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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

089607

APR 20 1976

Mr. John T. Wettach
Associate Administrator for
Finance and Investment
Small Business Administration

Dear Mr. Wettach:

On March 31, 1976, our report on our review of the section 502 local development company (LDC) loan program was issued to the Congress. That report contained our principal findings, conclusions, and recommendations on the LDC loan program. During our review, however, we identified other issues concerning the Small Business Administration's (SBA) management of the LDC loan program. This report discusses these issues which we believe warrant your attention.

As you know our review of the section 502 program was conducted under the Small Business Amendments of 1974 (Public Law 93-386) which directed the General Accounting Office to conduct a full scale audit of SBA. The primary objective of our review was to evaluate the program's effectiveness in fostering community economic development through loans to LDCs for the construction, conversion or expansion of plants for use by small businesses. We examined 95 loans--20 percent of the loans--made under this program during fiscal years 1970-74 by the SBA district offices in Atlanta, Los Angeles, Madison, and Minneapolis. A discussion of the additional issues follows.

LOAN PROCEEDS USED FOR
UNAUTHORIZED PURPOSES

At the four district offices, we identified 16 cases where loan funds were used for purposes not authorized by the loan agreement or by SBA's standard operating procedures or regulations.

In 10 cases examined loan funds were used for purposes not authorized in the loan agreement. These included:

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--Nine cases where funds authorized for construction were used in part to purchase plant equipment or office furnishings.

--One case where funds were used for construction of a building but substantial changes and additions were made to this building without obtaining SBA's approval.

Also according to SBA's standard operating procedure, section 502 funds cannot be used for debt payment or for working capital purposes. However, this occurred in one case involving a southeastern LDC which used construction funds for debt payment and to provide the small business with working capital.

For the remaining five cases section 502 funds were used to purchase businesses and/or equipment and none of the funds were used to construct, convert, or expand plants for use by the small businesses.

The approval actions by field offices violated SBA rules and regulations which require that section 502 funds be specifically used for plant construction, conversion, or expansion. Furthermore, SBA's standard operating procedures elaborate on this by stating that a change of ownership of a business must contain some new construction, conversion, or expansion.

The unauthorized use of loan funds appeared to have occurred because field officials responsible for approving the section 502 loans did not follow existing regulations and procedures nor adequately follow-up after approval was granted. These cases again illustrate that the program needs stronger supervision.

CRITERIA ON LDC CONTRIBUTION
IMPROPERLY USED BY ATLANTA DISTRICT OFFICE

SBA's regulation generally requires LDCs to provide 20 percent of the project investment. If the business to be assisted is in a small community, or the loan is to assist a business in a ghetto, target or high unemployment area, a lesser percentage of LDC participation, to a minimum of 10 percent, can be approved at the district office.

For 13 loans made by the Atlanta District Office, the LDC was permitted to provide less than 20 percent of the project financing called for in the regulations. The smaller percentage was being allowed because the Atlanta District Office:

--Routinely accepts a 10 percent funding of the project costs by minority-owned LDCs whether or not the business being assisted is in a ghetto, target or high unemployment area. For example, a project by a minority-owned LDC to assist a manufacturing business was approved for \$220,000. SBA provided \$154,000, an insurance company \$44,000, and the LDC \$22,000. There is a question whether the manufacturing business was located in a ghetto, target or high unemployment area. It appeared that the LDC came under the 20 percent requirement of SBA's regulation (\$44,000 contribution to the project funding). However in this case an SBA official advised us that SBA required only 10 percent participation because the LDC was incorporated by a minority group.

--Has based the LDC's contribution on the population of the city where the project is to be located rather than the operating area of the LDC. An LDC is defined as one organized under applicable State corporation law to operate in a specific area. SBA regulations allow 10 percent participation if the community where the LDC operates has a population of 5,500 or less people. For example, an LDC was incorporated to operate in a county of over 10,000 population which by SBA's regulation requires a 20 percent contribution. However, SBA only required the LDC to provide \$27,500 or 10 percent of a \$275,000 project. An SBA official said the 10 percent was required because the city's population was used rather than the LDC's area of operation. The remaining funds were provided by SBA and four banks in the amounts of \$137,500 and \$110,000 respectively.

To the extent that LDCs are allowed to contribute less than their reasonable part, SBA's contribution is increased, and a portion of the risk intended to be borne by the LDC is shifted to SBA.

FILE DOCUMENTATION INCOMPLETE

For 57 of the 95 loans, some portion of the required documentation was not included in the files. Missing documents included, but were not limited to the following: LDC and small business financial statements, LDC membership lists, and support for loan disbursement. We were not able to determine for all 57 cases whether the omission of documents was an administrative deficiency related to files maintenance, or in fact represented an incomplete analysis of the proposed loan, although we found individual instances in which both problems existed.

Most of the matters discussed in this letter are generally covered by SBA regulations and standard operating procedures intended to help assure the quality of loans made. The relatively large number of incidences for which these regulations were not fully implemented further indicates a need for stronger supervision by officials in the district offices.

We are aware that SBA is taking measures to correct the deficiencies disclosed in our report to the Congress. The matters discussed in this letter identifies additional opportunities for SBA to strengthen the controls over the program. We would appreciate your comments on the matters discussed herein.

Thank you for the cooperation given our representatives. We are enclosing as appendix I a listing of the loan numbers for the cases discussed in this report. Please contact us if you desire any further information on the matters discussed in this report.

Sincerely yours,


John Landicho
Associate Director

Enclosure

Listing of Loan Numbers for Cases
Discussed in Report

Description/Loan Number

Improper Population
Base Used

LD 806-255-00-03-GA
LD 176-709-10-01-GA
LD 785-731-00-00-GA
LD 785-710-00-07-GA
LD 100-313-10-00-GA
LDME 234-162-10-02-GA
LD 176-527-10-03-GA

Listing of Loan Numbers for Cases
Discussed in Report

Description/Loan Number

Construction Funds Used
for Equipment or Furnishings

LD 426-791-10-06-Mn
LD 831-523-00-00-Mn
LD 831-521-00-05-Mn
LD 426-787-10-07-Mn
LD 247-047-10-01-WI
LD 477-089-10-10-WI
LD 117-632-10-07-WI
LD 767-991-00-10-WI
LD 688-063-10-02-GA

Construction Changes
Without SBA Approval

LD 728-616-00-09-Mn

Construction Funds Used for Debt
Payment and Working Capital

LD 806-255-00-03-GA

No Construction, Conversion, Or Expansion

LD 207-329-10-02-Mn
LD 688-061-10-07-GA
LDME 116-607-10-00-CA
LD 253-621-10-08-CA
LDME 690-940-10-08-CA

Minority Owned LDCs

LDME 234-245-10-01-GA
LDME 234-161-10-10-GA
LDME 823-673-00-10-GA
LDME 806-347-00-05-GA
LDME 777-840-00-05-GA
LDME 806-209-00-07-GA