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REPORT BY THE

# Comptroller General

OF THE UNITED STATES

## Efforts To Improve Management Of The Small Business Administration Have Been Unsatisfactory--More Aggressive Action Needed

AGC00002

GAO made 52 recommendations in 1975 and 1976 to correct problems found in programs and activities of the Small Business Administration. However, this followup report shows that the actions taken by the agency have been unsatisfactory and that further actions are essential so that assistance programs can meet the needs of small businesses more effectively.

Additional actions are also needed to improve the agency's financial management and management control activities.



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

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To the Chairman, Senate Select Committee  
on Small Business and the *SEN05900*  
Chairman, House Committee on  
Small Business *HSE05300*

This is our followup report on the Small Business Administration's efforts to implement our recommendations contained in the series of reports issued to the Congress under Public Law 93-386.

Because we have found the agency's progress to implement our recommendations to be unsatisfactory, we are bringing these matters to your attention.

We are sending copies of this report to the Chairmen, Senate Committee on Governmental Affairs and House Committee on Government Operations; the chairmen of other interested congressional committees; the Director, Office of Management and Budget; and the Administrator, Small Business Administration.

*ARK-114*  
ACTING Comptroller General  
of the United States

COMPTROLLER GENERAL'S REPORT  
TO THE CHAIRMEN, SENATE  
SELECT COMMITTEE ON SMALL  
BUSINESS AND HOUSE COMMITTEE  
ON SMALL BUSINESS

EFFORTS TO IMPROVE  
MANAGEMENT OF THE SMALL  
BUSINESS ADMINISTRATION  
HAVE BEEN UNSATISFACTORY--  
MORE AGGRESSIVE ACTION  
NEEDED

D I G E S T

The Small Business Administration (SBA) has been unsuccessful in carrying out many GAO recommendations to correct problems in its programs and activities. Key programs and activities dealing with personnel, financial, and management control functions of the agency continue to need improvement.

In the mid-1970s the Congress expressed concern over the management of the agency's programs and activities. Consequently, under Public Law 93-386, GAO issued a series of reports with recommendations to improve operations. Although SBA agreed with many of the recommendations it has been slow to implement them. Top management attention is mandatory.

Some of the problems requiring attention are:

- SBA continues to produce unsound loans under the 7(a) business loan program because its approval and servicing procedures are not followed. These problems are manifested by the loss rate for the program, which has increased from 2.66 percent in 1975 to 3.64 percent in 1978. Although SBA agreed that more personnel were needed to process loans in accordance with procedures, its attempts have not significantly increased staffing nor has it decreased the program's loan volume. (See pp. 8 to 26.)
- The agency's monitoring of the local development companies' activities continues to be insufficient. For example, GAO found that the agency had not reviewed revised membership lists to ensure compliance with the eligibility requirements prohibiting small business principals from being on a local development

company's board of directors or owning more than 25 percent of its stock. Also, SBA did not create a system for determining the actual number of jobs created by the program. (See pp. 27 to 29.)

--Investment policies of 301(d) small business investment companies have not appreciably changed since GAO's prior review. These companies, which SBA licensed and financed, provide equity and long-term financing to firms that are owned by socially or economically disadvantaged persons. The companies' investments continue to be debt rather than equity and although the agency issued guidelines to investment companies regarding the eligibility of the small business concerns they finance, the companies have not documented the correlation between the applicant's disadvantages and his inability to compete successfully in the business world. (See pp. 32 to 40.)

--Some employees making or influencing decisions on assistance do not file statements of employment and financial interests, even though the agency issued rules and regulations on this matter after GAO's prior report. The new rules and regulations prohibit employees from purchasing bank stock, but GAO found that the policy regarding employees owning stock in bank holding companies was unclear. (See pp. 44 to 47.)

GAO also noted that SBA has changed its position regarding the use of personal resources by the principals of small businesses being financed by local development companies. In May 1977, the agency revised its rules and regulations whereby the owners of small businesses are no longer required to use personal resources prior to receiving assistance under the local development company program. (See pp. 30 and 31.)

#### CONCLUSIONS

SBA has not effectively corrected the problems noted in GAO's previous reports. Although the agency has issued new procedures

in some cases and reminded employees to follow existing procedures in others, most of the problems previously reported to the Congress still exist. Consequently, SBA's Administrator needs to take additional steps to ensure that GAO's prior recommendations are effectively implemented.

RECOMMENDATIONS TO THE ADMINISTRATOR

The Administrator, SBA, should:

- ✓ --Review SBA's actions to implement GAO's prior recommendations.
- Take the steps necessary to make sure that effective corrective actions are taken on those recommendations which have not been fully carried out.

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AGENCY COMMENTS

The Administrator agreed with GAO and directed that his staff take the following actions for all GAO reports issued since 1975, including those under Public Law 93-386.

- Review each report recommendation and determine whether the necessary corrective action has been taken.
- In those situations where the recommended action has not been taken, evaluate the reasons and take appropriate action.
- In those cases where the recommendation may no longer be appropriate, give the reasons or justification for this determination.
- Establish an appropriate monitoring system on a continuing basis to assure that actions are implemented.

GAO met with agency officials responsible for the various programs and activities in June and July 1979. Their specific comments and suggestions were considered in preparing the final report.

RECOMMENDATIONS TO THE SENATE  
SELECT COMMITTEE ON SMALL  
BUSINESS AND THE HOUSE  
COMMITTEE ON SMALL BUSINESS

In future oversight hearings on the local development company program, the committees should review SBA's March 1977 policy change which eliminated the requirement that owners of small businesses who have sufficient personal resources fund at least part of the loan. With this change, the agency is not a lender of last resort, as is the case in other small business loan programs.

The committees should also closely monitor the agency's progress in correcting the problems discussed in this report.

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#### ABBREVIATIONS

GAO	General Accounting Office
LDC	local development company
OPR	Office of Portfolio Review
SBA	Small Business Administration



## CHAPTER 1

### INTRODUCTION

The Small Business Administration (SBA) was established primarily to aid small businesses--businesses not dominant in their field. It makes direct loans or guarantees loans made by participating banks. It also administers special-purpose programs designed to provide contractual and financial assistance to minority small businesses, to assist homeowners struck by physical disasters, or to provide management and procurement assistance to small businesses. SBA performs management control functions through its standards-of-conduct monitoring system and its audits and investigations function. Benefits are delivered primarily through a network of field offices.

Among the major programs which SBA administers are the 7(a) loan program, 502 local development company (LDC) program, 8(a) procurement assistance program, and 301(d) investment company program.

--Under section 7(a) of the Small Business Act, as amended (15 U.S.C. 636(a)), SBA guarantees and makes direct loans to small businesses. It is SBA's basic and largest business loan program.

--Under section 502 of the Small Business Investment Act of 1958, as amended, SBA makes capital available to small businesses through loans to LDCs--organizations of local citizens which provide loans to small businesses.

--Section 8(a) of the Small Business Act, as amended (15 U.S.C. 637(a)), authorizes SBA to enter into procurement contracts with Federal agencies and subcontract the work to small businesses.

--Under section 301(d) of the Small Business Investment Act of 1958, as amended (15 U.S.C. 661), SBA regulates and, in part, finances privately owned and operated investment companies which provide equity capital, long-term loans, and management assistance to small businesses that are at least 50 percent owned and managed by socially or economically disadvantaged businessmen.

Appendix I provides additional background and details on these programs.

Because of the growing concern over SBA management and operation, the Congress, as part of the Small Business Amendments of 1974 (Public Law 93-386), directed us to conduct a full-scale audit of SBA. We issued eight reports to the Congress in 1975 and 1976 on the above-mentioned programs. We also reported on the lease guarantee program and SBA's personnel management, financial management, and management control activities. Appendix II contains a digest from each report.

The following chapters discuss how well SBA implemented our recommendations in six of the eight reports. Two reports were not included in this review--a report on SBA's lease guarantee program, which we found was not a self-sustaining program and was subsequently terminated, and a report on SBA's personnel management, which had no recommendations. The six reports reviewed contained a total of 46 recommendations.

SBA advised us in August 1977 that it had implemented 27 of our recommendations and had actions pending on 6. It disagreed with nine of our recommendations and four others are no longer applicable due to subsequent changes in the programs. We did not include these 13 recommendations in this review.

## CHAPTER 2

### SBA'S CORRECTIVE ACTIONS HAVE BEEN INSUFFICIENT

Our eight reports discussed how SBA could improve its operation and ensure the success of certain programs and management activities. When we found problems in the agency's ability to provide assistance we recommended actions that were designed to help SBA better assist the small business community and improve management activities.

In our followup we found that SBA did not satisfactorily correct the problems reported.

- A disregard for established procedures in approving and servicing 7(a) loans continues (chapter 3).
- SBA's monitoring of LDCs under the 502 program and measurement of program accomplishments is still insufficient (chapter 4).
- The 301(d) investment companies continue to show a preference for debt rather than equity investments. In addition, the program continues to operate with limited SBA guidance or control (chapter 5).
- Management assistance to 8(a) contractors, while apparently increased, remains untimely (chapter 6).
- SBA is still not requiring all employees involved in making financial assistance decisions to file statements of outside employment and financial interests. Further improvements are needed in SBA's audit, investigative, and review functions (chapter 7).
- SBA's financial management policies and procedures still do not provide the financial information management needs (chapter 8).

Field officials in the offices visited were generally unaware of our previous recommendations. In addition, they expressed concern about the increased workload and insufficient field staff and said that it was difficult to closely follow SBA procedures.

### MORE ACTION NEEDED TO MEET OUR RECOMMENDATIONS

In our opinion, effective corrective action has not been taken on 27 of the 33 recommendations we reviewed. Changes are needed in the assistance programs to improve chances of

meeting program objectives. Additional actions are also needed to improve SBA's financial management and management control activities. The table below shows the number of recommendations reviewed and our opinion of whether SBA's actions were satisfactory.

Program/activity <u>reviewed</u>	Number of report <u>recommendations</u>		<u>SBA actions</u>	
	<u>Total</u>	<u>Reviewed</u>	<u>Responsive</u>	<u>Nonresponsive</u>
7(a) program	17	16	2	14
502 LDC program	4	4	0	4
301(d) investment company program	4	4	1	3
8(a) procurement program	4	1	0	1
Management controls	9	3	2	1
Financial manage- ment	<u>8</u>	<u>5</u>	<u>1</u>	<u>4</u>
Total	<u>46</u>	<u>33</u>	<u>6</u>	<u>27</u>

#### 7(a) program

Our report on the 7(a) business loan program disclosed weaknesses in several areas of loan administration. SBA agreed with our recommendations and agreed that to accommodate the large demand for assistance, more personnel would be needed to process loans in accordance with standard operating procedures. Our followup disclosed that, in the 3 years since we issued our report, SBA has not filled all the positions authorized by the Congress. As a result, SBA field office personnel continue to process and service loans without performing adequate analysis and other requirements spelled out in its procedures.

#### 502 LDC program

SBA has not established a system to monitor LDCs' acceptance and participation in the section 502 program and their financial contributions to projects. Our report concluded that stronger supervisory control was needed to

prevent program benefits from being misused. SBA also has not established a system to determine the number of jobs created by small businesses receiving loans under the program nor has it issued criteria for loan approval which relate dollars invested to jobs created. In each case, SBA told us it would consider future actions on these matters.

#### 301(d) investment company program

SBA's 301(d) small business investment company program continues to prefer assisting socially or economically disadvantaged businesses through loans rather than more risky equity investments. The investment companies feel they have better control over an investment through a loan agreement. Although SBA issued procedures governing eligibility determinations and more efficient reporting, problems remain with the way the investment companies apply the new criteria. Even though the investment companies visited were aware of the new eligibility criteria, they were not using it properly. Firms were being assisted on the basis of the principal's social background, and the investment companies were not showing the connection between a person's social or economic disadvantage and his inability to compete successfully in the business world.

#### 8(a) procurement program

Our followup on the 8(a) procurement assistance program was limited to the program's management assistance segment because Public Law 95-507, dated October 24, 1978, made substantial changes in this program. We found that SBA still has no systematic approach for providing assistance to 8(a) firms, nor for following up on the assistance provided to determine if it was adequate or effective.

#### Management control

SBA disagreed with most of our recommendations for improving audit, investigative, and review functions and the corrective actions taken were either ineffective or were not responsive to our recommendations. Although SBA revised the employees' standards-of-conduct rules and regulations, some employees who participate in assistance decisions are still not filing statements of outside employment and financial interests. Also, some employees continue to own stock in banks even though the rules and regulations were amended to limit the purchase and ownership of such stock.

## Financial management

Although improvements were made in SBA's financial management activities, SBA needs to develop financial data which is useful to management and to make additional changes in its financial operations.

## CONCLUSIONS

The Congress' mandate under Public Law 93-386--a full-scale audit of SBA--required a substantial investment in terms of staff days to perform the work. Generally, SBA agreed with the facts contained in our reports and described actions that it would take to correct some of the problems noted during the reviews.

SBA's actions have not been effective in correcting the problems noted in our prior reports. Although SBA issued new procedures in some cases and reminded employees to follow existing procedures in other cases, most of the problems reported to the Congress in our prior reports still exist. Consequently, SBA needs to take additional steps to ensure that our prior recommendations are effectively implemented.

## RECOMMENDATIONS TO THE ADMINISTRATOR, SBA

We recommend that the Administrator, SBA:

- Review SBA's actions to implement our prior recommendations.
- Take the steps necessary to ensure that effective corrective actions are taken on those recommendations which have not been fully implemented.

## AGENCY COMMENTS

The Administrator, SBA, agreed with GAO and directed that his staff take the following actions for all GAC reports issued since 1975, including those under Public Law 93-386.

- Review each report recommendation and determine whether the necessary corrective action has been taken.

- In those situations where the recommended action has not been taken, evaluate the reasons and take appropriate action.
- In those cases where the recommendation may no longer be appropriate, give the reasons or justification for this determination.
- Establish an appropriate monitoring system on a continuing basis to assure that actions are implemented.

We met with the SBA officials responsible for the programs and activities discussed in the report in June and July 1979. Their specific comments and suggestions were considered in preparing the final report.

### CHAPTER 3

#### THE 7(a) BUSINESS LOAN PROGRAM CONTINUES

#### TO DISREGARD ESTABLISHED POLICIES AND PROCEDURES

SBA is still not following its own procedures for approving and servicing loans under the 7(a) program. Disregard for the basic steps that have been established to assure that quality loans are approved and that, after approval, there is a better chance of borrower success and loan repayment continues. In the 80 randomly selected loans we reviewed in four district offices, we found that:

- At least part of the loan approval process was inadequately performed for 76 loans.
- Servicing was inadequate for 68 loans.
- Management assistance was inadequate for 8 loans.

Some loans continue to be approved for questionable purposes. These include transfer of risk from creditors to SBA, refinancing SBA loans to protect them, and loans made to borrowers who apparently have the ability to secure financing without an SBA guarantee. Other questionable loans resulted from inadequate analysis. Servicing deficiencies included failure to verify the use of proceeds resulting in misuse, failure to follow up through field visits, and failure to receive and analyze borrowers' financial statements to evaluate progress. Management assistance was generally not provided. When provided, it was not always enough to meet the borrower's needs. These deficiencies are identical to those discussed in our February 23, 1976, report 1/ which was based on our review of 980 loans made in 24 SBA district offices. We made 17 recommendations to the SBA Administrator to correct the problems.

These problems are manifested by the increased loss rate that SBA has shown on the 7(a) loan program during the last few years. SBA's loss-rate figures, for all district offices, for fiscal years 1975-78 follow:

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1/"The Small Business Administration Needs to Improve Its 7(a) Loan Program" (GGD-76-24, Feb. 23, 1976).



Loss Rate by Type of Loan

<u>Fiscal year</u>	<u>Guaranteed</u>	<u>Immediate participation</u>	<u>Direct</u>	<u>Total</u>
1975	2.05	2.69	6.42	2.66
1976	2.69	2.82	6.51	3.12
1977	3.23	2.86	6.50	3.51
1978	3.37	2.97	6.61	3.64

We believe that the 7(a) program helps many small businesses; however, the existing problems with its administration diminishes its effectiveness.

SOME LOANS APPROVED FOR QUESTIONABLE PURPOSES

Our prior report disclosed that 7(a) loans had been approved for (1) transferring the risk of obtaining repayment from banks and creditors to SBA, (2) refinancing questionable SBA loans, and (3) wealthy borrowers not intended to receive SBA assistance. Accordingly, we recommended that the Administrator, SBA require:

- Loan specialists to follow established SBA procedures and fully analyze and document the appropriateness of (1) reducing a bank's exposure, (2) refunding bank loans, (3) paying off creditors, or (4) refinancing SBA loans so that, by paying off such debts, the borrower will have a better chance of becoming a viable business and that SBA will not merely be taking the place of existing creditors.
- Loan specialists to make indepth analyses of loans for which 50 percent or more of the proceeds are to be used for payment of borrower debts and to thoroughly justify the payment of such debts.
- Loan specialists to thoroughly analyze the financial resources available to a borrower so that SBA loans are made only to individuals otherwise unable to acquire financing. SBA's Internal Audit Division should review the district offices' compliance with this procedure.
- Participating banks to retain the same level of exposure after the SBA loan that they had prior to the loan.

Our followup disclosed that SBA has not taken adequate corrective actions to implement these recommendations.

Debt repayment

SBA procedures require that, if a major portion of a requested loan is to be used to pay an existing debt, the loan specialist's report must include a full explanation of the circumstances which resulted in the accumulation of the debt. Where applicable, the explanation should include why the applicant could not or did not pay the prior loan as agreed and how the new loan will improve earnings and the applicant's financial condition.

SBA operating procedures state that debts should not be transferred from private to Government hands, but that a certain amount of refinancing is frequently necessary in any growing business. Loan specialists must exercise judgment at all times so that loan proceeds do not bail out banks or other creditors. SBA procedures require that, if loan proceeds are used for debt refinancing, loan specialists carefully document in their loan evaluation reports the justification for debt payments and itemize in the loan authorization the debts to be paid.

Forty-five of the 80 loans in our followup sample were used at least partly to pay debts.

	<u>District Office</u>				
	<u>Boston</u>	<u>Hartford</u>	<u>Atlanta</u>	<u>Birmingham</u>	<u>Total</u>
Number of loans in which proceeds were used for debt payment	<u>9</u>	<u>12</u>	<u>11</u>	<u>13</u>	<u>45</u>
Debt repayment to partici- pating bank	2	7	9	8	26
Debt repayment to other creditors	6	7	8	10	31
Refinance SBA loans	5	3	-	2	10

In 24 loans, a major portion (50 percent or more) was used to pay an existing debt. Of the 24, 14 did not fully explain the circumstances of the debt accumulation and apparently transferred risk from creditors to SBA.

Debt repayment to  
participating bank

Of the 26 loans reviewed where proceeds repaid participating bank loans, 6 resulted in reducing the bank's exposure, thereby transferring the risk of loan default from the bank to SBA. In all these loans, the loan officer failed to thoroughly justify the bank's reduced exposure. In one of the six cases, we believe a bank was bailed out because it was about to sustain a loss.

In one case, SBA approved a \$495,000 loan with a 90-percent SBA guarantee on January 3, 1977. Proceeds were to be used as follows: \$214,000 to purchase equipment, \$173,500 to repay the participating bank, \$78,000 to repay the former owners, and \$29,500 for working capital. The bank's exposure was reduced by \$124,000 as follows:

Exposure before loan	\$173,500
Exposure after loan (10 percent of \$495,000)	<u>49,500</u>
Reduction in exposure	<u>\$124,000</u>

The loan officer indicated that the bank loan of \$173,500 was unsecured, but the borrower had a good record of repayment. Bank officials told SBA that it was necessary to refinance the loan since the borrower wanted to extend the terms beyond the bank's ability.

We believe the reduction in exposure was not fully justified in the loan officer's report because he failed to recommend other alternatives in lieu of substantially reducing the bank's exposure on an unsecured loan.

In another case, SBA approved a \$50,000 loan with a 50-percent SBA guarantee on February 2, 1977. Proceeds were to be used as follows: \$17,800 for leasehold improvements, \$7,600 to purchase machinery and equipment, \$14,600 to repay the participating bank loan (exposure increased to \$25,000) and \$10,000 for working capital. At the request of the bank, SBA increased its participation on February 23, 1977, to 75 percent, thus reducing the bank's net exposure as follows:

Exposure before loan	\$14,600
Exposure after loan (25 percent of \$50,000)	<u>12,500</u>
Reduction in exposure	\$ <u>2,100</u>

The loan officer's only comment was that SBA's increased participation would only cause a "small reduction" in the bank's exposure which was offset by the fact that it held a first lien on all collateral. In disbursing the loan proceeds, the participating bank did not follow the loan authorization. The March 15, 1977, statement indicating the use of loan proceeds showed that the bank paid itself \$18,267 (rather than \$14,600 per the loan agreement) to liquidate four notes owed by the borrower. Therefore, its exposure was reduced by \$5,767 instead of \$2,100.

The loan became delinquent in June 1977 after the borrower made two payments and was placed in liquidation in August 1977. The loan was charged off in March 1978, with an unpaid balance of \$47,481, of which 75 percent, or \$35,611, represented SBA funds.

In the case in which we believe a bank bailout occurred, SBA approved a \$225,000 loan with an 80-percent guarantee on June 10, 1977. Proceeds were to be used as follows: \$125,000 to repay the participating bank, \$78,800 for creditors, and \$21,200 for working capital. The bank's exposure was reduced by \$80,000 as follows:

Exposure before loan	\$125,000
Exposure after loan (20 percent of \$225,000)	<u>45,000</u>
Reduction in exposure	\$ <u>80,000</u>

The loan officer stated in his report that SBA would be reducing the bank's exposure. The justification was that the bank would be giving up the first position on collateral and that the bank had a problem with the legal lending limits. The fact that the "bank needs some relief" was cited as important to SBA. The loan officer added that the bank was new with SBA, and "its customers need help." The loan became delinquent on February 28, 1978, and was placed in liquidation July 14, 1978.

Our analysis of the borrower's financial position and the loan officer's report showed that the borrower's bank and creditors were in a position to sustain a loss. The loan officer's report indicated that the financial condition was weak but not critical. The weakest area was the debt to net

worth ratio. He said that with the favorable terms, the borrower's debt should be under control.

We believe that the loan was actually a bank bailout, but SBA district officials contend that as the bank neared its legal lending limit it could have recalled the loan. SBA officials added that they were attempting to keep the business from "going under."

#### Debt repayment to other creditors

We noted that 31 loans were used to pay off borrowers' debts owed to creditors, nonparticipating banks, or both. For 19 of the 31 loans, 50 percent or more of the loan was used to pay existing debts. Consequently, the loan officers were required to fully explain the circumstances which resulted in the debt accumulation, why the applicant could not or did not pay the prior loan as agreed, and how the new loan would improve the applicant's earnings and financial condition. Only in eight cases did we note that the loan officer's report met this requirement.

We believe that creditor bailouts occurred in 5 of the 19 cases. SBA recognizes a bailout to be paying off creditors in a position to sustain a loss because of weak collateral, insolvency, or weak financial condition. For example, in one case SBA approved a 90-percent guaranteed loan to an electronics manufacturer on February 15, 1977. The loan, for \$224,950, refinanced a prior SBA loan for \$89,232, paid \$88,762 in trade payables, purchased machinery and equipment for \$13,654, and provided \$33,302 in working capital. The loan specialist listed collateral at \$743,700, with prior liens of \$300,000. The collateral was not, however, appraised and consisted of \$356,100 in inventory, \$321,500 in accounts receivable and \$66,100 in machinery and equipment at book value. The prior liens of \$300,000 were on the accounts receivable.

According to a district servicing official, collateral that consists of nonfixed assets, such as inventory and accounts receivable, generally is liquidated by the borrower when a business gets into trouble. In addition, the book value of machinery and equipment may be an overstatement of its true market value. It is our opinion, therefore, that this loan was inadequately secured and transferred potential loss from creditors to SBA in the amount of \$88,762 in trade payables, less any recoverable collateral value.

### Refinancing SBA loans

According to SBA procedures, an additional or refunding loan shall not be made if the primary purpose is to protect an existing SBA loan and the new loan is subject to the same credit standards as the original loan. Refinancing a prior SBA loan is otherwise acceptable.

Ten of the loans we reviewed refinanced prior SBA loans. Two loans were approved to businesses in financial trouble where repayment of the existing loans was questionable. The approvals were apparently an attempt by the district offices to protect an existing loan.

One of these two loans was a 90-percent guaranteed loan for \$35,000 that was approved to an auto service center on February 11, 1977. District officials approved the loan despite the loan specialist's recommendation to decline it. Proceeds were to repay an existing SBA loan in the amount of \$19,516 and for operating expenses.

The loan specialist's report described the business as insolvent. He stated that the applicant has been unable to successfully operate the business and there were no indications that the poor performance record could be overcome. The business showed a net loss of \$5,161 in the 18-month period ended December 31, 1976, on sales of \$149,175. The loan specialist also stated that repayment of the new loan appeared doubtful. SBA procedures state that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan-making process.

There was no written justification for overriding the loan specialist. Officials said that their reasons for approval were in a memorandum which could not be located. They could not recall their reasons at the time of our review.

The borrower defaulted on the loan payments in January 1978, 9 months after the loan was disbursed. He ceased operations and never made another payment. SBA placed the loan in liquidation in May 1978. The loan, with an outstanding balance of \$34,617 was charged off in July 1978. Liquidation of collateral by private sale netted \$411. The collateral was valued at \$13,862 at the time the loan was approved.

### Loans made to borrowers who could apparently secure financing without SBA guarantee

SBA procedures require loan specialists to review personal financial statements of proprietors, partners, officers,

and stockholders with 20 percent or more ownership, for assets which could be used to raise funds in lieu of part or all of an SBA loan. The applicants for 31 of the 80 loans sampled appeared to have personal assets substantial enough to use or pledge as collateral for securing a loan on the open market. In 18 cases, the loan officer did not comment on whether funds were available from other sources as required by SBA procedures.

For example, SBA approved a \$100,000, 90-percent guaranteed loan to a manufacturer of machine parts on February 15, 1977. Our analysis of the two partners' personal financial statements showed total net worth of \$416,517, of which \$61,917 was in cash, life insurance surrender value, stocks and bonds, and accounts receivable. The loan specialist's report did not discuss the availability of funds from other sources. We believe personal assets were substantial enough to use, at least in part, to secure private financing.

A district official said the loan specialist considers borrowers' future cash needs when analyzing personal financial statements. Even though small business principals may have large personal net worth, the loan specialist may not believe the use of personal assets is justified. Unfortunately, this is not always documented in the file.

SBA officials informed us that a new policy statement was issued May 21, 1979, regarding the use of business assets and outside personal resources of applicants for loan guarantees. The policy statement states that cash, other investments, and other liquid assets of the principals in the business should be considered when they exceed 75 percent of the SBA guarantee requested. Neither family occupied residences nor cash surrender value of life insurance will be considered as personal assets available for business purposes.

With the implementation of this new policy, SBA will rely on the participating bank's judgment to ensure the maximum use of business assets and outside personal resources. They will be required to state in writing that

"\* \* \* other available assets of the applicant which are not to be used for the purpose of the loan are otherwise necessary for the business' healthy growth. Other assets of the appropriate principals could not be used for the purpose of the loan without causing undue personal hardship to the principals of the business."

No changes were made in SBA's policy as it relates to direct loans.

INADEQUATE ANALYSIS RESULTS  
IN SOME QUESTIONABLE LOANS

In our prior audit we showed that inadequate analysis of borrowers' financial condition and evaluation of collateral resulted in questionable loans, where it was doubtful that the loans were of sound value or so secured as to reasonably assure repayment. We recommended that the Administrator, SBA, emphasize the need for loan specialists to fully analyze the information provided by borrowers and document their justification for recommending loan approval. We also recommended that the Administrator direct district officials to use other data and techniques, including analyzing cash flow, evaluating projected earnings, and making site visits before loan approval. Additionally, we recommended that consideration be given to expanding the SBA appraisal function and that realistic appraisals of collateral be made where collateral is a critical factor in approving a loan.

Our followup showed that, in many cases, loan specialists continue to improperly perform loan analysis. Loan specialists did not fully utilize the other data and techniques we recommended and collateral was often not appraised for value or existence.

Applicants' financial condition  
not adequately analyzed or documented

According to SBA procedures, loan specialists are responsible for a complete professional review and accurate analysis of the loan application and supporting documents. In addition, the loan officer's report should be sufficiently comprehensive and accurate that a reviewing official could make a sound recommendation or take final action without referring to the supporting documents.

In 80 sampled loans, loan specialists often did not perform what we consider adequate analysis.

- Although SBA procedures state that the ability to repay a loan from the cash flow of the business is the most important consideration in loanmaking, we believe 64 loans had an inadequate cash flow analysis.
- Loan specialists accepted applicants' projected income figures at face value for 69 loans. SBA procedures state that blind acceptance of an applicant's representations should not be considered an adequate analysis.



- Loan specialists developed current and debt to net worth ratios in most cases, but except for 18 loans, failed to make comparisons to industry averages as SBA procedures recommend.
- In 31 cases, personal net worth was apparently substantial enough to secure private financing for all or part of the loan. Loan specialists did not, in our opinion, adequately evaluate personal assets.
- Often the loan specialist did not have enough prior year balance sheets and profit and loss statements to perform the best analysis of the applicant business. Procedures state that normally the past 3 full years will suffice. We found 30 cases in which less than 3 years of financial statements, or less than should have been available for a newer firm under 3 years old, were available to the loan specialist.

One example of a loan for which we believe the applicant's financial condition was not adequately analyzed or documented was a 90-percent guaranteed loan for \$45,000 which was approved to a new restaurant on February 28, 1977. In reviewing the application, the loan specialist apparently had the borrower's 1-year sales projection, which he mentions in his report but which was not in the file. Although the loan specialist stated in his report that the projection was high, he did not attempt to develop a realistic projection of earnings, as procedures state he should. Instead, he stated that the debt could be paid even if the sales figure was reduced.

There was no balance sheet on file for the firm. Nevertheless, the loan specialist developed current and debt to net worth ratios from figures apparently received from the borrower in undocumented form. He did not, however, make comparisons to industry averages because he said it would not be appropriate for a new business.

We believe this loan was also inadequately analyzed in other respects. No letter of decline from a bank was on file, as procedures require, stating the date, amount, and reasons why a bank would not provide financing without SBA, and the loan specialist did not make a site visit, as required for a new business.

The loan became delinquent and was placed in liquidation in May 1978. After a foreclosure sale of assets and the borrower's settlement, the balance of \$20,139 was charged off in August 1978.

Collateral not appraised  
for value or existence

Under SBA procedures, a loan will not be declined if the only unfavorable factor is inadequate collateral; procedures do require that collateral securing each loan be carefully evaluated. In the prior report, SBA stated that because of staff shortages in the appraisal services area and the demand for these services in servicing/liquidation work it had to continue to rely on bank capability for appraising collateral prior to loan approval and to hiring fee appraisers when necessary. Our followup showed that collateral was not appraised for 49 of the 80 sampled loans.

SBA officials advised us that when a loan is small and collateral is of minor importance, valuation of the collateral by the loan officer is acceptable. Conversely, when the loan is large and collateral is an important factor in the loan approval, then an appraisal should be obtained. Whether to obtain an appraisal is a matter of judgment based on the facts and circumstances of the case.

For the 49 loans where collateral was not appraised, the loan officer in most cases discussed its adequacy; but did not comment on whether the collateral was an important factor in the loan approval decision. There were 15 of these loans that ranged from \$110,000 to \$500,000 in value. In three cases the loan officers reported that the collateral was inadequate to secure the loan; they did not state whether the collateral was an important factor in the loan decision.

Because most of the 80 loans reviewed are still relatively new, we do not know how often collateral may have been overstated. In our prior audit, however, we found numerous examples of problems that can occur when collateral is not properly appraised. This includes accepting obsolete and inoperative equipment as collateral and overstating accounts receivable. These same problems were noted in our followup.

Four of the loans in the sample were charged off at the time of our review. In all four cases, the collateral value was less at foreclosure than at loan approval. SBA netted \$411 on collateral valued at \$13,862 for one loan; \$7,800 for collateral valued at \$10,000 for the second; \$3,600 for collateral valued at \$483,300 for the third; and \$2,000 for collateral valued at \$65,600 for the fourth. Overall, SBA realized less than 3 percent of the collateral's stated value.

## SBA LOAN SERVICING INADEQUATE

SBA defines servicing assistance as recognizing that a problem or potential problem exists, identifying the problem's underlying cause, and determining the appropriate solution. The loan servicing function begins at the time of initial disbursement. Servicing personnel are expected to become familiar with loans by reviewing documents on file and visiting borrowers.

In our prior audit we found SBA's servicing limited and categorized its problems as follows:

- Failure to verify that loan proceeds were used for authorized purposes.
- Inadequate procedures for detecting delinquent loans and the reason for delinquency.
- No knowledge of the borrower's problems and progress.

We said these problems resulted from understaffed Portfolio Management Divisions, which hindered SBA's ability to service loans, and an inappropriate reliance on participating banks to help borrowers overcome business problems.

We recommended that the Administrator, SBA:

- Enforce SBA's requirements for participating banks to submit, promptly after loan disbursement, settlement sheets showing in detail how loan proceeds were disbursed and for loan servicing personnel to resolve any major discrepancies.
- Determine the staffing level which would permit effective servicing, including initial field visits of the required scope to all borrowers and intensive followup on delinquent loans. Once this staffing need is determined, the Administrator should attempt to meet it through personnel realignments, changes in methods of operations to free personnel for servicing duties, or a proposal to the Congress for additional staff. If all other approaches fail, the only remaining alternative would be to limit the number of loans approved.

- Enforce SBA's requirement that participating banks submit written notice of borrower delinquency within 30 days. 1/
- Require borrowers to submit financial statements to SBA. SBA should consider the feasibility of a computerized analysis of these financial statements to enable a more extensive analysis of a borrower's progress.
- Require loan applicants to obtain the reasons why banks have refused to make loans to them.

In our 1976 report, SBA agreed that a major problem in providing effective loan servicing was the inadequate staffing. Although increased field staffing for Portfolio Management Divisions has been requested, the positions have not always been authorized, and even when authorized, have not been filled. The table below shows for the last 4 fiscal years, SBA's request to the Office of Management and Budget, the Office of Management and Budget's request to the Congress, the congressional authorization, and the number of employee positions filled at year end.

<u>Year</u>	<u>Positions requested</u>			<u>Positions filed</u>
	<u>SBA</u>	<u>Office of Management and Budget</u>	<u>Congressional authorization</u>	
1976	909	947	944	762
1977	1,026	1,047	985	866
1978	1,064	1,035	985	861
1979	1,224	995	995	<u>a/855</u>

a/As of April 30, 1979.

Our review of Portfolio Management Division staffing in the two regions included in our followup showed that from June 1975 to August 1978 the Boston region had a 14-percent increase in staff and the Atlanta region had a 42-percent increase. However, the total portfolio for each region increased by 84 percent during this same period.

Although staffing has increased, we believe loan servicing continues to be inadequate. The problems include failures

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1/This recommendation was dropped when SBA changed its procedures in October 1978 for detecting delinquent guaranteed loans.

to verify the use of proceeds, make site visits, obtain reasons why banks have refused to make loans, and analyze financial statements.

Failure to verify the  
use of proceeds

In our opinion, SBA did not adequately verify the use of proceeds or document its verification for 40 of the 80 loans.

When a loan is approved, the use of proceeds is specified in the loan authorization, a document notifying the borrower or participating bank of SBA's approval of the loan application. When the borrower signs an SBA loan agreement, he agrees to use proceeds in accordance with the authorization. The participating bank agrees to disburse loans in accordance with the authorization by entering into a loan guarantee agreement with SBA.

SBA has two ways to ensure that loan proceeds have been used for authorized purposes: (1) banks submit settlement sheets for SBA district counsel review showing how loan proceeds were disbursed and (2) the loan specialist checks use of loan proceeds during an initial field visit to the borrower.

Settlement sheets were not available for three loans. SBA cannot verify the use of proceeds without a settlement sheet. For the loans where settlement sheets were on file, SBA did not review or document its review of the use of proceeds in 40 cases. In addition, initial field visits were not made for 46 of the 80 loans. Field visits are one way of verifying purchases.

Failure to verify the use of loan proceeds can result in an inappropriate or potentially inappropriate use of funds. For example, SBA approved a \$50,000 direct loan to an electronics parts dealer on December 20, 1976. The loan was made to purchase inventory. Because it was a direct loan, SBA closed the loan and was totally responsible for assuring proper use of proceeds.

SBA prepared a settlement sheet showing disbursement of funds. According to the sheet, three checks were prepared to disburse the funds. Two checks were jointly made out to the borrower and supplier. The third, however, in the amount of \$28,899, was made out to the borrower. This reduces SBA's control of the funds.

An SBA management assistance officer made an initial field visit in June 1977 and two subsequent visits in August and December. According to the field visit reports, the borrower was uncooperative in furnishing information. In the December report, the management assistance officer said he could not determine whether loan proceeds were properly used.

Finally, in January 1978 a loan specialist visited the borrower who by then had gone out of business. He had been delinquent in payments since August 1977. The loan, with an outstanding balance of \$47,009, was placed in liquidation within two weeks of the visit. SBA planned to make a demand on the borrower and guarantors but placed no bid on the property because prior liens had depleted the equity.

The SBA attorney who closed the loan said he reviewed invoices totaling about \$40,000. He said these invoices were the basis for the \$28,899 disbursed to the borrower. He provided a letter from the borrower's attorney stating the same. Nevertheless, there were no documents on file to substantiate his comments.

Borrowers' problems and progress  
not known to SBA

We found that, for 53 out of 80 loans, SBA failed to require participating banks to disclose their reasons for declining loans without an SBA guarantee; for 46 loans, it did not make initial field visits to borrowers; and for 60 loans, it did not obtain borrowers' financial statements. These problems are similar to the ones discussed in our prior report.

SBA district officials continue to consider an application for a guaranteed loan as evidence that a bank would not make a direct loan. As a result, letters of decline do not concern them.

Officials in one district office told us they do not make required initial field visits because of excessive workload. The average caseload for each loan specialist in the four districts, as of October 31, 1978, was as follows:

	<u>7(a) loans</u>	<u>Total loans</u>
Boston	177	687
Hartford	319	490
Atlanta	316	2,052
Birmingham	253	941

One district official told us that the new guarantee loan agreement which went into effect October 1, 1978, is supposed to reduce workload. He does not, however, believe the reduction will be significant.

Financial statements are required at intervals stated in the loan agreement. The servicing group knows when statements are required and, if they are not received, sends letters and makes telephone requests. SBA officials said, however, that they can do little else to assure receipt of statements. Officials believed the loan specialists were reviewing statements received, but probably were not documenting their reviews adequately.

MANAGEMENT ASSISTANCE--  
LIMITED IMPROVEMENT

In our prior audit we found that management assistance--designed to foster the establishment, growth, and success of small business--was limited and untimely. We found that few borrowers received management assistance and attributed this to (1) borrower reluctance to accept it, (2) failure to identify borrowers' need for assistance, (3) failure to provide management assistance to borrowers, (4) the absence of an effective system for determining whether additional assistance was needed, (5) a scarcity of management assistance resources, and (6) the use of inappropriate program goals.

Accordingly, we recommended that the Administrator, SBA:

- Improve coordination between the servicing or Portfolio Management, and Management Assistance divisions at the district offices.
- Evaluate the impact of management assistance to identify areas needing improvement and demonstrate to borrowers the value of the assistance.
- Establish a system for determining whether additional assistance is needed to carry out recommendations.
- Intensify efforts to determine a borrower's need for management assistance at the time of loan approval.

In our followup audit we found that some borrowers were not provided adequate management assistance. Specifically, management assistance was not provided to 40 loans in the sample and, in our opinion, management assistance was inadequate for 8 loans.

One example of what we believe is inadequate management assistance was a direct loan for \$76,000 that SBA approved for a firm dealing in heavy farm equipment on February 9, 1977. The loan was closed in March 1977 and the borrower, as of November 1978, had made only four payments on the loan. All payments since July 1977 have been deferred or delinquent.

A Service Corps of Retired Executives representative made five management assistance visits between May 1977 and March 1978, reviewing the firm's financial statements. Although the borrower had not made a payment in 1978, neither the representative nor other management assistance resources had contacted the borrower during 1978 to provide assistance other than reviewing financial statements. We believe the firm needed assistance in specific areas, such as sales, and that a plan should have been developed to make the firm more profitable. At a minimum, management assistance should have been provided until the borrower became profitable.

SBA has taken steps to identify which borrowers need management assistance. Since October 1978, the field offices have been required to prepare a Summary Management Rating Form for each borrower at the time of loan application. SBA believes the form will establish a systematic method of assessing managerial potential, identifying prospective borrowers who need management assistance, and expediting the referral of clients to the management assistance staff. Also, it expects that coordination between the Management Assistance and Financing Divisions will be improved.

SBA maintains statistics on the activity of the District Management Assistance Divisions. Figures are available showing contacts made or actions taken with small businesses, referrals to the Management Assistance Division, types of assistance provided, and the number of training sessions and attendees. We obtained some of the figures for fiscal year 1978 for the four districts we reviewed. These figures reflect management assistance for all SBA loan programs.



	<u>Boston</u>	<u>Hartford</u>	<u>Atlanta</u>	<u>Birmingham</u>
Referrals to Management Assistance Division:				
Financing Division	239	281	63	273
Portfolio Management Division	349	144	119	250
Other	<u>3,734</u>	<u>1,791</u>	<u>1,982</u>	<u>810</u>
Total	<u>4,322</u>	<u>2,216</u>	<u>2,164</u>	<u>1,333</u>
Actions:				
Borrowers	3,065	1,920	1,038	1,609
Nonborrowers	<u>8,923</u>	<u>2,261</u>	<u>4,386</u>	<u>2,378</u>
Total	<u>11,988</u>	<u>4,181</u>	<u>5,424</u>	<u>3,987</u>

SBA has not measured the effectiveness of management assistance. They informed us of a headquarters study which is attempting to evaluate management assistance effectiveness by tracking the progress of a group of management assistance clients for a number of years and comparing their progress with that of firms which would not accept management assistance. Headquarters officials told us the study should be completed in September 1979.

#### CONCLUSIONS

SBA continues to approve 7(a) loans without following the procedures established to assure that quality loans are approved. Specifically:

- Loans have been approved which transfer risk from creditors to SBA.
- SBA has approved loans in an attempt to protect prior SBA loans.
- SBA does not require borrowers with substantial assets to privately raise at least part of the funds.
- Questionable loans have been approved due to inadequate analysis of the borrower's financial condition. Improved cash flow analysis in determining repayment ability, evaluation of projected earnings, preloan site visits, and appraisal of collateral are needed.

After approval, servicing continues to be inadequate. SBA has often failed to verify the use of loan proceeds and has not kept informed of borrowers' problems and progress.

Further, management assistance is not always sufficient to meet borrowers' needs, although it appears that more assistance is available now than previously.

## CHAPTER 4

### SBA'S MONITORING OF THE LDC

#### PROGRAM STILL NEEDS IMPROVEMENT

While we did not find LDCs set up for improper purposes as previously reported, 1/ our followup review of 28 loans in three district offices showed that SBA's monitoring of LDCs is still insufficient. In addition, SBA has not set up a system to accurately measure program accomplishments, or established criteria for relating dollars invested to jobs created. SBA is also still making loans where assistance may be available from other sources.

Since our prior report was issued, SBA revised its rules and regulations to eliminate the requirement that the principals of small business concerns being financed use their personal resources prior to receiving assistance. Since SBA acts as a lender of last resort for its other assistance programs, we believe that this change should be reviewed by the legislative committees for compliance with the intent of the authorizing legislation.

#### SBA'S MONITORING OF LDCS REMAINS INADEQUATE

Our prior report pointed out that SBA had set certain eligibility requirements for screening out LDCs which did not have community development in mind, but that when applying for funds, SBA had not exercised strong supervisory control over the program. Often LDCs were facades which allowed a small business to obtain the longer term, lower interest rates available under the program.

SBA has not established a formal and completely documented system for monitoring LDC entry into the program, as recommended in our prior report. Although our followup audit did not uncover any additional instances of LDCs being used as facades for small business concerns, we believe SBA's monitoring system is inadequate to ensure that this is not happening.

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1/ "The Small Business Administration's Local Development Company Loans Are Making Capital Available--But Other Aims Are Often Subverted" (GGD-76-7, Mar. 31, 1976).

LDCs not always meeting  
eligibility requirements

SBA has set certain eligibility requirements for LDCs applying for program assistance. An LDC must have a minimum of 25 members, of whom 75 percent do business or live in the LDC's area; LDC board of director members cannot be principals in the small business assisted; and a small business principal cannot own more than 25 percent of the sponsoring LDC's stock.

According to agency officials, an LDC's entry in the program is monitored by conducting a legal review of the charter, bylaws, size, and makeup to determine if the LDC is a legal entity and its operations are consistent with SBA rules and regulations. An official in one region said that monitoring also includes a visit to the LDC before the loan is recommended for approval or decline; however, this official stated that documentation on these visits was not available.

We reviewed 28 loans in three district offices and found that LDC eligibility is only determined when the LDC applies for the program and is monitored by letters of change in LDC membership, required with each loan application. Letters of change are, however, insufficient by themselves to assure adherence to eligibility requirements. We did not find evidence that SBA had reviewed revised membership lists for compliance with applicable eligibility requirements. In fact, an official in the Hartford district stated that, for new loans, they do not review LDC records to ensure that the small business principals are not on the LDC's board of directors or own more than 25 percent of the LDC stock. Therefore, the influence that a small business owner might have on his sponsoring LDC is not known. The field staff relied on the fact that borrowers are warned at preliminary meetings of what constitutes improper business relationships.

Records submitted by some LDCs are so incomplete that it is doubtful the LDC's eligibility could have been properly determined.

--A Massachusetts LDC had been declared eligible to participate in 12 previous loans. However, SBA records of this LDC do not contain the addresses of its members. Therefore, the eligibility criteria that requires 75 percent of the voting control be held by members living in the LDC area could not have been verified from existing records.

- In July 1977, SBA approved a loan for \$808,000, of which SBA's participation amounted to \$242,000. In the loan officer's opinion, the LDC was eligible to participate in the program. However, SBA's minimum membership requirement could not have been verified since records of the LDC members, their addresses, and stock ownership were not on file.
- One LDC file did not contain a membership list, though SBA determined it eligible to sponsor a loan totaling \$170,000.

PROGRAM ACCOMPLISHMENTS  
ARE NOT MEASURED

Our prior report discussed the fact that SBA did not have a system to assess the LDC program's overall accomplishments. SBA had been citing the number of jobs that were anticipated to be created as a measure of the program's success. We found, however, that SBA overstated accomplishments because the number of jobs anticipated were often greater than the number actually created.

SBA has still not set up a system to measure the actual number of jobs created, as recommended in our prior report. Instead, SBA continues to cite estimated jobs as program accomplishments. Although we did not, in our followup, verify actual jobs created, we believe because of the results of our prior audit that in some cases the estimates continue to be overstated. According to SBA officials, they have no way to determine whether the applicant achieves the number of jobs proposed in the application. Of the 28 loans examined, the applicants indicated that a total of 524 new jobs would be created--ranging from a minimum of 1 to a maximum of 106.

We also found in our prior audit that SBA did not have criteria for relating dollars invested to jobs created. Developing investment-per-job criteria would, in our opinion, help achieve maximum economic development with limited resources.

SBA continues to operate without investment-per-job criteria as recommended in our prior report. The estimated cost of creating a job in the loans we reviewed ranged from \$800 to \$68,250, with an overall average of \$6,992.

INADEQUATE ASSESSMENT OF APPLICANTS'  
NEED FOR ASSISTANCE

In our prior report we concluded that Federal funds provided under section 502 should provide equity capital and long-term loans not otherwise available for small businesses. SBA had not, however, taken adequate steps, as recommended in our prior report to ensure that the funds requested were not available from other sources. Bank credit refusals often were not obtained or were not acceptable because they lacked required information. In addition, LDC loans were made to small businesses whose principals probably could have provided all or part of the amount from other sources. Making such loans reduced SBA's ability to make loans to fully qualified businesses.

Nine of the 19 loans reviewed in the Boston and Hartford district offices did not have an appropriate bank credit refusal. For six of the loans, the small business principals' net worth was sufficient, in our opinion, to raise a significant part of SBA's share from other sources. All nine of the loans reviewed in the Atlanta district office had letters of decline from banks. However, for five of the nine loans, we believe the principals of the small business concern had net worth sufficient to contribute all or part of the loan.

Although SBA initially agreed with our original findings, it revised its rules and regulations in March 1977 to eliminate the requirement that the principals of the business concern being financed use their available personal resources prior to receiving assistance. SBA officials advised us that the program is now being used as a development tool to encourage new industry to come in a community or to assist existing ones to expand and remain competitive. When seeking a new industry in competition with other communities, the principals of that business cannot be asked to liquidate all possible assets to put into a plant. For these reasons, SBA's policy in using personal assets was changed.

For 11 of the 28 loans reviewed, it appears that the small business principals could have contributed toward the loan. Also, SBA loan files did not always contain personal financial statements from small business principals.

An example of inadequate assessment of an applicant's need for assistance was a first mortgage loan of \$200,000 at 6-5/8 percent interest SBA approved in March 1977. It was made for the purpose of expanding a furniture store operation

from distribution only to manufacturing and distribution. The total project cost was \$500,000, the balance of which was provided by the LDC and the participating bank. The business was owned by a father and son whose combined net worth was \$1.8 million, including \$197,138 in cash and savings accounts and \$192,722 in stocks and bonds.

Although there appears to be no legal prohibition against SBA providing funds to LDCs for financing small business concerns whose principals have substantial personal resources, the question remains whether this was the intent of the Congress when the program was established. Since neither the language of the act nor its legislative history requires a rigid use of personal resources, we believe the matter should be addressed by the Congress since many of the recipient firms have principals with substantial personal resources. Thus, in this program SBA is not a lender of last resort as is the case in other SBA loan programs.

#### CONCLUSIONS

SBA has not implemented various controls and other measures we believe the LDC program needs to function properly. Specifically:

- SBA did not establish a monitoring system to ensure that eligibility requirements are being met.
- SBA still does not have systems to evaluate program accomplishments and to relate dollars invested to jobs created.
- Small business owners are not required to use available personal resources prior to receiving assistance.

#### RECOMMENDATIONS TO THE SENATE SELECT COMMITTEE ON SMALL BUSINESS AND HOUSE COMMITTEE ON SMALL BUSINESS

In future oversight hearings on the section 502 LDC program, the committees should review SBA's March 1977 policy change which eliminated the requirement that owners of small businesses who have sufficient personal resources fund at least part of the loan. With this change, SBA is not a lender of last resort, as is the case in other SBA loan programs.

## CHAPTER 5

### INVESTMENT PATTERNS IN THE 301(d) INVESTMENT

#### COMPANY PROGRAM HAVE NOT CHANGED

SBA made some changes based on our prior review of the 301(d) investment company program. <sup>1/</sup> Our followup review of nine investment companies, however, showed that the same problems still exist.

- Investment companies continue to prefer debt rather than equity investments.
- Investment companies continue to exert control over the small businesses they finance through agreements for management services and the repurchase of equity investments.
- Investment companies still do not document decisions regarding the applicant's social or economic disadvantage and his inability to compete successfully in the business world.
- Revised reporting requirements for investment companies have not provided SBA with adequate management information.

#### INVESTMENT POLICIES REMAIN UNCHANGED

Investment policies of 301(d) investment companies have not changed since our prior review. The investment companies continue to invest most of their funds in debt rather than risky equity investments.

Our prior report noted that during 1974, only 10 percent of the amount invested by all 301(d) investment companies was for equity investments. In commenting on our prior report, SBA stated that while equity investments were fewer than desired, it thought the trend could be to more equity and equity-type investments.

We compared the investments made by all investment companies in 1974 with those made in 1978 to see if there had been a change to more equity and equity-type investments. As can be seen in the following table, this has not occurred.

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<sup>1/</sup>"A Look At How the Small Business Investment Company Program For Assisting Disadvantaged Businessmen Is Working" (GGD-75-76, Oct. 8, 1975).



<u>Type</u>	<u>1974</u>			<u>1978</u>		
	<u>Number</u>	<u>Amount</u>	<u>Percent</u>	<u>Number</u>	<u>Amount</u>	<u>Percent</u>
	(millions)			(millions)		
Loans	265	\$ 5.9	47	324	\$17.0	53
Debt Securities	79	5.3	43	117	13.5	42
Equity	<u>46</u>	<u>1.2</u>	<u>10</u>	<u>22</u>	<u>1.5</u>	<u>5</u>
Total	<u>390</u>	<u>\$12.4</u>	<u>100</u>	<u>463</u>	<u>\$32.0</u>	<u>100</u>

We also reviewed the investment activities of nine investment companies to determine what changes, if any, had taken place in their investment policy. These companies had been licensed by SBA for at least 3 and up to 8 years. The available data showed that equity investments accounted for only 8 percent of the total amount invested and 14 percent of the number of investments made whereas debt accounted for 65 percent of dollars invested and 73 percent of the number of investments. The table below shows by year, the number and dollar amount of the investments made by the nine companies as reported on the individual forms submitted to SBA giving details on each investment made.

<u>Year</u>	<u>Loans</u>		<u>Debt securities</u>		<u>Equity</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
	(thousands)		(thousands)		(thousands)	
1972	2	\$ 16	-	\$ -	-	\$ -
1973	19	509	10	296	6	87
1974	28	814	6	225	10	183
1975	27	586	4	141	12	225
1976	30	681	5	210	5	18
1977	59	1,506	4	317	4	12
1978	<u>35</u>	<u>290</u>	<u>7</u>	<u>620</u>	<u>1</u>	<u>1</u>
Total	<u>200</u>	<u>\$4,402</u>	<u>36</u>	<u>\$1,809</u>	<u>38</u>	<u>\$526</u>

Note: Because the investment companies failed to submit some of the required reports detailing each investment it made, this schedule only includes the data available at SBA headquarters and not necessarily all investments made.

Although equity investments reached a high of 24 percent of amount invested in 1975, the percentage of equity

investments fell to 2 percent or less in subsequent years. Officials of one company, which accounted for 45 percent of the equity investments in 1975, informed us that while it had tried to emphasize equity investments in earlier years, future investments would emphasize debt in order to gain operating income.

SBA advised us that our analysis should show which loans are subordinated debt and should classify them as equity investments. Its position is based on Public Law 95-507, enacted October 24, 1978, which defines equity securities to include subordinated debts for purposes of the investment companies qualifying for additional funding from SBA. Because SBA records do not specify which debt investments are subordinated, we could not evaluate the debt investments in our sample for this feature. Besides our sample is intended to show the types of investments as reported by the investment companies and any change in their investment policy. As indicated on the previous page, there has been no increase in the number and amount of equity investments.

We also reviewed the current investments reported by the nine investment companies in their latest annual reports, which are submitted to SBA at the end of the investment companies' fiscal year. These reports showed that the investment companies had 168 investments totaling over \$4.8 million. Twenty-six of these, totaling \$396,000, were equity investments. Although equity investments accounted for 15 percent of the number of investments, they represented only 8 percent of the funds invested.

Only Company F had a majority of equity investments, representing 84 percent of the funds invested and 62 percent of the number of investments. A breakdown of the type and number of investments by each of the nine investment companies follows.

<u>Company</u>	<u>Loans</u>		<u>Debt Securities</u>		<u>Equity</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
	(thousands)		(thousands)		(thousands)	
A	7	\$ 407	-	\$ -	8	\$ 40
B	13	592	-	-	2	22
C	58	1,495	9	606	2	34
D	5	130	-	-	2	70
E	5	69	8	218	3	-
F	2	10	1	25	5	182
G	4	120	3	158	1	10
H	2	49	8	420	2	13
I	<u>14</u>	<u>67</u>	<u>3</u>	<u>89</u>	<u>1</u>	<u>25</u>
Total	<u>110</u>	<u>\$2,939</u>	<u>32</u>	<u>\$1,516</u>	<u>26</u>	<u>\$396</u>

Company A--which has been in the program since 1974--had a majority of equity investments; however, the amount of equity investments represented only 9 percent of the total amount invested. Six of its eight equity investments were in firms with which it also had debt investments. The investments in these six concerns represents 78 percent of the total amount invested by Company A, of which only 7 percent represent equity investments.

Company E--which has been in the program since 1971--had three equity investments, representing 19 percent of total number of investments; however, the amount invested in equity totaled only \$250, representing less than 1 percent of total amount invested.

Investment company officials we interviewed said loans were a necessary part of each deal. The loan agreement provides a way to restrict small businesses, which the company believes is necessary to keep the firms profitable. These include restrictions on management changes, borrowings, sale of assets, stock issues, and working capital. Loans also provide interest income, which is necessary to keep some investment companies viable.

#### INVESTMENT COMPANY ARRANGEMENTS WITH SOME FIRMS NEED FURTHER IMPROVEMENT

Our prior report disclosed that investment companies exerted control over some of the small businesses through agreements for management services and the repurchase of equity investments. Although SBA made some improvements in these arrangements, problems still remain. Two of the

nine 301(d) investment companies reviewed reported that they provided management services to the small businesses they financed. They also entered into agreements with some small businesses for repurchasing their equity interest. We criticized these arrangements in our prior report because they appeared to be one-sided. For example, our earlier review of management services showed that the fees charged for such services ranged from zero to as high as 27 percent of profits before taxes. The terms of some of the repurchase agreements we examined required that the small business pay as much as 34 times the original investment to purchase the investment company's equity interest. The report also noted that some investment companies exerted restrictive controls on some firms they financed.

Our earlier report recommended that the Administrator, SBA, establish policies and guidelines to assist 301(d) investment companies in assessing management fees to assure reasonable earnings for the companies but also to assure that the small businessman is required to pay only fees that are commensurate with the value of the management services rendered. SBA has not developed any guidance for the investment companies relative to management fees, other than to require written approval of all management agreements where the services provided are nonadvisory.

No written procedures exist for determining the extent of control and the reasonableness of fees for management services. SBA's rules and regulations state that fees "shall not exceed comparable charges by established professional non-Licensee consultants." An SBA official said they use a "rule of reason" based on reviews of other management agreements to determine "comparable charges."

An SBA official told us that management fees must be based on a time and charges basis, rather than a flat fee or a percentage of profits. SBA officials stated that if the investment company wants to receive a percentage of profits, it should make an equity investment in the small business, rather than try to collect it through a management fee.

Although investment companies are required to submit a copy of the management agreements to SBA when financing reports are filed, program officials usually do not become aware of such agreements unless they are brought to their attention during SBA's annual audits of the investment companies.

Investment companies are required to submit a form to SBA detailing each investment it makes in a small business. This form was revised in March 1976 to require the investment

company to include information on the existence of management and repurchase agreements and to require that a copy of such agreements be attached to the forms submitted.

We reviewed the 129 forms submitted since March 1976, by the nine investment companies to ascertain the number of management and repurchase agreements. Only 29 investments, however were reported on the revised form. We were told that the investment companies were not instructed to use the new form, consequently most continued to use the older form.

Nineteen of these 29 financings indicated that management services were being provided to the small business concerns by two of the nine investment companies reviewed. However, only one form indicated that the services were being provided under a contract. The contract was not attached to the form, as required. This was brought to the attention of an SBA official, who said he would request a copy from the investment company.

We also reviewed the latest annual reports for the nine investment companies and found that only three reported income from management services:

<u>Investment company</u>	<u>Management fee income</u>	<u>Total income</u>	<u>Percent</u>
A	\$15,811	\$52,797	29.9
B	5,000	85,281	5.9
C	290	16,183	1.8

The individual financing forms for these companies indicated that only Company B reported that management services were provided to a small business under a contract. However, this investment was made after the annual report was submitted to SBA. The other two investment companies had not used the revised form which required them to report management agreements.

One of the two companies which had not used the revised form had management agreements with five of the six firms it had investments in. The company (Company A) collects an SBA approved fee of 5 percent of gross sales. This company, in effect, manages the operations of the firms it invests in until they become successful and then the firms' minority owners take over the management. The president of the investment company said one of the main factors in achieving success is having the flexibility to hire on-site managers at reasonable rates and having the option of replacing them without contending with the restrictions imposed by owner-management. Once the firm is successful, the minority individual can take

over the operation's management, under adequate compensation and with reasonable assurance that personal benefits will expand.

Two of the three investment companies that provided management services also reported that they had repurchase agreements with six firms. None of the forms for these investments had a copy of the repurchase agreement attached. We brought this to the attention of an SBA official, and were subsequently provided copies of the agreements for three of the investments. This official indicated that he would request copies of the three missing agreements from the investment companies.

SBA provided us copies of their letters to the investment companies indicating approval of the three repurchase agreements located in their files. The remaining three repurchase agreements and the one management agreement could not be located in SBA files, so apparently they were neither received nor approved by SBA.

#### ELIGIBILITY DETERMINATIONS NOT DOCUMENTED

SBA guidelines regarding the eligibility of the small businesses for financing do not provide assurance that only eligible businesses will be provided assistance. We found that the 301(d) investment companies have not documented applicants' social or economic disadvantage and the connection between this disadvantage and the applicant's inability to compete successfully in the business world.

Our prior report recommended that the Administrator, SBA, develop guidelines that define specific factors 301(d) investment companies should consider in declaring persons eligible for program assistance. As a result, SBA issued in June 1978 policy guidelines for determining a disadvantaged small business:

"In determining whether small business concerns are socially or economically disadvantaged, reliance should not be placed upon a single factor, but on a composite of such factors as the social or economic background of the principal owners, controlling individuals and managers of the concern, along with the general pattern of their life, opportunities and education which have prevented them from obtaining financial or other assistance available to the average entrepreneur in the economic mainstream."

Our prior report also recommended that SBA require investment companies to document all decisions regarding eligibility, particularly the connection between a person's social or economic disadvantage and his inability to compete successfully in the business world.

In our opinion, the June 1978 policy does not provide assurance that assistance is provided only to eligible firms. In our review of four investments made in 1977 under prior eligibility guidelines, we found that eligibility had not been discussed. Company officials told us SBA annually reviews their records and never indicated dissatisfaction with the absence of documented eligibility statements. They, therefore, felt no need to specifically document an applicant's social or economic disadvantage.

Officials of two 301(d) investment companies we reviewed stated that minorities, by virtue of that fact alone, are disadvantaged. For example, an official at one of these companies circled the designation "Puerto Rican" on an application and told us that this constituted eligibility. An official in the other company stated that minorities are disadvantaged regardless of their net worth. Neither of these two companies had additional documentation regarding eligibility determinations.

#### CHANGES MADE IN MANAGEMENT INFORMATION SYSTEM INEFFECTIVE

Neither SBA's reporting system for monitoring 301(d) investment company activities nor SBA examination policies and practices provide adequate management information. This was brought to SBA's attention in our previous report, in which we recommended that the Administrator improve the management control over the program by requiring that 301(d) investment companies provide more meaningful management reports. Although SBA did modify the reporting requirements for 301(d) investment companies, the changes have not provided more adequate management information.

SBA requires 301(d) investment companies to submit a form each time they make an investment in a small business concern. The form includes information on the amount and purpose of the investment, the type of security or other instrument evidencing the transaction, interest rate, discounts, fees, commissions, and other information. This form was revised in March 1976 to require the investment company to also report the existence of management and repurchase agreements, and to attach copies of any agreements to the form.

As mentioned before, most of the financings reported since the form was revised have not been reported on the revised form, consequently, SBA has not been receiving meaningful management information.

Further, the nine investment companies had made 57 investments for which no forms were on file. These investments had been reported on the investment companies' latest annual reports, which we also reviewed. The 57 investments represented 34 percent of the companies' total investments listed in the latest annual reports.

### CONCLUSIONS

The investment policies of 301(d) investment companies have not changed since our prior review--the majority of these investments are still debt rather than equity.

Although SBA has taken some actions to implement the recommendations in our previous report, its guidance and control of 301(d) investment companies continues to be limited. As a result, the companies tend to favor debt rather than equity investments. In addition, eligibility statements are not being documented, which could mean that ineligible businesses are obtaining assistance. Lastly, despite revised reporting requirements, SBA's monitoring system and examination policies and practices are still not providing adequate management information.



## CHAPTER 6

### MANAGEMENT ASSISTANCE TO 8(a) FIRMS

#### STILL NEEDS IMPROVEMENT

Management assistance is still not being provided to all 8(a) firms that request it. Moreover, the assistance that has been provided has not always been timely. These deficiencies were also noted in our April 1975 report. 1/

When our prior report was issued, SBA was using the program to help socially or economically disadvantaged firms achieve a competitive position in the financial marketplace by entering into procurement contracts with Federal agencies and subcontracting the work to such firms. Public Law 95-507, enacted on October 24, 1978, substantially changed the program. The Congress revised the eligibility criteria so that 8(a) assistance would go to firms that are both socially and economically disadvantaged.

We found in our prior audit that SBA's success in helping disadvantaged firms become self-sufficient and competitive was minimal. We recommended that the Administrator, SBA:

- Reconsider SBA's position of maintaining 1,500 active firms in its 8(a) program and periodically adjust the number of firms depending on the level of contracts that can be made available for the 8(a) program.
- Establish a system to monitor a sponsor's compliance with the terms of the sponsorship arrangement as approved by SBA, especially management agreements establishing a sponsor's services and fees.
- Revise the Standard Operating Procedures to require that field offices consider all of the suggested factors in determining the need for 8(a) assistance and document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world.
- Establish adequate internal controls to ensure that 8(a) firms are provided management assistance.

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1/"Questionable Effectiveness Of The 8(a) Procurement Program" (GGD-75-57, Apr. 16 1975).

Although we did not look into the first three recommendations because of the recent changes in the program, we did examine SBA's efforts to provide management assistance to 8(a) firms.

#### MANAGEMENT ASSISTANCE

#### STILL NOT ADEQUATE

In our prior report we stated that 8(a) firms need timely managerial assistance because they have little practical experience in operating a business. We found that 52 percent of the firms we interviewed had not been provided management assistance; some firms had not received assistance even though they had requested it. SBA also had no system for evaluating the assistance it provided.

Our followup study showed that while SBA recognizes that 8(a) firms have an acute need for management assistance, it has no systematic method for assuring that all 8(a) firms that need assistance receive it. The 8(a) program personnel are responsible for assessing a firm's initial business plan for management assistance needs and to review periodic reports from the firm. If assistance is needed, the 8(a) program staff requests it from the Management Assistance Division which selects the appropriate resources to be used. Most assistance is provided through SBA's section 406 call contract program because of its ability to furnish specific, indepth assistance in such areas as accounting, engineering, and marketing.

We were informed in one region that management assistance is provided on a day-to-day crisis basis rather than on a planned, on-going basis. Factors cited as contributing to this approach were the 8(a) firm workload and the lack of business experience and education of 8(a) firms.

We reviewed 17 8(a) case files in the two regions we visited and found that nine of the firms received assistance from professional consultants under the call contract program. Management assistance was requested for two firms in the Boston region but no assistance was provided.

Our followup also showed that the assistance provided was not very timely. On the average it took 5 months in the Boston region between the time assistance was requested and the time the consultant issued a final report specifying what was necessary to improve the firm's operation. According to a regional official, a firm could be in serious trouble by the time the consultant's report reaches SBA and the 8(a) firm. SBA does not receive interim reports from the consultants.

In the Atlanta region it took an average of 3 months to receive the assistance.

The files reviewed did not indicate whether or not the assistance was adequate, or whether or not SBA followed up on the consultants' reports. We found one case in which the consultant recommended that SBA closely monitor the company's activities. SBA did not monitor the company and, 1 month after the report was issued, the firm was terminated from the program. The company subsequently went out of business.

An SBA official informed us that Public Law 95-507 also changed the way management assistance will be provided to 8(a) firms. The public law created the Minority Small Business and Capital Ownership Development Program to provide assistance, including management assistance, exclusively to 8(a) firms. We were told that SBA's business development specialists will also participate with the consultant in his exit interview with the 8(a) firm, thus monitoring the firm's compliance with the consultant's recommendations. The agency also plans to review the company's compliance with the consultant's recommendations during yearly reviews of the 8(a) firm's participation in the program.

#### CONCLUSIONS

SBA has not always provided management assistance to 8(a) firms as requested. Although management assistance has been provided more frequently than in the past in at least one of the two regions we visited, it remains untimely. In addition, SBA's needs to followup on management assistance recommendations from outside consultants.

## CHAPTER 7

### MANAGEMENT CONTROL FUNCTIONS

#### STILL NEED IMPROVEMENT

Insufficient steps have been taken to improve SBA's management control functions. Although SBA acted on some of our prior recommendations, our followup showed that (1) some employees are still not required to file statements of financial interests and (2) procedures have not been developed for reviewing statements of financial interests.

SBA disagreed with many of our recommendations for improving its audit, investigative, and review functions. Although it has made some organizational and procedural changes to improve these areas, we continue to believe that changes are needed in (1) internal audits of SBA's program activities and (2) qualitative appraisals of SBA's loan portfolio.

#### SOME EMPLOYEES STILL NOT REQUIRED TO FILE STATEMENTS OF FINANCIAL INTERESTS

Our previous report 1/ noted that many employees participating in decisions concerning SBA financial assistance were not required to file statements of employment and financial interests. The report recommended that the Administrator, SBA, revise the "Rules and Regulations" on standards of conduct by developing definitive criteria to determine which employees have responsibilities warranting the filing of financial disclosure statements.

SBA revised its rules and regulations in 1976 to require Statements of Employment and Financial Interests (SBA Form 703) from employees who are in positions of discretion involving the granting of SBA assistance. This change was made to comply with our recommendation. Previously, only employees above a specified grade level (generally GS-13) were required to file. However, the revised rules and regulations do not specify which employees are in such positions--that determination is left up to the regional directors for regional employees and various office heads for SBA headquarters employees.

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1/"Management Control Functions Of The Small Business Administration--Improvements Are Needed" (GGD-76-74, Aug. 23, 1976).

Each regional director is required to (1) determine which individuals in his region will be required to file, (2) notify these employees they must file, and (3) notify the regional standards of conduct counselor as to who is required to file.

SBA's Atlanta and Boston regions have widely different policies as to who is required to file an SBA Form 703. In Atlanta, all professional employees except the equal employment opportunity officer, public affairs officer, and personnel specialist are required to file--regardless of their grade level. In Boston, only those employees who take final action on SBA assistance are required to file.

The Atlanta region required 307 employees to file in 1978. This represented 43 percent of the 707 employees as of June 30, 1978. We reviewed the statements and confirmed that everyone required to file statements had done so. No administrative problems were noted. In the Boston region, only 57 employees, 24 percent of the total 234, were required to file in 1978. Only 6 of 22 loan specialists within the region's six district offices' financing divisions were required to file even though the regulations require employees to file if they make recommendations which are frequently accepted as final action.

In Boston, the Regional Director and the regional counselor decided which employees involved with SBA assistance decisions should file in 1978. Both were relatively new to SBA and neither was sure which employees, other than those specified in the regulations, should submit statements. Generally, those who took final action on assistance were required to file. After it was brought to the regional counselor's attention he agreed that in 1979, all loan specialists recommending loan approval would be required to file statements.

This change should make Boston consistent with the other SBA regions. We reviewed who is required to file statements for the other nine SBA regions and found that seven of the nine required loan specialists to file. The other two regions did not show the titles of the individuals required to file.

Although SBA's standards of conduct counselor in Washington believes that the rules and regulations are specific as to who should be required to file statements of financial interests, he said the problem in Boston can be attributed to inexperienced personnel. Further, he said that SBA will place greater emphasis on the duties and responsibilities of regional counselors in annual training seminars.

GUIDELINES FOR REVIEWING  
FINANCIAL STATEMENTS ARE VAGUE

Regional standards of conduct counselors are required to review the Form 703s. Each regional counselor is also required to file a report annually to SBA's Associate General Counsel for Interagency Affairs (SBA's standards of conduct counselor) on filing requirements and his region's compliance with the requirements.

SBA revised its rules and regulations subsequent to our prior report to stipulate (1) who the standards of conduct counselors are, (2) that the counselors should provide general advice, monitor programs, and review the statements submitted, and (3) that the counselors should report annually on the filing requirements and compliance with the regulations. This revision only partially complies with our recommendation that specific guidelines be issued clearly defining the duties and responsibilities of the standards of conduct counselors because the revision does not provide the counselors with definitive procedures for reviewing employees' financial statements--which was the reasoning behind GAO's recommendation. The need for such procedures is evident by a statement of a regional counselor who said he did not review the statements for stock ownership in bank holding companies because he did not know how to review for it.

SBA's standards of conduct counselor in Washington informed us that informal general guidelines have been issued to the regional standards of conduct counselors, and that additional guidance is provided to counselors during annual training seminars. These informal guidelines were being used by the agency at the time our report was issued. No additional guidelines or procedures have been issued since then.

Our earlier report also recommended that specific guidelines be issued defining the duties and responsibilities of the ad hoc committee which advises the Administrator in promulgating and administering standards-of-conduct rules and regulations. Subsequently, SBA revised its rules and regulations to (1) change the name of the committee to the Standards of Conduct Committee, (2) change the composition of the committee, and (3) include specific situations involving possible conflicts of interest in which employees should request approval from the Standards of Conduct Committee. The revised rules and regulations also contain specific criteria for the Committee in carrying out its duties and responsibilities.

OWNERSHIP OF STOCK IN BANKS AND BANK  
HOLDING COMPANIES STILL PERMITTED

Our earlier report recommended that all employees who make or substantially influence decisions on SBA assistance and employees responsible for setting agency policy be prohibited from owning stock in banks or bank holding companies. SBA amended its rules and regulations to generally prohibit the purchase of stock in banks that participate in granting financial assistance. However, the change still permits the ownership of stock in participating banks under certain conditions as long as approval is obtained from the Standards of Conduct Committee.

Rules concerning bank stock ownership changed in July 1976, after which no employee could purchase bank stock. Those employees already owning bank stock had to have their case reviewed by the Standards of Conduct Committee. Of the 307 employees filing a conflict of interest statement at June 30, 1978, in SBA's Atlanta region, 31 owned approved bank stock. Two employees in the region were required to divest stock and five others had outstanding requests with the Standards of Conduct Committee at the time of our review. In the Boston region, only two employees were found to own bank stock--one was permitted to keep his stock which consisted of a small number of shares in a large bank, and the other had his case pending with the Standards of Conduct Committee.

Although our recommendation was also directed toward the ownership of stock in bank holding companies, we noted that the rules and regulations formulated on owning stock in banks do not directly refer to owning stock in bank holding companies. SBA's standards of conduct counselor in Washington advised us that SBA interprets the rules and regulations to include bank holding companies.

FURTHER IMPROVEMENTS NEEDED IN  
AUDIT, INVESTIGATIVE, AND REVIEW  
FUNCTIONS

Our earlier report contained several recommendations for improving the audit, investigative, and review functions within SBA. However, SBA disagreed with many of our recommendations and the corrective actions that were taken were either ineffective or were not responsive to our recommendations.

SBA disagreed with our recommendations on (1) reviewing the qualifications of examiners in the Office of Portfolio Review, (2) meeting staffing needs of the internal and external audit divisions through realignment of staffs or

changes in methods of scheduling audits, (3) distributing internal audit reports to field operating officials, and (4) developing written procedures for better documentation and communication of data by the security and investigations division. Since SBA disagreed with these recommendations, we did not do any additional followup work on these recommendations.

Although SBA generally disagreed with our recommendations concerning the functions of the Office of Portfolio Review (OPR) and concerning followup reviews on internal audit reports, it has taken some actions. However, they have either been ineffective or not specific enough to fully correct the problem. For example, we recommended that SBA attempt to meet staffing needs in the internal and external audit divisions through position realignments, changes in methods of scheduling and setting priorities for reviews, or through a proposal to the Congress for additional staff. SBA attempted to increase the staffing level of the internal and external audit divisions in 1976, 1977, and 1978 through requests to the Congress, but no increases were granted. It did not attempt to increase staffing by the other methods we recommended.

SBA does not follow up on  
all internal audits

SBA agreed that followup of internal audit reports is critical, but from a practical standpoint this had to be the day-to-day responsibility of the operating officials. SBA informed us that regional directors would be instructed to review followup actions as part of their periodic reviews.

The internal audit division still does not require more timely followup on its audit reports. We were told that ideally a followup review should be performed about 6 months after a report is issued, but this does not occur because of higher priority jobs. The internal auditors rely on those to whom their recommendations are addressed to implement the recommendations. We were told that when a significant recommendation is made, the internal auditors do follow up to insure it is acted on. We believe that adequate followup on all audits is critical to the effectiveness of SBA's internal audit function.

OPR is still not performing qualitative  
appraisals of SBA's loan portfolio

Our earlier report also recommended that (1) the original mission of OPR--performing qualitative appraisals of SBA's loan assistance portfolio--be reinstated and (2) that OPR's



policies and procedures be revised and its scope of review be redefined. SBA's actions have not been responsive to those recommendations.

OPR's standard operating procedure was revised in February 1976 to redefine OPR's purpose and the scope of OPR's examinations. The changes were apparently made to bring the stated policy and procedures more in line with OPR's actual activities. Before its standard operating procedure was revised, OPR's basic purpose was to provide a qualitative appraisal of the financial assistance loan portfolio. The revised standard operating procedure states that portfolio reviews should be conducted to identify field implementation problems in the financial assistance loan programs and to specify appropriate corrective measures. The scope of OPR examination, as originally defined in the standard operating procedure, was to evaluate the quality of the agency's financial assistance. The revised scope section states that:

"Portfolio reviews are an evaluation of the (1) quality of the Agency's loan portfolio, (2) managerial and first-line supervision, (3) effectiveness of aging systems and workflow, (4) effect of loan/credit collection policies of field implementation, and (5) the effect policies and procedures of other divisions (Central Office and field) have on field implementation of Finance and Investment policies."

In responding to our earlier report, SBA stated that the standard operating procedure was changed to eliminate any confusion and to clarify OPR's purpose. SBA also stated that OPR had been accomplishing its purpose and was vital to management. OPR's primary objective, as stated in SBA's response to our earlier report, was to review loan making activity and portfolio management activities. However, these statements are not consistent with its statements at the time of OPR's inception. As our earlier report noted, SBA had stated that OPR reviews were to be conducted in much the same context as bank examiners in the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

A review of some OPR reports issued in 1977 and 1978 showed that the reports pay considerable attention to how district office staffs process and service loans. The reports mostly dealt with how the staffs follow established procedures. Although the reports contained a schedule summarizing the various types of loans reviewed and classified these loans as to problems with processing, servicing, and probable losses, there was no discussion on the individual loans or their collectibility, or on the collectibility of

the district office's total loan portfolio. This type of report differs drastically from previous OPR reports which included a discussion of the collectibility of each loan that had been adversely classified during the examination.

The redefined purpose and scope of OPR, while reflecting OPR's duties, does not address our original point--that OPR was not, and still is not, conducting qualitative appraisals of SBA's loan portfolio.

SBA continues to disagree with us on the mission of OPR. Agency officials informed us that the stated mission of OPR, contained in the standard operating procedures, was changed to conform with what the office was doing. This was done because SBA management wants OPR primarily to determine whether the applicable standard operating procedures and rules and regulations were being followed and to uncover program or administrative problem areas. SBA officials also stated that a qualitative appraisal of SBA's loan assistance portfolio will not serve the needs of management in carrying out its responsibility, and accordingly, the mission of OPR was changed.

We were told that recently OPR has been moved to the newly created Office of Field Management and has become the Field Management staff. SBA officials stated that although its location is different and its functions broadened, its mission as it relates to the loan portfolio remains the same.

OPR review committee established  
to insure recommendations are  
implemented

Our earlier report noted that OPR's policies and procedures for reporting findings and insuring that corrective action is taken should be reviewed. The changes in the reporting format involved eliminating the discussion of the loans adversely classified during the examination and presenting the findings on loan processing and servicing in more detail. The new reporting format also eliminated details on bank visits, which are no longer made.

Procedures have been established to insure that corrective action is taken. However, we question the effectiveness of those new procedures. In May 1976, SBA's Associate Administrator for Finance and Investment established an OPR Review Committee which

- receives replies from those who are responsible for taking action on recommendations,
- determines whether replies are responsive, and
- follows up on those which are not responsive and initiates appropriate action.

The staff accountant for Finance and Investment was appointed Chairman of the committee. Other members are various office directors who report to the Associate Administrator for Finance and Investment. The OPR Review Committee, however, lacks the necessary authority to insure that corrective actions are implemented. This is due to SBA's organizational structure, under which the regional offices report directly to the Administrator and not to the Office of Finance and Investment. Thus the office responsible for establishing program policy has no control over the offices responsible for implementing that policy.

The standard operating procedure covering OPR's duties requires that field offices' responses be circulated to the members of the OPR Review Committee. The Chairman of the Review Committee informed us that the committee does not hold regular meetings and that the only time it does meet is when there is a problem to be resolved. Committee members individually review each OPR report and the district office's response to what corrective action has been or will be taken. Corrective action needed at the headquarters level is taken care of by the committee member who has responsibility for that particular area.

We reviewed eight OPR reports to ascertain the committee's role. We were informed by the Chairman of the OPR Review Committee that the Committee did not have to take any action on these reports because corrective action had already been taken or was planned by the district office.

Our review of four district offices' responses to the OPR reports indicated that generally the district offices had apparently taken adequate corrective actions. In some cases, the district office stated that they could not take corrective action because of circumstances beyond their control, such as a lack of sufficient staffing or equipment.

### CONCLUSIONS

Although SBA has improved its standards of conduct regulations, resulting in improved management control, problems still exist. Some key employees in one of the two regions

visited were still not required to file statements of employment and financial interests. We continue to believe that additional guidance is needed for standards of conduct counselors in reviewing conflict of interest statements.

SBA disagreed with many of our previous recommendations for improving its audit, investigative, and review functions. Although it acted in some cases, the results were either ineffective or were not responsive to our recommendations.

SBA attempted to meet the staffing needs of its internal and external audit divisions through requests to the Congress, but no increases were granted. SBA did not attempt to increase staffing through any of our other recommended actions--realigning positions, changing scheduling methods, or setting priorities for reviews.

SBA did recognize that followup on internal audit reports is critical. However, it has not changed its procedures to require timely followup. Field staff and program officials are responsible for making sure recommendations are implemented.

Although SBA did revise the policies and procedures covering the scope of OPR examinations, the changes only brought the stated policy more in line with what OPR does and did not reinstitute its original mission. Consequently, OPR is still not making qualitative appraisals of SBA's loan portfolio. The changes in the reporting format included a revised presentation of the deficiencies in processing and servicing loans and eliminated the discussion of bank visits and loans adversely classified by the OPR examiner.

## CHAPTER 8

### IMPROVEMENTS MADE IN FINANCIAL

#### MANAGEMENT ACTIVITIES

Although SBA has made some improvements in its financial management activities, it needs to develop additional financial data and to make additional improvements in its financial operations. SBA disagreed with our prior recommendations concerning (1) establishing a loss provision for guaranteed loans, (2) determining how many borrowers in default were able to cure their defaults and the time it took, and (3) establishing a limit on the number of days of accrued interest SBA would pay on defaulted loans. We did not perform any followup work in these areas. SBA also disagreed with our recommendation on gathering data on refinanced loans, but has started to gather such information.

Our followup showed that new procedures are being used to (1) show potential interest losses as an offset against accrued interest receivable, (2) reflect a loss allowance for surety bond guarantees, and (3) disburse advance payments to 8(a) subcontractors using letters of credit. The recommendation that SBA establish a loss provision for lease guarantees was dropped when the program became inactive.

SBA agreed with, but had not implemented our recommendations for:

- Collecting financial data on loans that have been deferred.
- Establishing guidelines for determining when uncollectible advance payments should be written off.
- Auditing its financial statements.

#### MANAGEMENT NEEDS USEFUL FINANCIAL DATA

SBA's accounting system should produce useful financial data so that officials can easily discharge their responsibilities. As noted in our earlier report, 1/ financial data can be used in planning, exercising financial control over

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1/"Need For Improvement In Small Business Administration's Financial Management" (FOD-76-7, Apr. 16, 1976).

resources, and promoting greater efficiency in day-to-day operations. We recommended that SBA develop procedures for (1) gathering data and reporting on SBA's procedure of granting deferments and refinancing loans, (2) showing a loss allowance for accrued interest receivable, and (3) establishing a provision for losses and a corresponding liability for guaranteed leases and surety bonds expected to default and for guaranteed loans SBA estimates it will be required to purchase because of default.

Our followup showed that SBA's accounting system still does not produce data on deferred and refinanced loans. Also, although SBA established loss allowances for accrued interest receivable and surety bond guarantees, it disagreed that a loss allowance should be established for guaranteed loans.

#### Data unavailable on deferred and refinanced loans

Our earlier report noted that SBA management did not know how many loans in its portfolio had been deferred or had been refinanced. Without periodic reporting of deferred or refinanced loans, an accurate assessment of troubled loans outstanding is not available to SBA management, the Congress, or other interested parties. Accordingly, we recommended that the Administrator, SBA, develop and report statistical data essential for evaluating the collectibility of deferred and refinanced loans and data useful in determining whether SBA's program of granting deferments and refinancing of loans has been successful.

Our followup showed that the only data available on loan deferments is a monthly summary of deferment actions SBA took to cure delinquent loans. The summary also shows the number of deferment actions that did not cure delinquent loans. This information has been gathered since October 1977. For fiscal year 1978, an average of 1,558 deferment actions per month were processed, of which an average 1,429 were to cure delinquencies. The summary does not show the number of loans cured by deferment; rather, it shows only the number of deferment actions during the month. Consequently, a loan can be deferred more than once and on the SBA report would be counted in each month a deferment action was processed.

SBA officials could not tell us the number or amount of deferred loans, or how many times a particular loan has been deferred. At the time of our followup, the total number of loans was being reported as current in the monthly Management Information System reports. We were told that in early fiscal year 1980, the monthly report will be revised to show the number and amount of deferred loans for each loan program.

SBA officials informed us that the basic data on deferred loans is being collected in the computer and is presently available on a special run basis. However, we were informed that the Office of Portfolio Management has tried unsuccessfully since May 1976 to obtain information on deferred loans; and that this type of information gathering has had a low priority within SBA. According to one SBA official, the lack of information on loan deferments has prevented any formal analysis of the collectibility of loans which have been deferred.

In commenting on our prior report, SBA stated that it did not believe it needed to collect data on refinanced loans, but that it would review the matter before a final decision was made. SBA officials have since informed us that data on the refinancing of loans will be gathered on all loans approved on or after June 1, 1979.

Loss allowance established for  
surety bonds but not for leases  
or guaranteed loans

Our earlier report noted that SBA did not present fairly the financial results of its lease and surety bond guarantee programs because it did not provide for costs incurred when it is required to honor its guarantees. The report pointed out that SBA recognized its lease and surety bond fees as income in the year in which they were collected, but did not recognize the potential loss resulting from the guarantees. Also, SBA's financial statements did not show its estimated loss on guaranteed loans that it may be required to purchase.

The report recommended that SBA establish a provision for losses and a corresponding liability for guaranteed leases and surety bonds expected to default and for guaranteed loans SBA estimates it will be required to purchase because of defaults. SBA agreed to establish reserves for the surety bond and lease guarantee programs. The reserve for surety bond losses was established in fiscal year 1977. Subsequent to our report, SBA informed us that establishing a provision for losses on lease guarantees would be meaningless because the program was inactive. SBA disagreed with us on establishing a reserve for guaranteed loans. It felt that such a reserve would be a valuation of an asset that did not exist since loans made by banks and guaranteed by SBA are not SBA loans until the guarantees are exercised.

OTHER AREAS IN SBA'S FINANCIAL  
OPERATIONS NEED IMPROVEMENT

Our prior report noted that certain SBA financial management policies, procedures, and practices needed to be strengthened to promote greater efficiency and economy in operations. We recommended that SBA (1) establish a limit on the number of days of accrued interest that may be paid to banks on defaulted loans, (2) require the use of letters of credit on 8(a) advances in excess of \$250,000 when such use was in conformance with the Treasury Fiscal Requirements Manual, (3) develop guidelines and procedures for writing off uncollectible 8(a) advances and (4) require the Internal Audit Division to audit SBA's financial statements.

SBA disagreed with the first two recommendations. It tried unsuccessfully to get a waiver from the Department of Treasury on using letters of credit. Although it agreed to develop procedures for writing off uncollectible advances, none were developed. Finally, the internal audit staff has not yet audited SBA's financial statements even though it recognized the importance of a regular audit.

We met with SBA officials in July 1978 to evaluate their efforts to review the collectibility of 8(a) advances. At that time they were making a limited examination of outstanding advances, but we were advised in September 1978 that, because of the magnitude of problem cases and our expressed interest, a comprehensive review of all outstanding advance payments would be recommended. As a result, the Inspector General's report issued in April 1979 disclosed that the advance payment method of funding has been improperly managed by SBA personnel, controls over payments generally have been ineffective, and field officials have not followed SBA procedures. The report disclosed that out of about \$61.5 million outstanding as of March 31, 1979, about \$17.6 million may be uncollectible. About \$1.5 million has been written off. The report contained recommendations to strengthen SBA's control over payments.

Improvements achieved in  
timing of advance payments

Our earlier report noted that potential savings could be realized through more careful timing of advance payments to 8(a) contractors. We pointed out that SBA did not use letters of credit even though the Treasury Fiscal Requirements Manual requires they be used for advances of more than \$250,000 annually, when the agency has, or expects to have, a continuing relationship of at least 1 year with the recipient. Accordingly, we recommended that SBA (1) use letters of credit on



advances of \$250,000, when such use was in conformance with the Treasury Fiscal Requirements Manual and (2) consider disbursing advances not meeting Treasury's criteria in two or three installments.

SBA initially disagreed with our recommendation to use letters of credit for disbursing advance payments. It said that most SBA advance payments were not subject to the Treasury Fiscal Requirements Manual.

The Treasury turned down SBA's May 1976 waiver request from the letter of credit requirements in making 8(a) advances. Subsequently, Treasury approved SBA's letter of credit procedures in October 1978, requiring that 8(a) advances be made through letters of credit when:

- The relationship between SBA and the 8(a) subcontractor is expected to be for a period of at least 1 year.
- The 8(a) program advances are \$120,000 or more annually.
- The 8(a) subcontractor assures that payment requests will be timed and limited to immediate disbursement needs.
- The 8(a) subcontractor agrees to establish and maintain financial records and controls that will provide for complete accountability and required reporting of program funds.

SBA officials informed us that its letter of credit procedures were implemented in June 1979.

SBA agreed that, generally, advances over \$250,000 should be disbursed in two or three installments and that SBA procedures would be amended to implement the suggestion. Although SBA implemented such procedures in February 1977, our analysis showed that advance payments continued to be made in single payments. However, since headquarters files merely show the financial transactions, we could not determine whether the single payments were justified.

The Office of Budget and Finance official who approves advance payments told us that statistics on the number of advance payments paid in multiple payments are not maintained. Therefore, we reviewed the files for 12 advances authorized after SBA's procedures were revised to determine whether advances were being disbursed in multiple payments. The advances ranged in amounts from \$300,000 to \$8 million and totaled about \$15.4 million.

Our analysis showed that in 4 of the 12 cases the 8(a) advances were disbursed in multiple payments. The following table shows the amount of the advance and the number of payments.

<u>Advance amount</u>	<u>Number of payments</u>
\$ 750,000	3
900,000	2
910,000	3
<u>1,500,000</u>	5
<u>\$4,060,000</u>	

The files generally contained only financial information on the advances, that is, advance authorizations, disbursements, and payments. Therefore, we were unable to determine whether the eight single payments, totaling about \$11.3 million, were justified. We noted that an \$8 million advance, which was made on an \$11 million contract, was disbursed in a single payment.

We discussed this with the Office of Budget and Finance official who approves the payments and were told that the field office decides when an advance is to be made in a single payment. The official said he is responsible for ensuring that the subcontractor is entitled to the advance and that the amount requested is not in excess of that authorized.

Guidelines have not been established  
for writing off uncollectible advances

Our prior report pointed out that SBA had not established guidelines for determining when advances to section 8(a) subcontractors should be considered uncollectible and written off. Consequently, assets were overstated since uncollectible receivables were not written off. SBA agreed with our recommendation and said that guidelines and procedures would be developed for writing off uncollectible advances; however, our followup showed that procedures had not been developed.

An 8(a) program official told us that he knew of no procedures for determining when 8(a) advances are uncollectible and should be written off. He thought that the same procedures which are used for determining when loans should be written off could apply. These procedures state that a loan specialist's recommendation to liquidate a loan should be made after the loan specialist determines that (1) it is no longer reasonable to assume that the borrower can succeed and the borrower cannot or will not work out a

reasonable schedule of repayment or (2) although it appears that the borrower may have the ability to repay the loan, he will not do so in a reasonable period despite the loan specialist's efforts.

The Office of Budget and Finance official who is involved with SBA accounting procedures and policies told us that there are no formal procedures for writing off uncollectible 8(a) advances, and that it is basically a judgment on the part of program personnel. He also told us that while the planned automation of the 8(a) program will alert program personnel when an advance is overdue, the system will not contain criteria for deciding when an advance should be written off. Rather, such a decision will continue to be the responsibility of the 8(a) program personnel.

SBA officials informed us that guidelines will be developed by September 30, 1979, for writing off uncollectible 8(a) advances. We were also informed that the guidelines would be general because the contracting officer is still directly responsible for the monitoring and compliance of the contractual provisions between SBA and the 8(a) firm.

#### SBA's financial statements have not been audited

Our earlier report recommended that SBA's Internal Audit Division be instructed to audit the agency's financial statements, including evaluations of prescribed policies, procedures, and internal controls. The report noted that SBA's financial statements had not been audited for 5 years.

Although SBA's financial statements have not yet been audited, the Internal Audit Division's fiscal year 1977 and 1978 audit plans called for such an audit. The Division Director told us, however, that the audit was not performed because of priority work in the 8(a) program. This official told us that although the audit has been rescheduled for fiscal year 1979, he was not sure whether the 8(a) work would again preclude the financial statement audit.

#### CONCLUSIONS

Although SBA's accounting system generally is operating satisfactorily, it needs to provide more complete, accurate, and timely information to management, the Congress, and the public. Our followup showed that data on refinanced loans has been gathered since June 1979, but that data on deferred loans is still not available. Nor does SBA know if its policy of deferring and refinancing loans has been successful.

The only data currently being gathered on deferred loans is a tabulation of the number of deferment actions that are processed each month. Although SBA's program personnel have requested more detailed information on deferments, information is not being gathered. Without this information, SBA cannot determine how successful its deferment actions have been.

SBA's financial statements have been revised to reflect a loss allowance for accrued interest receivable and for surety bond guarantees. Although SBA agreed to establish a reserve for its lease guarantee program, it was not necessary when the program became inactive.

Even though we recommended that SBA establish a reserve for guaranteed loans that SBA anticipated it would be required to purchase because of defaults, it disagreed and said that such a reserve would be a valuation of an asset that did not exist.

Although SBA generally agreed with our recommendations for strengthening its financial operations, it did not always implement them. SBA felt that Treasury fiscal requirements for use of letters of credit did not apply to advances to 8(a) subcontractors. A waiver was denied and, subsequently, SBA developed procedures whereby letters of credit will be used under specific conditions. The new procedures were implemented in June 1979. SBA also agreed to disburse its advances in multiple payments in those cases where the Treasury requirements did not apply; however, this has not been done in all instances.

Our earlier report noted that some 8(a) advances appeared to be uncollectible and should have been written off. SBA did not have procedures for determining when advances were uncollectible or for determining when they should be written off. Although SBA agreed to establish such procedures, they have not yet been established. SBA plans to have the new procedures issued by September 30, 1979.

SBA has also not implemented our recommendation that the Internal Audit Division audit its financial statements. Although the financial statement audit had been included in the audit plans for 1977-78, it was not performed due to higher priority work.

## CHAPTER 9

### SCOPE OF REVIEW

Our work was performed at SBA headquarters, Washington, D.C.; at SBA's Atlanta and Boston regional offices; and at SBA district offices in Atlanta, Georgia; Birmingham, Alabama; Boston, Massachusetts; and Hartford, Connecticut.

Our work on the 7(a) program consisted of reviewing 20 randomly selected loans in each of the four district offices. These loans were approved during the period January 1 through June 30, 1977. We reviewed loan files to determine how loans are made and serviced and how management assistance is provided to borrowers. We also reviewed district office correspondence and interviewed employees in each district office.

Our work on the 301(d) small business investment company program was performed at SBA headquarters and at four investment companies in or near Atlanta; Boston; Hartford; and Miami, Florida. In addition, we reviewed the activities of five other 301(d) investment companies, but personal visits were not made. We interviewed company officials at the four investment companies and examined corporate minutes and financial statements; accounting records; and files pertaining to investments made, rejected, or being considered by the companies.

We examined records and spoke with SBA officials concerned with the section 502 program at the Washington, D.C., headquarters and at the Atlanta, Boston, and Hartford district offices. A total of 9, 15, and 4 loans, respectively, were reviewed in these offices.

Our review of the 8(a) procurement program was limited to SBA's management assistance effort (17 firms selected in two SBA regions--Atlanta and Boston).

We examined records and spoke with officials at SBA's headquarters concerning our recommendations on management control and financial management. We also examined records and spoke with officials in SBA's Atlanta and Boston regional offices about the extent to which the regional offices prevent potential conflicts of interest by using statements of outside employment and financial interests.

We reviewed all relevent internal audit reports dealing with the areas covered by our prior reports. Due to congressional interest, a major part of SBA's total audit effort was devoted to the 8(a) program.

BACKGROUND ON SBA PROGRAMS AND ACTIVITIES7(a) BUSINESS LOAN PROGRAM

A major SBA responsibility is administering the business loan program. Under this program, SBA makes loans to small businesses to finance plant construction, conversion, or expansion; to purchase equipment, facilities, machinery, supplies, and materials; and to supply working capital.

The Small Business Act provides that:

"\* \* \* no immediate participation [loan] may be purchased unless it is shown that a [guaranteed loan] is not available; and no [direct] loan may be made unless it is shown that a participating [loan] is not available."

A guaranteed loan is made by a lending institution under an agreement with SBA. This agreement obligates SBA to purchase the guaranteed portion of the loan (not more than 90 percent of the balance outstanding) from the lending institution if the repayment of principal or interest is in default for more than 90 days.

An immediate participation loan is made by either SBA or the lending institution. The lender purchases an agreed percentage of the loan immediately upon disbursement. The SBA share of an immediate participation loan generally cannot exceed 75 percent of the loan amount.

A direct loan is made by SBA with no participation by a lending institution.

Several SBA offices are involved in administering the 7(a) loan program:

--The central office provides technical direction to regional offices, evaluates regional offices' operations, and supervises district offices.

--Regional offices provide technical guidance to district offices, supervise district office operations, evaluate district office performance, make necessary corrections, and review declined loan applications or requests for reconsideration.

--District offices are operating offices under the jurisdiction of regional offices.

--Branch offices have limited operating responsibilities and are under the jurisdiction of district offices.

Each district office has three basic functions in the 7(a) loan process--loan approval, loan servicing, and management assistance.

#### Loan approval

A loan specialist in the financing division is responsible for reviewing the loan package and recommending approval or disapproval of loan applications. The specialist is to issue a report (loan specialist's report) containing, at least:

- A statement of the applicant's eligibility as a small business.
- A determination that funds are not otherwise available on reasonable terms.
- A balance sheet for the applicant, with questionable items explained.
- An analysis of the adequacy of working capital.
- An analysis and comparison with industry averages of past and/or projected earnings.
- A brief description of any collateral.
- A determination of the adequacy of invested capital or equity.
- Comments on management evaluations.
- Comments on the adequacy and conditions of leases if the applicant is renting.
- Comments on the adequacy and availability of hazard insurance.
- Support for any reduction in a bank's exposure explained in detail and thoroughly justified.



--A recommendation for approval or disapproval of the loan.

Two SBA officials must recommend each loan application for approval before a loan can be made. Approval is generally given by a combination of the following officials: loan specialist; supervisory loan specialist; chief, Financing Division; assistant director, Finance and Investment Division; or district director.

#### Loan servicing

Loan servicing, the responsibility of a loan specialist in the Portfolio Management Division, begins after the loan has been made.

The loan specialist looks primarily at loans with problems, rather than at the entire portfolio of loans assigned to him. He monitors his portfolio for warning signals, such as delinquent payments, request for changes in the loan's terms and conditions, adverse changes, or declining trends. If a borrower's problem is beyond the range of the loan specialist's technical knowledge, the case is to be referred to the Management Assistant Division (business management specialist). If management assistance is needed, the Management Assistance Division is to take the necessary action to provide it.

Servicing assistance is

- the early recognition that a problem or potential problem exists,
- the identification of the basic cause, and
- a determination as to the appropriate solution.

#### Management assistance

When management assistance is needed by a loan recipient, a business management specialist in the Management Assistance Division provides the proper assistance through his own expertise or the professional expertise of the Service Corps of Retired Executives, the Active Corps of Executives, the Small Business Institute, a consultant-contractor, and others.

The Financing Division can ask the Management Assistance Division to evaluate the loan applicant's management needs. Also, SBA requires a monthly review of problem or delinquent loans in the district office's loan portfolio from both servicing and management assistance personnel, to determine if the borrower needs management assistance.

301(d) SMALL BUSINESS INVESTMENT  
COMPANY PROGRAM

The Small Business Investment Act of 1968 (15 U.S.C. 661), as amended, authorizes SBA to license, regulate, and provide supplemental financial assistance to small business investment companies.

In 1969, SBA found that this program was not meeting minority businessmen's needs and initiated a new program for licensing and financing a special class of investment companies to assist specified minority groups. These companies were called minority enterprise small business investment companies.

In 1972 the Congress amended the act adding section 301(d) which specifically authorized the special program and eliminated the inference that the program was only for minority groups. Section 301(d) emphasized that the program should be directed to all socially or economically disadvantaged persons. Accordingly, SBA changed the designation from minority enterprise small business investment companies to "301(d) investment companies."

To help 301(d) investment companies become established, the Congress provided more liberal conditions than those required of conventional investment companies. The new conditions included more liberal funding provisions and eligibility requirements for SBA matching funds. A 301(d) investment company can receive up to \$4, of long-term subordinated Government funds, from SBA for each private capital dollar. SBA matching funds are provided through the purchase of 301(d) investment company preferred stock or debenture bonds. The preferred stock provides for a 3 percent a year cumulative dividend to SBA that can be deferred until the company pays dividends on its other stock. The debenture bonds may be issued with terms up to 15 years and interest at the average market yield on comparable outstanding U.S. obligations, with a 3 percent reduction in the interest rate for the first 5 years.

With their resources, the investment companies provide equity capital, long-term loan funds, and management assistance to small businesses that are at least 50-percent owned and managed by socially or economically disadvantaged businessmen.

Equity investments usually provide for buy-back clauses which define the terms small businesses must meet to buy back the the 301(d) companies' investments.

#### 8(a) PROCUREMENT ASSISTANCE PROGRAM

Section 8(a) of the Small Business Act of 1953 authorizes SBA to enter into procurement contracts with Federal agencies and to subcontract the work to small businesses.

In awarding an 8(a) subcontract, SBA hopes to provide a firm with enough work to operate at a profitable level while developing its own commercial and Government sales (referred to as commercial sales). Each firm normally prepares a business plan, subject to SBA approval, which projects, on a multiyear basis, the amount of subcontracting assistance needed to reach self-sufficiency. Each firm also projects the growth in commercial sales which it believes it needs to become self-sufficient.

SBA obtains Federal prime contracts that ordinarily would be competitively awarded. The contracts are negotiated first between the Federal agency and SBA (prime contractor) and then between SBA and the 8(a) firm (subcontractor). To assist firms in becoming self-sufficient, SBA also provides management assistance to help firms solve their business problems. This assistance is usually through management courses and individual assistance in specific problem areas, such as accounting and marketing. Assistance is available from SBA as well as from professional consultants under Federal contract.

#### LDC LOAN PROGRAM

Under section 502 of the Small Business Investment Act of 1958, as amended, SBA makes loans to LDCs for constructing, expanding, or converting plants for specific small businesses. Through 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 to meet the long-term credit needs of small businesses. SBA believes that LDCs attract 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 regulations, an LDC shall be principally composed of and controlled (75 percent of voting control) by persons residing or doing business in the community.

The LDC's primary objective is to benefit the community by increasing employment and business volume, 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.

#### MANAGEMENT CONTROL FUNCTIONS

We previously reviewed and determined (1) the adequacy of SBA's standards-of-conduct monitoring system, (2) the effectiveness of SBA's two review groups--OPR and the Office of Audits and Investigations, and (3) the adequacy of SBA's information provided to central office and field office officials for program management.

Standards of conduct

Executive Order 11222, dated May 8, 1965, prescribed standards of ethical conduct for Government officers and directed the Civil Service Commission to establish regulations. In November 1965, the Commission issued instructions requiring each agency to prepare employee conduct standards and establish a review system for employee financial disclosure statements.

SBA's "rules and regulations" (13 CFR 105), which governs employees' conduct, was issued in 1966. It prescribes standards of conduct for all SBA employees and establishes a system for disclosure and review of financial interests.

SBA revised its rules and regulations in 1976 to require all employees in positions involving decisions on SBA assistance to file statements of outside employment and financial interests.

Audit, investigative, and review functions

Our previous audit discussed OPR's and the Office of Audits and Investigation's operations. OPR's stated objectives at the time of our review were to (1) examine the loan portfolio and financial assistance programs of all field offices through onsite reviews and provide a qualitative appraisal\* of SBA's financial assistance loan portfolio, (2) provide quality control--insure uniformity in the application of financial assistance policies and procedures nationwide, and (3) recommend changes in existing policies and procedures or the need for new ones. Subsequent to our review, OPR's purpose and scope were redefined. The revised purpose is to identify field implementation problems in the financial assistance loan programs and to specify appropriate corrective measures.

The Office of Audits and Investigations has been redesignated as the Office of the Inspector General and is responsible for planning, directing, and executing all audit and investigation activities within SBA. The Office is made up of four divisions: internal audit, external audit, security and investigations, and compliance audit. All but the security and investigations division maintain field staffs in various SBA regional offices.

FINANCIAL MANAGEMENT ACTIVITIES

SBA manages three revolving funds which

- finance nine business, investment, and disaster loan programs;
- guarantee payment of rents on properties leased to small businesses; and
- guarantee bid, performance, and payment bonds on small and emerging contractors.

SBA also enters into procurement contracts with Federal agencies and subcontracts the work to small businesses.

DIGESTS OF EIGHT REPORTS ISSUEDUNDER PUBLIC LAW 93-386

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESS

QUESTIONABLE EFFECTIVENESS OF  
THE 8(a) PROCUREMENT PROGRAM  
Small Business Administration

D I G E S TWHY THE REVIEW WAS MADE

Section 8(a) of the Small Business Act of 1953 gives the Small Business Administration (SBA) the authority to enter into procurement contracts with Federal agencies and, in turn, subcontract the work to small businesses. SBA has used this authority to develop a program designed to assist socially or economically disadvantaged small businessmen in achieving a competitive position in the financial marketplace. Since 1968, when the 8(a) program was started, SBA has awarded 6,912 subcontracts totaling \$737,100,000 to over 2,800 business firms. (See pp. 4 and 5.)

Members of Congress have expressed concern over the benefits derived from the 8(a) program. Accordingly, GAO reviewed the program to determine whether eligible firms were becoming self-sufficient and viable.

GAO did most of its work in Washington, D.C., and in the Atlanta, Dallas, Detroit, Philadelphia, New York, and San Francisco areas. (See p. 35.)

FINDINGS AND CONCLUSIONSProgress of 8(a) firms

SBA's success in helping disadvantaged firms to become self-sufficient and competitive has been minimal. From 1968 to August 1974, only 31 firms successfully completed the program.

GAO evaluated the progress of 110 firms that had received at least 1 subcontract before December 31, 1970. These firms received over \$81.4 million in 8(a) subcontracts. (See p. 7.)

Of the 110 firms, 73 had not reached self-sufficiency. Twenty firms deteriorated financially, 27 went out of business, and the remaining 26 had either a slight financial improvement (but not enough to make the firm self-sufficient) or no change. Of the remaining 37 firms, 18 became self-sufficient and 19 were not classified because of insufficient information.

A major reason for this lack of success was SBA's inability to control the supply of contracts from Federal agencies. Although applicants specify in business plans the amount of

assistance they need each year to become self-sufficient, SBA cannot guarantee any level of assistance.

SBA did not provide adequate assistance to the 20 firms that deteriorated financially or the 27 firms that went out of business. Sixteen of these 47 firms projected a need for \$17.1 million of assistance, but SBA provided only \$5.8 million in assistance. (See p. 9.)

Fourteen of 19 officials at Federal agencies supplying contracts to SBA advised GAO that they could not forecast their procurement needs so they could not guarantee SBA any given level of contracts for the 8(a) program. (See p. 10.)

#### Extent and effect of sponsorships

SBA encourages nondisadvantaged businesses (sponsors) to provide management services, training, and capital to 8(a) firms.

Ineffective monitoring by SBA of the activities of sponsors coupled with the high degree of control exercised by sponsors over disadvantaged firms permits some sponsors to maintain their standing in the marketplace by using the 8(a) program. Eighty-nine firms accepted into the 8(a) program had part owners and/or sponsors who were

nondisadvantaged. Of these firms, 77 received contracts amounting to about \$132.5 million under the program.

Experienced contractors normally become sponsors by forming new corporations using former employees as stockholders and officers and by providing goods and services to the new corporations for a fee. The sponsors also obtain 49 percent or less ownership in the 8(a) firms. (See app. IV for a description of the relationship between a sponsor and an 8(a) firm and the extent to which the sponsor exercised controls.) (See p. 19.)

It appears that SBA relinquished to sponsors its responsibility for insuring that 8(a) firms are provided with capital, management services, and training to aid them in becoming self-sufficient. The sponsors often controlled the firms, contrary to SBA's objective of helping the firms to become self-sufficient.

This occurred because SBA did not (1) monitor the extent to which sponsors controlled 8(a) firms or (2) determine whether firms were becoming self-sufficient. Instead, SBA considered majority ownership of the firms by disadvantaged individuals as evidence of their control.

Officials of six of the seven sponsors GAO reviewed expressed a desire to develop



viable businesses and at the same time make a profit. However, five said they had very little incentive to create viable businesses which later would become competitors.

SBA lacks criteria to define the extent to which sponsors can collect fees for services rendered. For example, the sponsors GAO reviewed charged fees ranging from about 6 percent to about 17 percent of gross receipts. Moreover, SBA does not regularly analyze financial transactions between sponsors and 8(a) firms to insure their propriety and reasonableness. (See p. 18.)

#### Eligibility

SBA requires that owners of applicant firms be socially or economically disadvantaged to be eligible for the 8(a) program.

SBA has admitted applicants in the program on the basis of social disadvantage without documenting the reason the assistance is needed. SBA field offices should be required to document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world. Furthermore, some applicants whose need for assistance appears questionable have been admitted to the program. (See p. 27.)

#### Administration

SBA emphasizes that the performance of 8(a) firms must be closely monitored, but it has not regularly done so. Therefore, SBA has not been able to identify the contractual and management assistance requirements of 8(a) firms or to promptly fulfill these requirements. (See p. 32.)

Although SBA considers management assistance an important tool in correcting the deficiencies of 8(a) firms, it has not provided such assistance to about 52 percent of the firms GAO reviewed. Seven firms that requested management assistance did not receive it. Of the 88 firms that received management assistance, only 33 were satisfied with it. (See p. 32.)

SBA has established goals for the 8(a) program in terms of the number and dollar amount of contracts awarded. GAO believes this is not a valid measure of effectiveness.

For example, SBA has met its monetary goals, even though business plan projections were not met, in each of the last 3 fiscal years, but only 31 firms graduated from the program. A more appropriate goal would appear to be based on the desired number of successful program completions. (See p. 33.)

RECOMMENDATIONS OR SUGGESTIONS

GAO suggested that the Administrator of SBA consider the following as means of improving the 8(a) program:

- Identify and evaluate potential courses of action which could be taken to alleviate SBA's lack of control over supply of contracts by considering alternatives such as (1) allocating more SBA resources for identifying and processing suitable 8(a) contracts and/or (2) reducing the number of firms in the 8(a) program.
- Provide firms with more assistance and guidance in developing sales.
- Establish a system to monitor (1) the extent to which sponsors control 8(a) firms and (2) the progress of the sponsor-controlled firms toward becoming self-sufficient.
- Develop criteria to define the extent to which sponsors can collect fees from 8(a) firms for service and other items.
- Evaluate each firm's need for management assistance and provide such assistance as required while they are in the program.
- Establish realistic goals for the 8(a) program that would include the number of successful program completions.

AGENCY COMMENTS AND UNRESOLVED ISSUES

SBA expressed general agreement with the facts contained in this report and described actions that had been taken to correct the problems noted in GAO's review. See pages 15, 24, 31, and 34 for SBA's specific comments concerning each suggestion.

Although the actions taken by SBA should improve the 8(a) program, GAO believes that additional improvements are necessary. Accordingly, GAO recommends that the Administrator, SBA:

- Reconsider SBA's position of maintaining 1,500 active firms in its 8(a) program and periodically adjust the number of firms depending on the level of contracts that can be made available for the 8(a) program. (See p. 17.)
- Establish a system to monitor a sponsor's compliance with the terms of the sponsorship arrangement as approved by SBA, especially management agreements establishing a sponsor's services and fees. (See p. 26.)
- Revise the standard operating procedures to require that field offices consider all of the suggested factors in determining the need for 8(a) assistance and document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world. (See p. 31.)

--Establish adequate internal controls to insure that 8(a) firms are provided management assistance. (See p. 34.)

MATTERS FOR CONSIDERATION BY THE CONGRESS

This report--the first in a series pursuant to Public Law 93-386, which requires GAO to conduct a full-scale

audit of SBA--demonstrates the need for fundamental changes in SBA's 8(a) program if the longstanding congressional aim of assisting disadvantaged businessmen is to be achieved.

The Congress may wish to review what is being done to correct the program's problems when considering future authorization and appropriation requests.

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESSA LOOK AT HOW THE SMALL  
BUSINESS ADMINISTRATION'S  
INVESTMENT COMPANY PROGRAM  
FOR ASSISTING DISADVANTAGED  
BUSINESSMEN IS WORKINGD I G E S T

The Small Business Administration licenses, regulates, and, in part, finances privately owned and operated investment companies whose purpose is to provide equity capital, long-term loans, and management assistance to small businesses that are at least 50 percent owned and managed by socially or economically disadvantaged businessmen.

It does so under section 301(d) of the Small Business Investment Act.

Although the program is just getting into high gear, patterns have emerged which warrant actions by the agency:

- Available funds are being only partially invested. (See p. 4.)
- For those businesses receiving help, the investment companies are opting for loans rather than more risky equity participation. (See p. 7.)
- Granted the risks assumed by the investment companies, some of their arrangements with small businesses appear to be one sided. (See p. 9.)
- Eligibility requirements were poorly defined, and help was being given to some businesses that did not appear to need assistance. (See p. 12.)
- Better management information could result if improvements were made in the reporting system for monitoring 301(d) investment company activities. (See p. 14.)

--The Small Business Administration has essentially adopted a hands-off approach to the program, preferring what it terms "the capitalistic way."

As the advocate of the small businessman, the Small Business Administration needs to be more directly concerned with the practices of these companies in their continuing effort of providing equity financing.

GAO's findings were brought to the attention of the Administrator. He has agreed to take action on (1) apparent ineligibility of business applicants and eligibility guidance, (2) the contingency of management fees based on profits, and (3) the reporting system to provide better management information.

Other than those matters, he believes that the Administration is doing what it can and should do, consistent with the authorizing legislation.

GAO recommendations are contained on page 19.

Whether the small businesses becomes viable depends to a large measure on the practices of the investment companies. Since these practices can promote or hinder the interests of small businesses, they should be carefully watched by the Agency.

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

D I G E S T

Under its lease guarantee program, the Small Business Administration helps small businesses obtain leases of commercial and industrial space which, because of insufficient credit standing, they would otherwise not be able to obtain at reasonable terms.

The agency does this by guaranteeing rent payments to landlords, either directly or in participation with a private insurer. As of June 30, 1974, the agency's contingent liability was about \$337 million.

The program is required to be self-sustaining. Administrative expenses and payments to landlords must be covered by premiums charged the small businessman or the landlord.

The program is not self-sustaining for policies issued through fiscal year 1974. GAO projects that net losses may be about \$17 million by the end of the average life of the currently outstanding leases (fiscal year 1987).

The Congress should be aware that:

- Additional appropriations may be needed to cover projected losses on lease guarantees already issued.
- New actuarial studies will likely show that the 2.5-percent legal limitation on loss premiums will have to be increased if the program is to be self-sustaining.

The Small Business Administration's Administrator should (1) give the Congress estimates of total losses on policies issued to date for future funding purposes and (2) have new actuarial studies made to determine the self-sustaining premium rates.

If, as expected, these studies show that the portion of the premium necessary to cover default payment must exceed the 2.5-percent legal limitation, the Small Business Administration should ask the Congress to consider amending the enabling legislation.

The report also contains a series of recommendations to improve program administration. This report--the third in a series pursuant to Public Law 93-386, which requires GAO to conduct a full-scale audit of the agency--concludes that the Small Business Administration:

--Has not updated actuarial studies on which premiums are based since January 1971, even though experience has shown that some assumptions underlying previous studies were in error. (See p. 10.)

--Has not monitored the program's solvency. (See p. 11.)

--Used poor judgment in approving guarantees for businesses which could not reasonably be expected to succeed. (See pp. 14 to 21.)

--Does not have an adequate system for screening high-risk applicants with major deficiencies and has guaranteed rents on specialized properties which are difficult to re-rent when defaults occur. (See pp. 24 to 25.)

The Small Business Administration agreed to act on GAO's recommendations but pointed out that a new study, if performed by professional actuaries on a contract basis, would be expensive and require an estimated 1-1/2 years to complete. The agency believes that further discussions with the appropriate committees of the Congress are necessary before such a study is initiated.

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESSPERSONNEL MANAGEMENT IN THE  
SMALL BUSINESS ADMINISTRATIOND I G E S T

Section 13 of Public Law 93-386 dated August 23, 1974, directed GAO to conduct a comprehensive audit of the Small Business Administration. This report, one of a series prepared in response to the legislative mandate, discusses the Agency's personnel management practices.

GAO's review of Small Business Administration personnel management involved:

- Determining the Agency's corrective actions to improve personnel management in response to Civil Service Commission reports.
- Surveying opinions of 518 employees, or over 10 percent of the Agency's personnel, on how they perceived their Agency's personnel management.
- Determining the issues concerning allegations of political influence in personnel actions.

During its routine evaluations at the Agency, the Commission 1/ found weaknesses in the Small Business Administration's personnel management. (See pp. 11 to 14.)

GAO noted that the Small Business Administration had generally taken corrective action on Commission recommendations.

GAO's employee opinion survey showed that the majority considered personnel programs and practices good or fair. When specific allegations of improprieties were made, GAO attempted to determine their validity but was generally unable to document that specific actions were improper.

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1/ The evaluations were often conducted jointly with the Agency.



The Commission in an August 1974 report entitled "Alleged Political Influence in Personnel Actions at the Small Business Administration," stated that:

--"Sponsorship by partisan political figures, political affiliations, and political clearances were factors in the selection of four District Directors in SBA; in the absence of a viable staffing plan for District Director positions, SBA has permitted a personnel management vacuum to exist in which political interests are allowed to influence appointments to these key positions."

--"A number of improper or illegal personnel actions have been taken by SBA as a result of efforts to provide preferential treatment to some candidates and employees; and in some cases, the personnel actions which resulted from the preferential treatment were based on considerations of political support."

--"Disciplinary action should be considered with respect to certain SBA officials who violated personnel laws or were otherwise responsible for such violations on the part of their subordinates or other employees."

The Commission recommended specific corrective actions and the Administrator of the Small Business Administration agreed to implement them. (See p. 20.)

About 37 percent of the 518 employees interviewed by GAO thought political appointees had been placed in Small Business Administration positions and that some appointments responded to changes in the White House administration.

GAO noted numerous political referrals in Small Business Administration correspondence files, including statements beyond character or residence, the two items permitted by 5 U.S.C. 3303. GAO believes that although the official examining an applicant may not legally consider such references they are difficult to ignore and put undue pressure on the examining official.

In view of Executive Order 11222--which prohibits any action which might give or create the appearance of giving preferential treatment to any person--and that over one-third of the Agency employees we interviewed believed that political appointees had been placed in positions aspired to by careerists, the Small Business Administration should avoid even the appearance of preferential treatment to any person. The Commission remarked that

"\* \* \* while certain technical legal and regulatory details may have appeared, on the surface, to have been compiled with, it is clear from an examination of the cases reported that the true spirit and intent of personnel laws and merit principles were violated."

Because of on-going personnel management evaluations at the Small Business Administration, corrective actions initiated or taken by the Agency, cases under litigation, congressional hearings and proposed legislation on the merit system, GAO does not consider it appropriate to make recommendations.

D I G E S T

Under section 7(a) of the Small Business Act, the Small Business Administration guarantees and makes direct loans to small businesses. The 7(a) program is the agency's basic and largest business loan program.

As of June 1975, 80,582 loans valued at \$3,930.4 million were outstanding and 6,880 loans valued at \$344.1 million were delinquent 60 days or more or in liquidation.

GAO reviewed the 7(a) loan program at 24 of the agency's district offices, randomly selecting and examining 980 loans. (See app. III.)

Although the agency has aided, counseled, and assisted many small businesses throughout the Nation, GAO found problems that require management attention.

Loan proceeds were approved for questionable purposes.

--Numerous loans were approved which merely transferred the risk of loan payment from banks and other creditors to the agency itself. (See pp. 9 to 21.)

--Some loans were made to wealthy businesses not intended to receive assistance. (See pp. 21 to 24.)

The Small Business Administration did not always analyze the prospective borrowers' financial condition adequately or verify the adequacy of collateral pledged. As a result, loans were approved when it was questionable whether they were of such sound value or so secured as to reasonably assure repayment. (See ch. 4.)

The agency did not act effectively after loans were made to increase the chances of borrower success and loan repayment.

- Borrowers used loan proceeds for unauthorized purposes which went undetected. (See pp. 36 to 39.)
- The Small Business Administration did not have adequate procedures for detecting delinquent loans and the reasons for the delinquency, and therefore did not know of borrowers in need of help. (See pp. 39 to 44.)
- The agency did not routinely visit borrowers to check their progress. (See pp. 46 to 49.)
- Its management assistance program was not helping businesses overcome their problems. (See ch. 6.)

A problem which permeates the entire loan process is a shortage or improper alignment of personnel at the district office level.

To correct these problems, the Small Business Administration should take numerous actions, including:

- Insuring clarification of and compliance with established operating procedures.
- Determining its proper staffing level to effectively analyze and service the loans approved. To achieve this level, the agency should consider realigning its current personnel or requesting additional staff from the Congress. If these approaches fail, the only option would be to limit the number of loans approved. (See pp. 25, 34, 54, and 68.)

This is the fifth in a series of reports pursuant to Public Law 93-386, requiring GAO to conduct a full-scale audit of the Small Business Administration. The Congress can use this report in assessing the agency's management; administration; and fulfillment of its legislative mandate to aid, counsel, and assist small businesses.

The Small Business Administration generally agreed with GAO's recommendations. The agency

appreciated the overall positive tenor of GAO's report and acknowledged the managerial shortfalls uncovered.

It said that remedial measures are either underway or planned but these must be accomplished within budgetary constraints. (Specific agency comments are discussed on pp. 26, 34, 55, and 69.)

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.

--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.

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.

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.



COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESSNEED FOR IMPROVEMENT IN  
SMALL BUSINESS ADMINISTRATION'S  
FINANCIAL MANAGEMENTD I G E S T

Although the Small Business Administration's accounting system generally is operating satisfactorily, it needs to provide more complete, accurate, and timely information useful to management, the Congress, and the public.

- The true extent of the number of troubled loans in the agency's portfolio is hidden because under agency procedures delinquent loans are classified as current when borrowers are granted deferments or when loans are refinanced. Disclosure of loans in this category would be helpful in evaluating the collectability of the agency's loan portfolio and would be useful in determining whether the agency's program of granting deferments and refinancing loans is successful. (See pp. 5 to 7.)
- Contrary to the accounting principles and standards prescribed for Federal agencies, the agency accrued interest on delinquent loans without making any provision for the loss of interest should the loans prove to be uncollectable. In fiscal year 1974 the agency charged off \$5.5 million in uncollectable interest. (See pp. 7 to 8 .)
- Because the agency did not provide for costs to be incurred when its guarantees had to be honored, the true status of the lease and surety bond program was not being revealed. From inception of the lease guarantee program through June 30, 1974, agency records showed income exceeded expenses by \$3.6 million. In another report to the Congress, GAO estimated the agency's net loss on leases issued through fiscal year 1974 would be \$17 million by the end of fiscal year 1978. (See pp. 9 to 12.)

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Certain agency financial management policies, procedures, and practices need to be strengthened to promote greater efficiency and economy in operations. The following relate to the need for such improvements.

- The agency sets no ceiling on the number of days accrued interest it will pay to banks on defaulted loans. The longer banks delay in requesting the agency to purchase their defaulted loans, the more interest banks will collect from the agency. In fiscal year 1974 the agency paid more than 180 days of accrued interest on over 1,000 of the 3,400 guaranteed loans it purchased. The agency would have saved \$209,000 in that year if 180 days had been established as the limit on the number of days interest it would pay to banks. The agency would have saved \$370,000 if 105 days had been established as the limit. At the time of GAO's computation the rate paid to banks was limited to 8 percent. Now the rate to be paid by the agency is the same rate of interest as provided for in the note, making the interest costs to the Government even higher. (See pp. 13 to 16.)
- The accounting records for the Surety Bond Guarantee Program do not show whether all fees due from contractors and sureties were collected. Because of the large volume of fees collected, the agency does not attempt to identify payments with contracts. The agency is studying the feasibility of automating accounting for the program. If accounting is automated, the problem should be solved. (See pp. 17 to 18.)
- When making advances to subcontractors the agency deposits funds in special bank accounts and the subcontractor draws on these funds. Funds were allowed to remain idle because deposits were not timed to coincide with needs of contractors. In one agency region the Government could have saved \$15,000 in interest costs in an 18-month period by timing deposits better. (See pp. 18 to 19.)

--The agency's financial statements have not been audited for the past 5 years by the agency's Internal Audit Division. Periodic audits of financial statements are needed to assure management that the financial management systems and reports are reliable. (See pp. 20 to 21.)

The financial statements of the combined revolving funds--with three exceptions--present fairly the Small Business Administration's financial position as of June 30, 1974, and the results of its operations and changes in financial position for the year then ended in conformity with principles and standards of accounting prescribed by the Comptroller General of the United States.

The exceptions are

--lack of provision for estimated losses on accrued interest (see pp. 7 to 8),

--lack of a provision for estimated losses on leases and surety bonds (see pp. 9 to 12), and

--overstatement of the allowance for losses on loans (see pp. 25 to 26.)

The agency generally agreed with GAO's conclusions and recommendations with the following exceptions.

--The agency did not agree that it should purchase defaulted loans sooner by establishing a limit on the number of days accrued interest it pays to banks. (See pp. 15 to 16.)

--The agency did not agree that it should show a liability in future financial statements for estimated loss on guaranteed loans expected to default which the agency will be required to purchase. (See pp. 11 to 12.)

This report is the seventh in a series under Public Law 93-386, which required GAO to conduct a full-scale audit of the agency.

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESS

MANAGEMENT CONTROL FUNCTIONS  
OF THE SMALL BUSINESS  
ADMINISTRATION--IMPROVEMENTS  
ARE NEEDED  
Small Business Administration

D I G E S T

There has been congressional concern over the management of activities and programs by field offices of the Small Business Administration.

GAO sought to evaluate certain "management tools" or management control functions the Small Business Administration uses to control its operations. These tools include:

- A standards-of-conduct system requiring employees in key positions to file a statement of outside employment and financial interest.
- Audit, investigative, and review groups which assess the activities and programs of the Small Business Administration at field offices and the central office.
- A management information system which periodically provides reports to management.

Many employees making or influencing decisions on assistance do not file statements of employment and financial interest because regulations emphasize an employee's grade level rather than his duties; employee financial statements which are filed are not adequately reviewed by the Small Business Administration. Moreover, despite the Small Business Administration's significant participation with banks, the regulations do not provide a specific policy on bank stock ownership.

Improvements are needed to provide the standards-of-conduct counselors with definitive guidelines for reviewing financial statements. GAO's recommendations are found on page 16.

GGD-76-74

GAO noted at the time of the review that the office of portfolio review's primary purpose--making quality appraisals of loan portfolios--was not being achieved because of its policies and procedures, its appraisal practices, and the fact that actions are not taken on its findings. GAO has serious reservations as to the qualifications of the examiners assigned to this office.

The Small Business Administration redefined the purpose of the office of portfolio review in February 1976, and will review financial assistance activities to see whether policies are being executed. GAO questions this decision and continues to believe that qualitative appraisals of loan portfolios could provide Small Business Administration program managers with a valuable service in loan portfolio management. GAO's belief is based in part on the results of its audit of Small Business Administration programs and activities pursuant to Public Law 93-386, which culminated in seven previously issued reports to the Congress. GAO's recommendations are found on page 42.

GAO's review of the activities of the other groups responsible for auditing, investigating, or evaluating Small Business Administration internal or external program activities showed that although each group has generally performed adequately, each group has also experienced problems, thereby reducing its effectiveness as a "management tool." Generally, the weaknesses noted in the internal and external audit functions resulted from understaffing. GAO's recommendations are found on page 42.

From a questionnaire sent to 540 key officials, GAO determined that improvements are needed in the Small Business Administration's management reports. GAO suggested that the Small Business Administration have its steering committee study the management reports system and recommend changes to improve the system's usefulness.

The Small Business Administration agreed with GAO's recommendations concerning the need for more stringent rules and regulations on standards-of-conduct and for an improved reports management information system. Actions have either been taken or are in process. (See pp. 17 and 51-52.)

The Small Business Administration agreed with GAO's recommendations to improve the audit, investigation, and review functions. It also recognized that there is a need to pursue efforts to obtain more staff for the internal and external audit divisions.

The Small Business Administration acknowledged that quality appraisals of the loan portfolio have not been performed, although the Congress was told otherwise in November-December 1973. It said that the office of portfolio review now reviews financial assistance activities from a program standpoint to see whether policies are being followed.

Portfolio quality control goes beyond a review of noncompliance of policies and should include a loan portfolio evaluation or appraisal.

This report is the eighth and last in a series under Public Law 93-386 which requires GAO to conduct a full-scale audit of the Small Business Administration. Digests of the seven previously issued GAO reports are contained in appendix VII.

GAO Note:

Page references throughout the preceding Digests refer to the respective accompanying report.

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