained personal financial statements from seven principals who owned 57 percent of the business. At the time of the loan, these individuals had a combined net worth of more than \$2 million, \$565,983 of which was in such liquid assets as cash savings, stocks, bonds, and life insurance surrender value. SBA approved the loan without obtaining credit refusals. According to the small business' president, no other sources of financing were sought.

Another loan was approved in November 1972 for a mid-western medical clinic. The credit refusal obtained stated that the length of time requested at the rate desired made the loan impossible, but the refusal did not specify the term or rate discussed.

SBA needs to know the reasons why credit was refused to insure that private financing was sought first. The date, term, and amount of the loan requested are essential for assuring that the request for credit was recent and for the needed amount at reasonable terms. Without this information, there is no assurance that other financing was sought.

FINANCIAL STATEMENTS NOT OBTAINED

For 26 of the 95 loans, SBA had not obtained personal financial statements from small business principals. As shown on page 16, these individuals often have considerable personal assets which could and should be used instead of SBA loan funds.

CONCLUSION

The Congress intended that Federal funds provided by the section 502 program would supplement private equity capital and long-term funds not available in adequate supply for small businesses. However, SBA has not always taken adequate action to assure that the funds requested were not available from other sources. As a result, loans have been made to persons who could have provided all or part of the amount from other sources. To the extent that such loans are made, the ability to make loans to fully qualified businesses is reduced.

RECOMMENDATIONS

We recommend that the Administrator of SBA strengthen its controls for assuring that loans are made only to small businesses whose financial condition warrants this assistance. This would enable SBA to determine the extent to which its field offices were

--adhering to established requirements for obtaining credit refusals,

--obtaining personal financial statements from small business principals for all loans, and

--requiring small business principals to use their personal resources or credit for project financing when their financial condition permits them to do so.

AGENCY COMMENTS

The Acting Administrator said that a recent staff realignment has brought the LDC personnel under close supervision of the Assistant District Director for Finance and Investment which should curtail errors in documentation and assure that SBA is fulfilling its role as a lender of last resort. Further, he said that loan officers will be required to document why the assets of a small business or its principals which appear to be available for the project are not used.

CHAPTER 5

SCOPE OF REVIEW

We examined records and spoke with SBA officials concerned with the section 502 program at its Washington, D.C., headquarters office and at SBA district offices in Atlanta, Georgia; Los Angeles, California; Madison, Wisconsin; and Minneapolis, Minnesota. These offices were selected on the basis of their loan volume and the comprehensive internal audit review in six other SBA field offices.

We reviewed 95 loans made during fiscal years 1970 through 1974. This represented at least 20 percent of the section 502 loans made during that period by each office involved. We selected the individual loans on the basis of (1) fiscal year of loan, (2) type and amount of loan, (3) number of jobs to be created, and (4) type of small business being assisted. We also interviewed LDC and small business officials, as well as officials of participating banks.



U.S. GOVERNMENT
SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF THE ADMINISTRATOR

JAN 21 1976

Mr. Victor L. Lowe
Director, General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

As requested by your letter of December 22, 1975, enclosed are our comments to the draft report entitled, "The Small Business Administration's Local Development Company Loan Program Is Making Capital Available to Small Businesses-- But Other Objectives of the Legislation Are Often Subverted."

We appreciate the opportunity to comment on this report and we believe that the actions indicated in the enclosure will improve the implementation of this program.

If you have any questions or need further information with regard to our comments, please advise.

Sincerely,

Louis F. Laun
Acting Administrator

Enclosure

SMALL BUSINESS ADMINISTRATION'S COMMENTS

ON

GENERAL ACCOUNTING OFFICE DRAFT REPORT

ENTITLED

"THE SMALL BUSINESS ADMINISTRATION'S
LOCAL DEVELOPMENT COMPANY LOAN
PROGRAM IS MAKING CAPITAL
AVAILABLE TO SMALL BUSINESSES--
BUT OTHER OBJECTIVES OF THE
LEGISLATION ARE OFTEN SUBVERTED"

(Report Submitted for Comments on December 22, 1975)

"Recommendation (Page 14)

We recommend that the Administrator of SBA establish a system to monitor LDC's entry into the program and their financial contributions to projects. Such a system should help to improve verification that the LDC has the community participation deemed essential to the program's success."

With regard to this recommendation, we intend to restudy the entire membership requirements and to develop requirements that will insure community participation essential to the program's success. This study will take into consideration the differences among large and small communities, as well as, the innercity LDC's of the minority program. We recognize that except in very small communities, an LDC of 25 members could be suspected of being self-serving for one industry. In addition, we intend to institute retraining programs for those now assigned to the packaging and processing of Section 502 loans to assure a better understanding of the objectives of the program.

"Recommendation (Page 23)

The Administrator of SBA should:

- establish a system to more accurately report program accomplishments for the purpose of providing decision makers with more accurate data on program results. Such a system should monitor small businesses' progress in achieving employment goals.
- establish criteria for loan approval which relate dollars invested to jobs created."

We agreed that there is a need for more information concerning the accomplishments of this program. Therefore, we are considering activating a system which was discontinued in 1969.

BEST DOCUMENT AVAILABLE

At that time, a "Local Development Company Evaluation Data" form was used to secure meaningful historical and current financial information and employment data about the businesses assisted by Section 502 loans.

[See GAO note 1,
p. 26.]

Further, we intend to study the advisability of establishing job cost-benefit guidelines for use by our field office personnel. However, in our study, we will consider the retention of existing jobs along with the newly created jobs to adequately measure the attendant job cost-benefit.

It appears that no consideration was given to this in the draft report.

"Recommendations (Page 29)

We recommend that the Administrator of SBA strengthen the Agency's controls for assuring that loans are only made to small businesses whose financial condition warrants such assistance. This would enable SBA to determine the extent to which its field offices were:

- adhering to established requirements for obtaining credit refusals;
- obtaining personal financial statements from small business principals for all loans; and
- requiring small business principals to use their personal resources or credit for project financing when their financial condition indicates the ability to do so."

We believe that our recent realignment which has brought the LDC/CED staffers under the close supervision of the Assistant District Director for Finance and Investment should definitely curtail errors in documenting our loan presentation and assuring that our loans are indeed made only in our role as a lender of last resort. Our loan officers will also be

required to be more explicit as to why assets are not available when they appear to be available and are not used. However, since the communities are in a competitive market to develop their economy, SBA must be cautious in demanding use of possible available resources of the small business principals, if the communities are to gain the economic benefits of locating the facilities in their areas.

We are also giving consideration to the development of a corps of community development specialists who have the expertise to carry out objectives of this program.

Other Observations

We would like to address some comments with regard to the statement on page ii of the Digest which states: "Although the agency had set certain eligibility requirements intended to screen out such companies, it did not establish procedures for checking on the extent to which its field offices were enforcing compliance with these requirements."

We take some exception to this remark, since in the report itself, you recognized a recent internal audit that was made of the program which did report on aspects concerning implementation of the program. Further, our Office of Portfolio Review also makes periodic review of these loans and, even though they do not review them to the extent the auditors do, information is received concerning the implementation of the program. In addition to supervision, we consider these functions as part of our internal control over this and other programs.

However, to strengthen our control, we intend to reemphasize to our field attorneys that at the time of disbursement, they should satisfy themselves as to the sources of such funds as one of their "closing" functions.

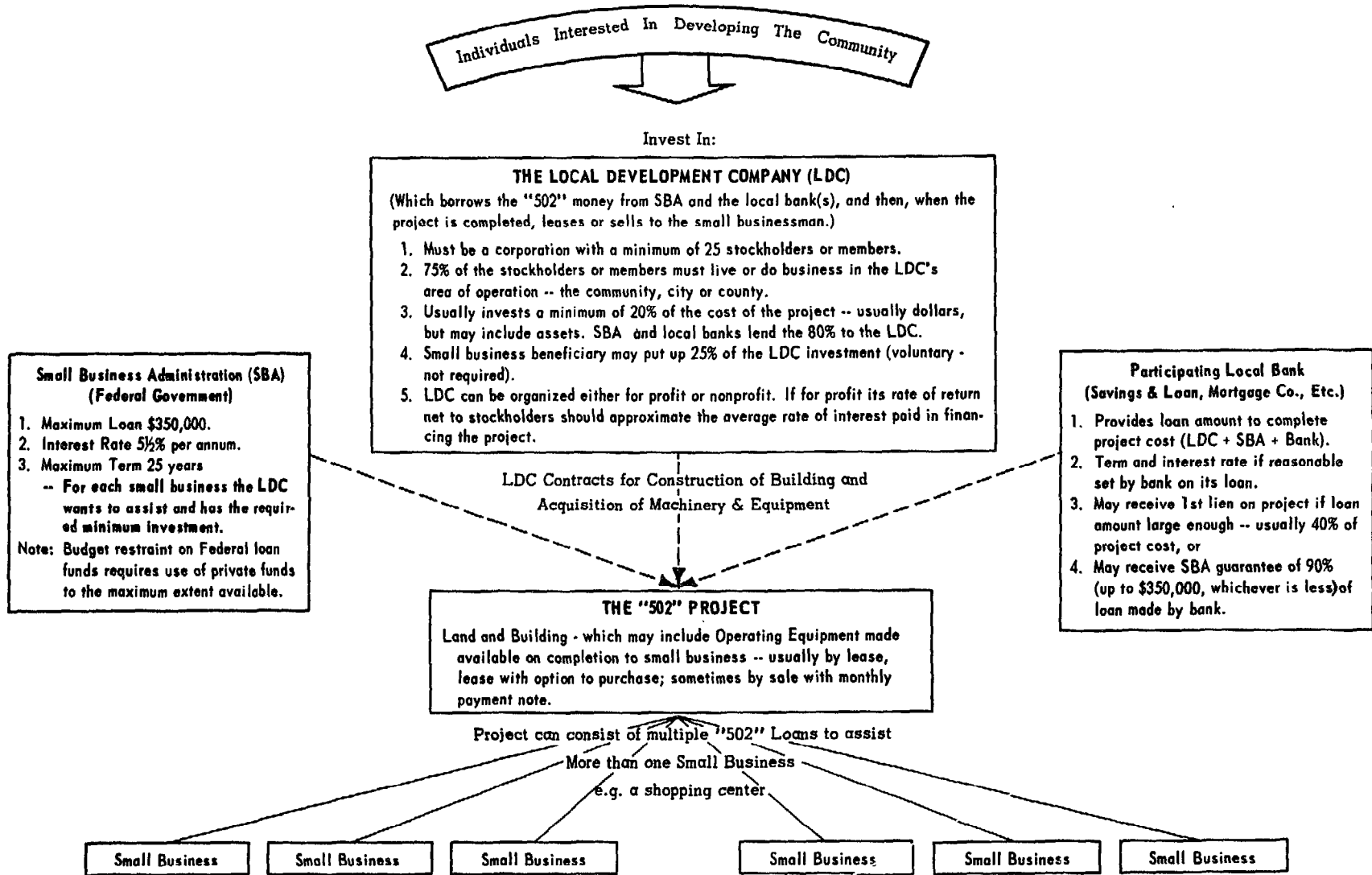
[See GAO note 2.]

- GAO notes:
1. Deleted sentence refers to a copy of the "Local Development Company Evaluation Data" form which was attached to SBA's comments. This form was not included in the final report due to its length.
 2. This statement has been clarified in the digest.
 3. Page reference refer to our draft report and may not correspond to this final report.

THE "502" LOAN PROGRAM OF THE SMALL BUSINESS ADMINISTRATION

Purpose: To encourage economic growth and prosperity in a community by making available low-interest, longterm loans to local development companies for the purchase of land, the construction, expansion, or remodeling of buildings and the purchase of operating machinery and equipment for use therein by a small businessman.

27



SCHEDULE OF LOANS FOR WHICH SBA'SREQUIREMENTS WERE VIOLATED

<u>Loan number</u>	<u>More than 25% of LDC contribution provided by small business</u>	<u>More than 25% of LDC owned or controlled by small business (note a)</u>	<u>LDC equity credit valued in excess of costs without approval</u>	<u>LDC membership requirements not met</u>
1	X			
2			X	
3			X	
4			X	
5	X		X	
6			X	
7			X	
8			X	
9			X	
10			X	
11				X
12			X	
13			X	
14			X	
15	X			
16			X	
17	X		X	
18			X	
19			X	
20				X
21				X
22		X		X
23		X		X
24	X			
25	X			
26	X	X		X
27		X		X
28				X
29		X		X
30	X	X		X
31				X
32	X	X		X
33	X	X		
34			X	
35	X		X	
36	X			
37		X	X	X
38			X	
39	X	X		X
40			X	
41			X	
42			X	
43		X		X
44	X			X
45	X			X
46				X
47	X			
48	X			
49	X			
50	X		X	
51	X		X	
52	X			X
53	X			
54				X
55	X			
Total	<u>23</u>	<u>11</u>	<u>25</u>	<u>20</u>

a/Or others with financial interest in loan project.

SUCCESS OF SMALL BUSINESSES
IN MEETING EMPLOYMENT GOALS

<u>Loan number</u>	<u>Employment at date of application</u>	<u>Estimated number of new jobs</u>	<u>Actual number of jobs created (lost)</u>
1	190	30	2
2	0	75	0
3	13	2	(9)
4	8	4	3
5	0	18	4
6	30	95	100
7	27	25	(27)
8	140	45	(14)
9	130	30	(4)
10	8	2	(1)
11	15	25	8
12	25	25	(14)
13	5	19	29
14	2	1	1
15	0	10	10
16	20	10	14
17	231	30	(42)
18	3	4	4
19	0	18	0
20	0	4	3
21	120	22	60
22	5	1	0
23	12	8	25
24	0	2	1
25	40	20	(19)
26	22	43	18
27	0	4	7
28	0	55	34
29	0	25	0
30	30	10	39
31	50	15	5
32	0	40	23
33	0	30	22
34	30	47	165
35	35	50	(30)
36	7	20	(2)
37	23	72	22
38	0	30	47
39	0	100	105
40	0	41	60
41	0	10	11
42	0	6	9
43	0	40	35
44	6	9	7
45	0	25	16
46	0	12	9
47	0	30	6

APPENDIX IV

APPENDIX IV

<u>Loan number</u>	<u>Employment at date of application</u>	<u>Estimated number of new jobs</u>	<u>Actual number of jobs created (lost)</u>
48	65	200	15
49	0	100	45
50	112	138	14
51	0	30	64
52	0	60	54
53	0	135	68
54	59	11	13
55	0	50	88
56	0	20	0
57	6	40	3
58	23	77	47
59	0	20	14
60	0	36	53
61	7	7	14
62	17	12	(17)
63	0	4	11
64	0	20	8
65	0	10	11
66	225	225	(28)
67	0	31	21
68	0	8	0
69	8	1	(4)
70	0	10	10
71	0	46	30
72	0	9	11
73	0	36	52
74	9	3	4
75	33	32	6
76	2	2	0
77	10	10	1
78	5	20	19
79	6	19	16
80	0	29	0
81	6	16	27
82	0	6	0
83	0	12	0
84	0	6	0
85	0	51	0
86	0	20	18
87	55	15	49
88	0	75	23
89	63	37	0
90	18	75	4
91	5	7	2
92	63	37	10
93	0	4	3
94	6	19	13
95	0	4	6
Total	<u>2,030</u>	<u>3,074</u>	<u>1,540</u>

PRINCIPAL SBA OFFICIALS RESPONSIBLE
FOR ACTIVITIES DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
ADMINISTRATOR:		
Mitchell P. Kobelinski	Feb. 1976	Present
Louis F. Laun (acting)	Oct. 1975	Feb. 1976
Thomas S. Kleppe	Jan. 1971	Oct. 1975
Hilary Sandoval, Jr.	Mar. 1969	Jan. 1971
DEPUTY ADMINISTRATOR:		
Louis F. Laun	Sept. 1973	Present
Anthony Chase	Feb. 1971	Sept. 1973
Einar Johnson	June 1970	Feb. 1971
W. Donald Brewer	Oct. 1969	June 1970
Richard B. Blankenship	Mar. 1969	Oct. 1969
Howard Greenberg	Aug. 1967	Mar. 1969
ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT (note a):		
John T. Wettach	Sept. 1975	Present
Ronald G. Coleman (acting)	Feb. 1975	Sept. 1975
Einar Johnson (acting)	Jan. 1975	Feb. 1975
David A. Wollard	Feb. 1973	Jan. 1975
Anthony S. Stasio (acting)	Jan. 1973	Feb. 1973
Jack Eachon, Jr.	Dec. 1969	Jan. 1973
Howard G. Rogerson (acting)	Aug. 1969	Dec. 1969
Logan B. Hendricks	Aug. 1964	July 1969
DEPUTY ASSOCIATE ADMINISTRATOR FOR FINANCE (note b):		
Anthony S. Stasio	July 1970	Oct. 1974
Howard G. Rogerson	Dec. 1966	July 1970
DIRECTOR, OFFICE OF COMMUNITY DEVELOPMENT:		
Earl L. Chambers	Jan. 1975	Present
Einar Johnson	Feb. 1971	Jan. 1975
Glenn A. Swanson (acting)	July 1970	Feb. 1971
Anthony S. Stasio	Nov. 1966	July 1970

a/Before February 1973 this position was Associate Administrator for Financial Assistance.

b/This position was abolished in October 1974.



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