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STEPHEN L. KELETI and JOSEPH A. MARANTO

The GAO Audit of the Small Business Administration

The 93d Congress directed GAO to conduct a full-scale audit of the Small Business Administration and report to the House and Senate not later than 6 months from the date of the act. Previous articles in the Review *(Fall 1975, Spring 1976) described the overall plan and how GAO performed the audit of the Administration's largest loan program. This article describes the results of the work performed.*

Exactly 2 years after the passage of Public Law 93-386 on August 23, 1974, GAO completed the last in its series of eight reports to the Congress on a total audit of the Small Business Administration. The eight reports covered a wide spectrum of SBA activities:

- Procurement matters.
- Major loan programs.
- Lease guarantees.
- Personnel practices.
- An examination of financial statements.
- Organization, management, and review functions.

The General Government Division was responsible for six assignments; the Federal Personnel and Compensation Division and the Washington regional office each handled one assignment. The Special Analysis Section of the Office of the General Counsel provided legal assistance throughout the work. All 15 GAO regional offices participated in the assignments that were conducted at 53 SBA field offices.

An article in the Fall 1975 *GAO Review* described our overall plan for the SBA audit. It also described the key events preceding the August 1974 act, including the House Banking and Currency Committee's investigation of 20 of SBA's 91 field offices, with the Richmond, Virginia, office receiving the largest amount of attention. We also described the manner in which we selected eight major programs and activities with

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Mr. Keleti, an assistant director in the Community and Economic Development Division, holds a B.S. degree in accounting from Saint Joseph's College in Philadelphia. He received the GAO Meritorious Service Award in 1972 and 1973 and is a previous contributor to *The GAO Review.*

Mr. Maranto, a supervisory auditor in the Community and Economic Development Division, received his B.S. degree from Northwestern State University with further studies at George Washington University. He is a member of the National Association of Accountants and a previous contributor to *The GAO Review.*

Both Mr. Keleti and Mr. Maranto were members of a group that received the General Government Division's Director's Award in 1976 for their participation in the audit of SBA.

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the idea that they would provide us with broad coverage of SBA's operations, including the effectiveness of several SBA loan programs and the efficiency with which SBA carried out its personnel management and financial operations.

In the Spring 1976 issue of the *GAO Review*, a second article described the effective cooperative working relationships between GAO's Washington and regional office staffs in carrying out an extensive audit of the agency's largest loan program.

GAO staff members dealt with the staff of the House Committee on Banking and Currency in all events that occurred before and immediately after the act was passed. However, a House action changed the legislative responsibility for small business from the Banking and Currency Committee to the newly created House Small Business Committee. The change became effective with the start of the 94th Congress in January 1975. In February 1975, we briefed the new committee's staff on our review efforts under the public law.

Audit Findings

GAO's work was summarized in eight reports. The principal findings are described below.

Questionable Effectiveness of the 8(a) Procurement Program

Section 8(a) of the Small Business Act of 1953 gives 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 programs designed to assist socially or economically disadvantaged small businessmen in achieving competitive positions in the financial marketplace. At the time of our report (GGD-75-57, Apr. 16, 1975), SBA had awarded 6,912 subcontracts totaling $737,100,000 to over 2,800 business firms.

We reported that:

- SBA's success in helping disadvantaged firms become self-sufficient and competitive had been minimal. We evaluated the progress of 110 firms, 73 of which had not become self-sufficient. A major reason for the lack of success was SBA's inability to control the supply of contracts from Federal agencies.
- SBA's ineffective monitoring of sponsors' activities to provide management service, training, and capital to 8(a) firms, as well as sponsors' high degree of control over disadvantaged firms, permitted some sponsors to maintain their standing in the marketplace by using the 8(a) program.
- Owners of applicant firms must be socially or economically disadvantaged to qualify for the 8(a) program. SBA has admitted applicants in the program on the basis of social disadvantage without documenting the reason assistance is needed. Some applicants whose need for assistance appears questionable had been admitted to the program.

The Investment Company Program

Section 301(d) of the Small Business Investment Act, authorizes SBA to license, regulate, and finance privately owned and operated investment companies. The 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.

Our report on this program was entitled "A Look at How the Small Business Administration's Investment Company Program for Assisting Disadvantaged Businessmen Is Working" (GGD-75-74, Oct. 8, 1975).

We reported that:

- Available funds were only partially invested.
- For those businesses receiving help, the investment companies were opting for loans rather than more risky equity participation.
- Granted the risks assumed by the investment companies, some of their arrangements with small businesses appeared to be one-sided.
- Eligibility requirements were poorly defined, and help was being given to some businesses that did not appear to need assistance.
- Better management information could result if improvements were made in the reporting system for monitoring 301(d) investment company activities.
- SBA had adopted a hands-off approach to the program, preferring what it terms "the capitalistic way."

The Lease Guarantee Program

Under its lease guarantee program, SBA helps small businesses lease commercial and industrial space, which, because of insufficient credit standing, would not be obtainable at reasonable terms. 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 to the small business or the landlord.

Our report, entitled "Substantial Losses Projected for the Small Business Administration's Lease Guarantee Program" (GGD-75-101, Oct. 9, 1975), showed that:

- The program was not self-sustaining for policies issued through fiscal year 1974, and projected net losses might be about $17 million by fiscal year 1987.
- Additional appropriations might be needed to cover projected losses on lease guarantees already issued.
- New actuarial studies would likely show that the 2.5 percent legal limitation on loss premiums would have to be increased if the program was to be self-sustaining.
- SBA used poor judgment in approving guarantees for businesses which could not reasonably be expected to succeed.
- Although SBA did not have an adequate system for screening high-risk applicants with major deficiencies, it guaranteed rents on specialized properties which are difficult to re-rent when defaults occur.

Personnel Management

During its routine evaluations at the agency, the Civil Service Commission found weaknesses in SBA's personnel management. We noted that the agency had generally taken corrective action on Commission recommendations.

Our employee opinion survey showed that the majority considered personnel programs and practices good or fair.

When specific allegations of improprieties were made, we attempted to determine their validity but were generally unable to document improper actions.

We found numerous political referrals in correspondence files. Thirty-seven percent of the agency's employees felt that political influence had been used in filling certain jobs.

This report was entitled "Personnel Management in the Small Business Administration" (FPCD-76-10, Nov. 28, 1975).

The 7(a) Loan Program

Under section 7(a) of the Small Business Act, SBA guarantees and makes direct loans to small businesses. This program is the agency's basic and largest loan program. We reviewed the program at 24 of the agency's district offices, randomly selecting and examining 980 loans.

Although the agency has aided, counseled, and assisted many small businesses throughout the Nation, we found problems that required management attention. Our report, entitled "The Small Business Administration Needs to Improve Its 7(a) Loan Program" (GGD-76-24, Feb. 23, 1976), brought out that:

- 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. Some loans were made to wealthy businesses not intended to receive assistance.
- SBA did not always adequately analyze the prospective borrower's financial condition 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.
- The agency did not act effectively after loans were made to increase the chances of borrower success and repayment.
  - —Borrowers used loan proceeds for unauthorized purposes which went undetected.
  - —Procedures were not adequate for detecting delinquent loans and the reasons for the delinquency, and therefore borrowers in need of help were not known.
  - —Borrowers' progress was not routinely checked.
  - —Management assistance programs were not helping businesses overcome their problems.

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

Local Development Company Loans

SBA is making capital available through loans to local development companies for constructing, expanding, or converting plants for use by small businesses. From the program's inception in fiscal year 1959 to June 30, 1974, the agency approved 5,271 loans valued at over $1 billion. SBA's philosophy is that, through the local development company, the program attracts local financial and moral support because the resulting business improves the local economy through increased jobs, taxes, and indirect stimulation of other businesses.

Our report was entitled "The Small Business Administration's Local Development Company Loans Are Making

Capital Available—But Other Aims Are Often Subverted" (CGD-76-7, Mar. 31, 1976). We reported that:

- The local development company often was a facade allowing a small business to obtain the benefits of the longer term, lower interest rate loans available under this program.
- One or more of the program's eligibility requirements had not been met in 36 of the 95 loans examined.
- SBA overstated the program's accomplishments because it did not have a system to measure the economic benefits.
- No loan approval criteria had been established which related dollars invested to jobs created.
- Loans were approved without adequate assurance that the financial assistance applied for was not otherwise available on reasonable terms.

Financial Management

GAO's examination of SBA's financial management policies, procedures, and practices and the ability of its accounting system to provide financial information responsive to management needs enabled us to recommend that the usefulness of financial data be improved to help SBA control resources and operations and the financial management system be improved.

Our report on this function was entitled "Need for Improvement in Small Business Administration's Financial Management" (FOD-76-7, Apr. 16, 1976).

Management Control

The Congress was concerned about the SBA field offices' management of activities and programs. In evaluating certain "management tools" SBA used to control its operations, we found that tighter requirements would improve SBA's disclosure and review of employees' financial interests, organizational and procedural changes would improve the audit and review functions, and SBA's management reports system needed improvement. The title of our report was "Management Control Functions of the Small Business Administration—Improvements Are Needed" (GGD-76-74, Aug. 23, 1976).

Bank Examiners Assistance

SBA's Office of Portfolio Review appraises the financial assistance loan portfolio to give management an overview of how well district offices are administering them. To help us out, we contracted with a team of bank examiners to evaluate (1) the office's policies and procedures, (2) selected examinations made by the portfolio review staff at four SBA field offices, and (3) the qualifications of the portfolio review staff. The bank examiners worked at the SBA central office and at district offices in Washington, D.C.; Miami, Florida; San Diego, California; and Albuquerque, New Mexico.

Referrals to the Department of Justice

During our review, we were on the lookout for irregularities. As a result, we turned over to the Department of Justice 15 cases of alleged improper actions involving the 7(a) and 8(a) programs. These cases concerned banks' improper use of loan proceeds, misleading financial data furnished by borrowers, and improper acts by SBA employees. However, the Department of Justice declined to pursue these cases any further.

Congressional Action

Senate and House Committees concerned with small business conducted oversight hearings during 1975 and 1976. These hearings, however, did not have the flavor or mood of those the House Banking and Currency Committee held before the act was passed.

GAO testified on several reports, as follows:

- March 4, 1975, House Committee on Small Business. GAO presented its audit plan of SBA programs and activities and targeted reporting dates.
- February 23, 1976, Senate Select Committee on Small Business. GAO testified on the results of its review of the 7(a) business loan program.
- March 9, 1976, Subcommittee on Small Business, Senate Committee on Banking, Housing and Urban Affairs. GAO testified on the results of its review of the 8(a) procurement and lease guarantee programs.
- May 6, 1976, Senate Select Committee on Small Business. GAO testified on the results of its review of the local development company program.

The oversight committees held other hearings on SBA programs and activities but as of December 1976, no major alterations had been made in SBA programs and activities as a result of congressional actions.

SBA Actions

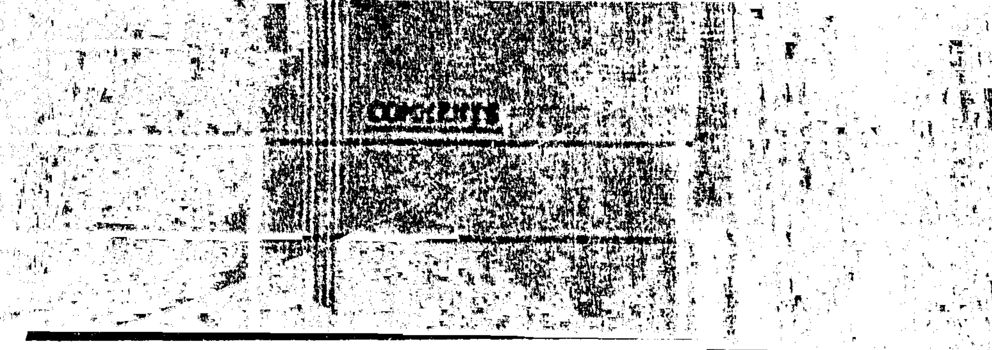
As a result of GAO's audits, regulations governing SBA programs and activities were tightened up. However, many of SBA's problems are basic and result simply from poor attitudes and decisions of SBA employees. There is a "people" problem in SBA; for example, not enough people to handle SBA programs and activities.

As a result of GAO's review, SBA terminated its lease guarantee program. Our projections of losses eventually occurred, and SBA took the action, acknowledging that heavy losses could rightfully be attributed to the long delays experienced by field personnel in re-renting defaulted facilities, particularly single-purpose facilities.

After our local development company review, SBA said it intended to restudy membership requirements to develop requirements that will insure community participation essential to the program's success. It also said it was going to *institute retraining programs* for persons who package and process loans, plus realign local development company personnel *under close supervision* of the Assistant District Director for Finance and Investment. This should curtail errors in documentation and assure that SBA is fulfilling its role as a lender of last resort.

Public Reaction

Public reaction to GAO's work was good. There was a large number of requests for copies of the reports. Newspapers and magazines ran several articles on what we found and sometimes gave us more credit than was due. For example, a news magazine ran an article



titled "Why Small Business May find Federal Aid Harder to Get." They used our 7(a) report to illustrate problems in the program and how Uncle Sam will be a lot more leery than in the past about who gets this aid.

New Administrator Takes Over

In spite of all the publicized problems of SBA, Tom Kleppe, who had been Administrator at SBA for 5 years, had little difficulty in obtaining Senate confirmation as Secretary of the Interior. His departure came at a time when most of the loose strings of controversy had been tied down and GAO had practically finished its audits.

Mitchell P. Kobelinski—formerly the director of the Export-Import Bank of the United States—became Administrator of SBA in February 1976. Mr. Kobelinski, the son of a Polish emigrant, was a small businessman himself; he takes credit for having started a new bank. Like any new administrator, Mr. Kobelinski saw the need for changes in SBA and vowed to make these in hopes of making opportunities better for small businessmen.

Continuing Controversy

On February 19, 1976, the Comptroller General ruled that SBA lacks the authority to purchase guaranteed loans from banks which have not complied with SBA regulations requiring banks to notify SBA of a borrower's delinquency within a prescribed period. The decision referred to the importance of early notification in order to provide management assistance to a borrower and thereby protect the Government's interests.

This regulation was changed on March 19, 1976. SBA is bound by the Comptroller General's decision as follows:

- Before purchasing a loan which went into default *before February 19, 1976*, SBA must determine that the Government has not been seriously harmed by a bank's failure to provide notice of delinquency *within 30 days*.
- SBA may not pay interest on a loan which went into default *after February 19*, unless the bank submits notice *within 45 days*.
- SBA may not purchase loans which went into default *after February 19*, unless the bank submits notice *within 90 days*.

On August 10, 1976, SBA again changed its delinquency notice regulations, this time to remove the forfeiture of the guarantee penalty for late reporting.

We reviewed SBA's decision to purchase 87 loans in 3 district offices and found that these offices have not been complying with implementing procedures for determining there was no harm to the government.

Conclusions

Contrary to general belief, GAO did not find total chaos in SBA field offices whereby employees by the hundreds were scheming with businesses and banks to make a fast dollar. The mere presence of GAO auditors in large numbers had to create some concern that resulted in changes in the attitudes of SBA employees towards their work and program decisionmaking. GAO's review did accomplish one thing the Congress wanted, and that was to shakeup SBA to force changes to improve the economy, efficiency, and effectiveness of SBA programs and activities.

Code For All Seasons

A person's moral code—or lack of one—will affect all phases of his or her life, occupational and social. The employee who lives by a fixed moral code, for example, will take it into consideration when making a business decision. Organizations have the responsibility to nurture moral decisions through the force of the example of their top managers and the managerial behavior they reward.

James L. Hayes
President and Chief Executive Officer
American Management Associations
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