



**STATEMENT OF PEGGY E. GUSTAFSON
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**BEFORE THE SMALL BUSINESS COMMITTEE,
UNITED STATES HOUSE OF REPRESENTATIVES**

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Introduction:

Chair Velazquez, Ranking Member Graves, and distinguished members of the Committee, thank you for giving the Small Business Administration (SBA) Office of Inspector General (OIG) the opportunity to discuss some of our current activities.

As you know, I am the head of an independent office established within SBA by statute to deter and detect waste, fraud, abuse and inefficiencies in SBA programs and operations. Every year, our staff of approximately 110 employees, which includes criminal investigators, auditors, and program analysts, conducts numerous criminal investigations to identify fraud and other wrongdoing throughout the country, and issues dozens of audit reports identifying weaknesses and deficiencies in SBA programs and operations. We also issue an annual report identifying what the OIG believes to be the most significant management challenges for the Agency. Since it would be impossible to discuss all of our current efforts in the time allotted, my testimony today will focus on several recent audits and reviews we have completed, several important indictments and convictions we have obtained through criminal investigations, and two new management challenges that the OIG introduced in October of 2009. To review our reports and learn more about my office's activities, I invite you to visit our website at www.sba.gov/ig.

Audits:

During the first 7 months of Fiscal Year (FY) 2010, the OIG issued 24 reports of audits and other reviews, containing 97 recommendations to SBA to promote efficiency and reduce waste. A number of these reports focused on the early identification of problem loans and Agency controls over programs financed by the American Recovery and Reinvestment Act (Recovery Act).

PCL/CDC Executive Compensation Report. In March of this year, the OIG issued a report on an audit of the underwriting practices and compliance of three of the largest Premier Certified Lenders (PCLs) in the CDC/504 Loan Program. This program is administered through cooperative agreements with non-profit organizations, called Certified Development Companies (CDCs), who work with private sector lenders to provide financing for real estate construction and other capital projects to eligible for-profit businesses. CDCs typically originate CDC/504 loans and forward them to SBA for approval; however, lenders granted PCL status are authorized to approve, close and service CDC/504 loans, with SBA reviewing the loan requests only for eligibility.

The OIG found that PCLs may not have used prudent practices in approving and disbursing 68 percent of the sampled loans, totaling nearly \$8.9 million, due to (1) poor loan underwriting and (2) eligibility or loan closing issues. Projecting the sample results to the universe of CDC/504 loans disbursed in FY 2008 by the three PCLs, we estimated that at least 572 loans, totaling nearly \$254.9 million in CDC/504 loan proceeds, had weaknesses in the underwriting process, eligibility determinations, or loan closing practices. The OIG estimated that a minimum of 183 of these loans, totaling \$56.4 million or more, were made to borrowers based on faulty analyses of whether they could repay the loans. We also estimated that loans totaling \$209 million involved problems in determining borrower eligibility and/or loan closing issues.

Further, our examination of CDC expenditures for executive compensation disclosed that eight CDCs paid more than 20 percent of their gross receipts towards executive compensation, one of which paid almost 44 percent. SBA regulations require that any excess funds remaining after payment of staff and overhead expenses be retained by the CDC as a reserve for future operations or for investment in other local economic activity; therefore, high compensation expenditures reduce the amount of funds for the reserve or for economic development activity.

The OIG recommended that SBA revise its procedures to clarify the analysis that CDCs should use to determine borrower repayment ability and borrower eligibility, and that SBA develop a process to ensure that corrective actions are taken in response to the Agency's onsite reviews if errors are identified with CDC underwriting and loan origination practices. The OIG also recommended that SBA consider establishing guidelines on the level of excess funds that CDCs should retain as a reserve or invest in other local economic and development activities.

Oversight of Recovery Act Programs. The Recovery Act, which was signed into law on February 17, 2009, contains a number of provisions intended to help SBA promote economic recovery for the nation's small businesses. These include reduced loan fees, higher guaranties, new SBA credit programs, secondary market incentives, and enhancements to current SBA programs. In order to provide enhanced levels of transparency and accountability, the Recovery Act and implementation guidance from the Office of Management and Budget require increased reporting and oversight to deter and detect fraud, waste, and abuse and ensure that program goals are met. Since the passage of the Recovery Act, the OIG has developed a Recovery Oversight Plan; created a separate group within the Auditing Division to oversee SBA Recovery Act Programs staffed with several temporary auditors, program analysts, and contractors; and issued 14 Recovery Oversight reports, identifying programmatic and other deficiencies.

Recently, the OIG completed an audit of loans made by lenders under the 7(a) program subject to SBA guaranties. Our review examined loans disbursed under the authority of the Act to determine whether they were originated and closed in compliance with SBA policies and procedures and to identify any evidence of suspicious activity. We reviewed a statistical sample of 30 Recovery Act loans that had been reviewed and approved by SBA and 30 loans that had been approved by lenders without SBA review. Our review identified deficiencies in 23 percent of the SBA-approved loans and 53 percent of the lender-approved loans. These problems included deficiencies in change of ownership transactions; the absence of borrower certifications as to whether they were engaged in a pattern or practice of hiring or recruiting illegal aliens for employment in the United States; and miscellaneous origination, closing and eligibility deficiencies. The inappropriate approval of these loans both increased the risk of loss to SBA should the loans default and reduced the availability of SBA loans to other eligible borrowers.

The OIG recommended that SBA improve lending program procedures and processes and provide additional training for lenders and Agency personnel involved in approving loans.

Procurement audits. We also recently completed several audits that raised concerns with SBA's procurement of goods and services. In February, we issued a report on an audit of SBA's annual certification regarding the quality of the Agency's acquisition data in the Federal Procurement Data System (FPDS). Data in FPDS must be accurate because it is used to report on government contracting actions, procurement trends, achievement of small business goals, and contract activity under the Recovery Act.

The OIG found that SBA certified to the accuracy of its FY 2008 contracting data, even though 92 percent of a random sample of contract actions reviewed by the OIG contained one or more inaccurate or incomplete data elements in FPDS. Most of the problems noted involved inaccurate data entries involving the size of the business, the North American Industrial Classification System code used to determine the size standard, type of award, the contractor's Data Universal Number System (DUNS) number, and location of contract performance. While SBA had developed a data quality plan for FY 2008, it did not fully implement the plan, which contributed to the errors identified by the OIG. Further, due to the volume of errors identified in FPDS, it appears that contracting personnel did not review FPDS data inputs to ensure they reflected accurate information, as required by the Federal Acquisition Regulations.

Our review of the accuracy of SBA's data from FY 2009 showed a higher rate of error in that approximately 97 percent of the contract actions sampled contained one or more inaccurate or incomplete data elements, indicating continued problems with reviews by SBA contracting personnel of data accuracy. However, overall, fewer problems were noted with each data element.

The OIG recommended that SBA either update its FY 2008 data quality plan or revise applicable procedures to include explicit steps to be taken to ensure data is reviewed for accuracy and completeness; conduct an independent review to ensure that the data quality plan or procedural requirements have been fully implemented; and ensure that contracting personnel are held accountable for the accuracy of FPDS data. In response to these recommendations, SBA stated that it would revise the data quality plan to include specific steps that must be taken to ensure data is properly reviewed for accuracy and completeness, and would provide training to contracting specialists/officers to reinforce this effort. In addition, the Agency awarded a contract to conduct an independent review of the FPDS data, and stated that it would revise annual performance plans for contracting specialists/officers to include a critical element associated with the accuracy and completeness of FPDS data.

In April, the OIG issued two additional reports raising concerns about SBA's procurement function. One report found that the current workforce involved in procurement actions is insufficient to effectively award, administer, and oversee Recovery Act contracts as well as other SBA contracts. Without adequate staff to perform contract execution and administration functions, and to oversee the contractors, the Agency is exposed to an increased risk of mismanagement, improper payments, fraud, waste, and abuse. In response to the OIG's recommendation, SBA agreed to implement a staffing solution.

In the second April report, we found that SBA did not report all non-competitive contract actions to Recovery.gov and mischaracterized some of the actions it did report. SBA agreed to take all of the recommended actions.

Criminal Investigations:

During the first six months of this fiscal year, OIG criminal investigations resulted in 51 indictments and 14 convictions. Potential recoveries and fines from these investigations totaled approximately \$16 million. Most of our investigations involve false statements by white collar criminals who seek to manipulate SBA programs for their personal gain. These cases involve: (1) fraud by borrowers who seek to obtain SBA-guaranteed loans or disaster loans; (2) fraud by company executives who seek to use programs set-aside for small, disadvantaged, or other minority-owned businesses to obtain government contracts; and (3) fraud by loan agents and/or lender employees who seek financial gain by orchestrating origination of multiple SBA-guaranteed loans based on falsified information.

Fraud by loan agents and other consultants involved in packaging or brokering 7(a) loans remains a significant problem. For many years, OIG investigations have revealed a pattern of fraud in the 7(a) business loan guaranty program by loan packagers and other for-fee agents. Although loan agents often serve a useful purpose by helping to connect borrowers with guaranteed lenders, unscrupulous agents have pursued multi-million dollar fraudulent schemes involving numerous loans. In the last decade, the OIG has obtained convictions and guilty pleas on numerous cases involving loan agent fraud, totaling in excess of \$260 million. In the last six months alone, fraudulent schemes involving loan agents have been identified in more than \$60 million of SBA loans.

For example, in February of this year, as a result of a joint investigation between the OIG and the Federal Bureau of Investigation (FBI), a 185-count indictment was unsealed charging eleven individuals in Missouri with various federal crimes for their involvement in a scheme involving at least 31 fraudulent business loans, totaling more than \$10 million. Among those charged were a former executive vice president and chief lending officer of a bank, a former SBA branch manager, and two business consultants that assisted in putting the loans together.

Also in February, as a result of a joint investigation between the OIG and the FBI, the former owner of an Illinois finance company was sentenced to 135 months imprisonment, five years supervised release, and ordered to pay restitution of \$7.4 million. He previously pled guilty to providing false bank entries, reports, and transactions. The investigation revealed his involvement in a scheme to provide fraudulent information to a lender and SBA to approve a \$1.35 million SBA-guaranteed loan to one of his companies. In addition to obtaining an SBA loan for himself, he brokered 46 SBA-guaranteed loans—totaling more than \$44 million—for others which he admitted involved the submission of false information to lenders.

The OIG also remains concerned about fraud in the 8(a) and HUBZone Programs and other contract preference programs for small and socio-economically disadvantaged businesses. Recent OIG audits and investigations, and recent reports from the Government Accountability Office show that ineligible companies continue to obtain set aside contracts and that non-disadvantaged individuals are exploiting these programs. Recently, an investigation by OIG working with other agencies led to the U.S. Air Force issuing indefinite suspensions to 19 companies and 4 individuals affiliated with a subsidiary of an Alaskan Native Corporation. The suspension actions stemmed from a multi-agency investigation of a conspiracy by the principals of the subsidiary and its numerous business entities to defraud the SBA and the U.S. Defense Department by failing to divulge business and ownership agreements in order to remain in the 8(a) program.

The OIG is also working with the Department of Justice to pursue criminal and civil False Claims Act prosecution against companies that the GAO identified as fraudulently obtaining contracts under the HUBZone and Service Disabled Veteran contracting programs. Additionally, we are working with SBA so the Agency can develop a more robust debarment and suspension program. The OIG believes the Agency needs to be more aggressive in pursuing debarments and other enforcement activity against companies that wrongfully obtain preferential contracting benefits.

Management Challenges:

As required by law, the OIG issues a report in October of every year identifying key management challenges for SBA. Our most recent report contained ten management challenges, including two new challenges dealing with: (1) improper payments in the Disaster and 7(a) Loan Programs, and (2) SBA's management of a major project to integrate its loan monitoring and financial management systems and move them to a new operating platform, known as the Loan Management and Accounting System (LMAS).

Improper Payments. Recent OIG audits of SBA's Disaster and 7(a) Loan Programs determined that the improper payment rates that SBA had reported for these programs were significantly understated. SBA estimated that improper payments in the Disaster Loan Program were about \$4.5 million, or 0.55 percent of the \$819.7 million in loans approved in FY 2007. However, the OIG reported that improper payments should be based on loan disbursements, not loan approvals, and estimated that the improper payment rate was at least 46 percent of \$3.4 billion in loans disbursed in 2007, or approximately \$1.5 billion. SBA also reported that the improper payment rate for the 7(a) Program was 0.53 percent for FY 2008. Of \$869 million in total outlays during that fiscal year, this would represent improper payments of \$4.6 million. However, the OIG estimated the rate to be 27 percent, or approximately \$234 million. We concluded that SBA's improper payment rates were understated because the Agency did not adequately review sampled loans, used flawed sampling methodologies, and did not accurately project review findings for both programs. Additionally, the SBA Office of Financial Assistance inappropriately overturned improper payments identified by reviewers. As a result, we added this as a management challenge for SBA, and identified recommended actions to improve SBA's reporting of improper payments, reduce the rate of improper payments, and increase recovery of improper payments.

Loan Management and Accounting System (LMAS) Project. In November 2005, SBA initiated the LMAS project, which is the latest in a series of attempts to update the Agency's Loan Accounting System (LAS) and migrate it off of SBA's mainframe. With an estimated cost of over \$250 million, LMAS is currently SBA's largest IT project. When completed, it will increase functionality, reduce data entry redundancies, and allow real-time updates and inquiries of loan data. Previous OIG reports have stressed the urgency of replacing the current loan accounting system, which presents substantial risk to SBA because it is dangerously close to the end of its expected useful life, relies on obsolete technology, contains major security vulnerabilities that cannot be addressed until the system is moved to a new operating platform, and is costly to operate.

Despite the cost and risks associated with the current system, SBA was unable to replace LAS prior to the expiration of the mainframe contract in February 2007, and subsequently extended the contract to 2012. SBA also revised its acquisition strategy in May 2008 from a

requirements-based approach to one that relies on a provider to design a system that best meets SBA's business objectives. Consequently, the project is still in the planning phase. Recent OIG reports have raised concerns about how the project was being managed. The OIG reported that the project did not comply with SBA's System Development Methodology in key quality assurance and earned value management areas, which threatened SBA's ability to control LMAS costs and quality. The OIG also found that SBA had not established either an enterprise-wide or project-level Quality Assurance function to ensure that project deliverables meet SBA's requirements and quality standards. Finally, the OIG reported that the project lacked a defined process for reviewing and accepting deliverables that met Agency standards.

Due to the importance of this project, the OIG added this as a management challenge for SBA, and provided recommended actions to improve SBA's acquisition process for the LMAS project. Although SBA has taken steps to address the OIG's concerns, more needs to be done.

Conclusion:

In conclusion, the OIG will continue to aggressively investigate fraud in SBA programs, and will continue to seek creative and effective ways to improve internal controls within SBA to limit waste and inefficiency within agency programs and operations.

Thank you for the opportunity to comment. I look forward to answering any questions that you may have.