

THE USE OF PROCEEDS FROM GULF COAST DISASTER LOANS

Report Number: 09-06
Date Issued: January 15, 2009

**Prepared by the
Office of Inspector General
U. S. Small Business Administration**



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Steven Smith, Chief, Executive Office of Disaster
Strategic Planning and Operations

Date: January 15, 2009

Herbert L. Mitchell, Associate Administrator
Office of Disaster Assistance
/s/ original signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of the Use of Proceeds from Gulf Coast Disaster Loans, Report No. 09-06

This final report summarizes the results of our audit of *the Use of Proceeds from Gulf Coast Hurricane Disaster Loans*. As of November 2008, approximately \$6.6 billion in loans had been disbursed to assist Gulf Coast disaster victims. The objectives of the audit were to determine whether the Office of Disaster Assistance (ODA) has adequate controls in place to reasonably ensure that the proper documents were secured from borrowers and adequately reviewed before making subsequent¹ loan disbursements to disaster victims.

To determine whether ODA had adequate controls to secure the proper documents before distributing additional loan proceeds, we reviewed Borrower's Progress Certification forms and other supporting documents on 127 of 4,252 statistically sampled loans that were disbursed between October 2005 and October 2007. We compared these documents to requirements established in the Loan Authorization and Agreement for each loan, and Standard Operating Procedures (SOP) for the Program. To determine whether the Small Business Administration (SBA) adequately reviewed the expenditure of prior proceeds, we reviewed Borrower's Progress Certifications and entries in SBA's Disaster Credit Management System (DCMS). We also interviewed ODA staff assigned to the Fort Worth Loan Processing and Distribution Center (PDC), including attorneys within the Accounts Department, to determine the process followed for subsequent disbursement reviews. Additionally, we reviewed policy revisions relating to the requirements for subsequent disbursements.

¹ Throughout the report we refer to subsequent disbursements, which include those disbursements made after the initial distribution of loan proceeds.

Finally, we contacted contractors associated with 31 loans to verify that they had completed work as claimed by borrowers, and visited selected borrowers' homes to inspect progress made on repairs.

We conducted the audit from December 2007 to August 2008, in accordance with *Government Auditing Standards* as prescribed by the Comptroller General of the United States.

BACKGROUND

In 2005, Gulf Coast Hurricanes Katrina, Rita and Wilma caused more than \$118 billion in estimated property damage. Many of the disaster victims of these hurricanes were eligible for SBA disaster loans. Before SBA can disburse funds, disaster loan applications must undergo various stages of processing. Real estate physical disaster loans over \$10,000 and economic injury loans over \$5,000 must be secured with collateral. Initial disbursements are made to borrowers in these amounts. Subsequent disbursements can be made to borrowers, as requested, based on support for how prior disbursements were used. Generally, secured loans are disbursed in stages that correspond with the borrowers' needs and how they spent prior disbursements.

The Borrower's Progress Certification (SBA Form 1366) requires the borrower to certify that he/she used initial loan funds in accordance with the Loan Authorization and Agreement (SBA Form 1391). The form requires borrowers to itemize expenditures made with the loan proceeds and to attach receipts as proof of expenditures.² Prior to 1994, ODA was required to perform receipt reviews for all subsequent disbursement requests after \$10,000 had been disbursed to borrowers on both unsecured and secured physical loans to ensure the proper use of proceeds before authorizing further disbursements.

In 1994, the threshold for secured loans was temporarily raised to \$25,000, and subsequently made permanent in SOP 30 50 4, *Disaster Assistance Program*, which allowed subsequent disbursements up to \$25,000 upon receipt of the SBA 1366 from the borrower demonstrating how 80 percent of prior proceeds had been used. These requirements were important controls to ensure repair work was being performed and to deter fraud in the disaster loan program. However, in March 2006, ODA again changed its requirements for reviews of borrower expenditures by requiring evidence of how previously disbursements had been used only when the aggregate amount of funds disbursed would exceed \$50,000. Additionally, case workers could use their discretion in determining which

² Borrowers are not required to provide proof of expenditures on items costing less than \$1,000.

documents could serve as evidence of how prior proceeds were used. In November 2007, ODA made the new threshold permanent in version 6 of its SOP.

Case workers in the Accounts Department at the PDC are responsible for reviewing subsequent disbursement requests to ensure borrower receipts support their use of prior loan proceeds. If more detailed reviews are needed, the Accounts Department can request that the Loss Verification Department conduct them. Despite which group conducts the reviews, all disbursements are ultimately approved by the Accounts Department.

RESULTS IN BRIEF

ODA did not have adequate controls to ensure that proper borrower certifications and receipts were submitted with requests for subsequent disbursements. Based on our sample, 69 of the 127, or 54 percent, of the disbursements were made without proper documents and certifications. Rather, ODA processed disbursements with incomplete and unsigned certifications from borrowers. For example, case workers relied on vendor quotes and contractor proposals as evidence of work completed, receipts of questionable authenticity, and in many instances, no supporting documentation.

This occurred because ODA made procedural changes that eliminated from review borrower documentation supporting how prior proceeds were used for disbursements under \$50,000 on secured loans and provided ODA case workers with discretion over which documents to review in determining whether prior proceeds had been used appropriately when disbursing over \$50,000 in aggregate. Previously, case workers were required to review the Borrower's Progress Certification forms and accompanying receipts. As a result, ODA processed questionable claims involving potential fraud. Based on several smaller samples, the OIG identified 4 potential false statements from borrowers and one instance where a damaged home was not brought back to its original condition, as required, with the use of loan proceeds.

Through discussions with vendors associated with 31 of the disbursements, we determined that ODA accepted inadequate support for \$350,000 in expenditures on four loans that, upon further analysis, proved to be false claims made by the borrowers. Contractors hired to make the repairs on the affected properties told us they had not completed the work claimed by the borrowers. Although the support submitted by the borrowers was questionable, case workers did not follow up with contractors and/or inspect the damaged property to verify whether the proceeds were used as claimed. Further, because ODA had not secured borrower

certifications for these expenditures, the Agency may have weakened its ability to pursue criminal penalties as well as civil remedies from these borrowers under the False Claims Act.

ODA officials told us that the review requirements were changed to expedite the disbursement process and to make it easier for borrowers to get subsequent disbursements. However, in changing the requirements, the Associate Administrator for Disaster Assistance acknowledged that his office did not inform borrowers of the changes in requirements for obtaining subsequent disbursements. Consequently, borrowers continued to submit certifications and receipts, and although these submissions were incomplete or inaccurate, they were accepted by SBA, but not reviewed. Had ODA reviewed these documents it may have noted, as the OIG did, that some of the documentation was questionable or false.

Further, while we acknowledge that ODA may have been unable to review every disbursement given the large volume of Gulf Coast loans, at a minimum, we believe it should have reviewed a sample of disbursements to obtain assurance that funds were spent in accordance with borrowers' loan agreements, and should have automatically rejected unsigned forms from borrowers. Further, because the change in review requirements was implemented through an amendment to SBA's SOP, this policy is in effect for all current and future loans. Therefore, the problems noted in the audit will likely persist until the procedure is strengthened.

Finally, while ODA officials told us that reviews had been completed for all disbursements over \$50,000 in aggregate, we could not confirm whether reviews had actually been made because individuals conducting the reviews did not always sign the Borrower Progress Certification forms or document their reviews in DCMS. Based on DCMS entries, we confirmed that loss verifiers reviewed 33 of the 127 disbursements. However, the remaining 94 disbursements were reviewed by ODA case workers who did not document their reviews in DCMS or on the certification forms, with 30 of these that required reviews. Program officials told us that the SOP does not require reviewers to sign these forms, which would provide evidence of reviews. Further, ODA did not require that site visits to damaged properties take place, in cases where questionable receipts were submitted as evidence of the use of loan proceeds.

We recommended that ODA reject unsigned and/or incomplete Borrower's Progress Certification forms. Further, because the "use of proceeds" review is an important control to detect fraudulent claims and to make sure repairs are being made, we also recommended that ODA revise its SOP to require either a review of all, or a sample of, disbursements over \$10,000 to provide assurance that borrowers used prior disbursements in accordance with their Loan Authorization and Agreement. The SOP should also require that the Borrower's Progress

Certification forms and supporting receipts be reviewed and the certification be signed by ODA to document that a review was made. Finally, we recommended that ODA re-emphasize with reviewers that they should conduct site visits or contact vendors to confirm expenditures when questionable contractor receipts are submitted by borrowers.

All recommendations were agreed to by ODA. We request written comments to our office identifying planned actions and target dates.

RESULTS

54 Percent of Borrowers Did Not Adequately Disclose How Loan Proceeds Were Used or Certify to Their Expenditures

Our review of 127 disbursements disclosed that ODA had not secured adequate supporting documentation for 69, or 54 percent, of the disbursements, prior to distributing subsequent loan proceeds. These disbursements totaled \$10.1 million. Of the 69, 13 were over \$50,000 in aggregate, although reviewed under the new requirements, were disbursed without adequate evidence supporting how prior proceeds were spent. The other 56 disbursements were under \$50,000 in aggregate. While ODA requires borrowers to send in receipts and certify how proceeds were used, these were not reviewed by ODA and hence a majority of them were accepted even though they were incomplete.

In 43 of the 69 instances, borrowers submitted vendor quotes and contractor proposals as evidence of work completed, receipts of questionable authenticity, and incomplete and unsigned borrower certifications of how loan funds were spent. In the remaining 26 instances, disbursements were made to individuals who had provided no supporting documentation. For example:

- One borrower received \$1.5 million without any supporting receipts. The only documentation provided was a letter from the contractor, stating that he was paid by the borrower for work he had performed. However, the letter did not identify how much of the completed work was associated with the SBA loan.
- ODA disbursed \$850,000 to a borrower based solely on invoices provided by vendors. However, the borrower did not submit receipts to demonstrate that he had actually paid the vendors.
- One borrower received \$1.5 million by submitting primarily cancelled checks that he wrote to himself for cash, which predated his SBA loan.

- One borrower received \$256,517 based on a vendor quote that was used as evidence of work completed. Upon contacting the vendor to verify that the proceeds were used for work on the borrower's home, we learned that the vendor only billed the borrower for approximately \$1,200.
- Another borrower received \$361,600, but submitted only a blank and unsigned Borrower's Progress Certification form with no receipts or any other documentation supporting his use of the loan proceeds.
- ODA disbursed \$47,100 to another borrower, who submitted only an estimate for needed repair/reconstruction work. Our site visit to the borrower's damaged property revealed that the borrower did not use the proceeds to bring his home back to pre-disaster condition, as required by his Loan Authorization and Agreement. Rather, the borrower had only renovated the garage, while the rest of the house remained unfinished.

Of the missing documents, the Borrower's Progress Certification forms and accompanying receipts are the most critical evidence for determining borrower use of proceeds. The certification form is the borrower's representation of how he/she spent prior loan funds. Borrowers are asked to list on the form 80 percent of the expenditures they made with the SBA loan proceeds and to attach receipts supporting those expenditures. Should SBA later discover that the information provided on the forms is false; the certification can then be used as evidence of a false claim for purposes of pursuing either criminal penalties or civil remedies under the False Claims Act. Under the Act, any person who knowingly presents to the United States Government a false or fraudulent claim for approval is liable to the U.S. Government for civil penalties of not less than \$5,000 and not more than \$10,000, plus three times the amount of damages the Government sustained because of the act of that person.

ODA Changed Documentation Requirements, Potentially Impacting Its Ability to Ensure Proceeds Are Used Properly and to Pursue Criminal and Civil Remedies for Fraudulent Claims

In March 2006, ODA temporarily changed its review requirement to those disbursements over \$50,000 in aggregate, and in November 2007, ODA reissued the SOP, making the change permanent. However, according to the Associate Administrator for Disaster Assistance, borrowers were not notified of this change and continued to submit certifications and receipts with requests for subsequent disbursements below \$50,000. ODA accepted these submissions, but did not review them as only aggregate disbursements exceeding \$50,000 require a review of prior proceeds use.

PDC officials told us that their intention in changing the review requirement was to expedite the disbursement process and make it easier for borrowers to get subsequent disbursements. They acknowledged the risk involved in not verifying disbursements, but stated, “it was a trade-off they had to live with, realizing that the new procedures would de-emphasize the importance of the Borrower’s Progress Certification form.” While ODA may have been unable to timely review every disbursement given the large volume of loans processed for the Gulf Coast hurricanes, at a minimum, we believe ODA should have reviewed a sample of subsequent disbursements between \$10,000 and \$50,000 to provide assurance that borrowers were generally using their loan funds as intended.

Further, we believe that when ODA first raised the threshold to \$25,000 in 1994, its basic policy of controlled disbursements did not change. In its 1994 memorandum, ODA states that because it was criticized in the past for borrowers using their loan funds for ineligible purposes, their intent was to control disbursements as funds are expended or committed in accordance with the loan agreement. Consequently, we do not believe that waiving prior proceed reviews for all disbursements under \$50,000 is consistent with ODA’s prior guidance, or that a permanent change in the review requirements is justified. In recent discussions with ODA, it agreed to review a sample of disbursements exceeding \$10,000.

Finally, by allowing case workers the freedom to choose the supporting documentation upon which to base their reviews, many disbursements were made without adequate or any documentation showing how prior proceeds were spent.

ODA Disbursed Funds Based on Questionable Claims Made by Four Borrowers

Of the 69 borrowers who did not sign or adequately complete the Borrower’s Progress Certification forms, four made false claims about how they spent prior loan proceeds. SBA made subsequent disbursements to these borrowers based on vendor quotes, and one proposal for repair and reconstruction work that had not been completed. Specifically:

- One borrower submitted a vendor quote for \$256,517 in electrical work. However, the vendor who performed the work told us that he had completed only approximately \$1,200 of the work. Although the quote was submitted on company letterhead and signed both by the borrower and vendor, the borrower provided no documents or receipts to support this quote for completed work.

- A second borrower submitted a \$50,000 vendor quote for a room addition, roof, ceiling, chimney, and siding repair as evidence of work he claimed had been completed on his home. However, the vendor whom the borrower claimed had performed the work denied completing any work for the borrower. The borrower had transmitted the quote to SBA from the vendor's fax machine, to make the quote appear to be an official document authorized by the vendor. However, the vendor told us that he was not aware that the borrower had used his fax to transmit the quote to SBA.
- A third borrower submitted a contractor proposal for \$26,400 in repair work for drywall; the replacement of windows, doors, and trim; and plumbing and siding work that was prepared on a standard form such as could be purchased from an office supply store, rather than on the contractor's official letterhead. No other supporting documents or actual receipts for work completed were provided. The contractor, when contacted, told us that he completed only about \$1,500 worth of work on the property.
- Finally, a fourth borrower submitted a vendor quote for \$13,551 for work that the borrower claimed had been completed on his home. However, the vendor told us that he had not completed any work for the borrower.

ODA inappropriately accepted vendor quotes and proposals as evidence of work performed and did not follow-up with contractors to confirm whether the work had been performed. Additionally, ODA did not make site visits to the properties to determine whether borrowers had used their loan proceeds in accordance with their Loan Authorization and Agreements. [FOIA ex. 7(A)]

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ODA Reviews of Prior Disbursements Were Generally Not Documented

According to information in DCMS, loss verifiers reviewed 33 of the 127 disbursements, and documented their reviews in DCMS. However, the remaining 94 disbursements were reviewed by ODA case workers who did not document their reviews in DCMS or on the certification forms, with 30 of these that required reviews. ODA employees stated that they had performed reviews, although they were unaware of any language in the current SOP requiring them to sign the forms, which would provide evidence that reviews were conducted.

ODA employees are not required to sign the Borrower's Progress Certification form prior to making a subsequent disbursement. Further, because ODA no longer

requires that case workers use this form in conducting their reviews, it has no way of determining whether a review was conducted.

RECOMMENDATIONS

We recommend that the Chief, Executive Office of Disaster Strategic Planning and Operations direct the Associate Administrator for Disaster Assistance to:

1. Reject Borrower's Progress Certification forms/claims that are unsigned and/or incomplete without making subsequent disbursements.
2. Revise SOP 50 30 6, to require that a review be conducted of how prior proceeds were used on a sample of, disbursements exceeding \$10,000 to provide the Agency with some assurance that borrowers used prior proceeds appropriately. The SOP should also require that the Borrower's Progress Certification form and supporting receipts be reviewed and signed by ODA to document that a review was made.
3. Require site visits or follow-up with vendors when questionable invoices, including quotes for large dollar amounts with no receipts, unsigned certifications or vendor quotes, inadequate certifications, or no official documents, are submitted to verify the accuracy of what the borrower has reported.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On October 22, 2008, we provided a draft of the report to ODA for comment. On December 17, 2008, ODA submitted its formal comments, which are contained in their entirety in Appendix I. On December 18, 2008, the Chief of the Executive Office of Disaster Strategic Planning and Operations submitted his endorsement of ODA's comments, which is provided in Appendix II. ODA concurred with all three of the report recommendations, but disagreed with the report's description of the disbursement thresholds and its characterization of the timing of and reasons for the changes to the thresholds. ODA's specific comments and the OIG's evaluation of them are summarized below.

Management Comments

Management commented that the report did not take into consideration that ODA had legitimate reasons for changing its policy. Namely, ODA's decision to increase the threshold to \$50,000 was to ensure that borrowers had adequate funds in the rebuilding process as many contractors would not commit to a major

construction project without a substantial down payment on the contract. Management also commented that the report was incorrect in stating that:

- SOP 30 50 5 required receipt reviews for subsequent disbursements after \$10,000 was disbursed.
- ODA went from a \$10,000 disbursement level without receipts directly to a \$50,000 level in response to the Gulf Coast storms.
- A borrower is required to attach receipts as proof of expenditures for items costing less than \$1,000.
- Borrowers were still required to submit certifications and receipts with requests for subsequent disbursements after ODA increased the disbursement threshold to \$50,000.

OIG Response

The report does not comment on whether management inappropriately raised the disbursement threshold. Instead, the report focuses on ODA's responsibility to ensure that prior disbursements have been used appropriately before disbursing additional funds, especially because in its 1994 memorandum ODA acknowledged that it had been criticized in the past when borrowers used their proceeds for ineligible purposes. We believe ODA has a fiduciary obligation to the taxpayers to ensure that loan funds are used as intended.

Regarding the report's characterization of the disbursement threshold, we believe the report is correct in stating that the original threshold was \$10,000. This threshold is still in effect for unsecured loans, but has been increased to \$50,000 for secured loans. To support our interpretation, we have provided in Appendix III excerpts from ODA's policy memoranda and SOPs establishing these thresholds. Further, as shown in Appendix III, we correctly stated the requirement in SOP 30 50 5 that receipt reviews be made for subsequent disbursements above \$10,000 on unsecured loans, and have added language characterizing review requirements for subsequent disbursements on secured loans.

We agree that ODA is correct in stating that the threshold did not jump directly from \$10,000 to \$50,000. We have added language to show that the threshold for secured loans increased incrementally, from \$10,000 to \$25,000 in 1994, and then to \$50,000 in 2006.

To clarify that borrowers are not required to attach receipts as proof of expenditures for items costing less than \$1,000, we added a footnote stating that

borrowers are not required to provide proof of expenditures on items costing less than \$1,000.

With respect to whether borrowers were required to submit certifications and receipts with requests for subsequent disbursements, after ODA increased the disbursement threshold to \$50,000, SOP 50 30 6 states that prior to any subsequent disbursement where the funds disbursed would, in aggregate, exceed \$50,000, SBA must have evidence that funds previously disbursed have been used in accordance with the loan agreement. This evidence may include the borrower's progress certification, paid invoices, and a joint payee check, among other documents. The SOP language is provided in Appendix IV.

Finally, ODA agreed with all three recommendations and proposed an acceptable alternative to recommendation 3. However, it did not indicate a target date and specific actions it plans to take on recommendation 1, or provide target dates for completing actions proposed on recommendations 2 and 3. Consequently, to be fully responsive to the recommendations, we request that ODA provide an additional response within 15 days of the final report date.

ACTIONS REQUIRED

We request that you submit written comments identifying (1) the actions you plan to take to implement recommendation 1 and the target date for completion of such action, and (2) target completion dates for recommendations 2 and 3. We would appreciate receiving your additional comments within 15 days of the final report date.

We appreciate the courtesies and cooperation of the Office of Associate Administrator for Disaster Assistance and DCMS Operations Center representatives during the audit. If you have any questions concerning this report, please call me at (202) 205-[FOIA ex. 2] or Pamela Steele-Nelson, Director, Disaster Assistance Group, at (202) 205-[FOIA ex. 2].

APPENDIX I. AGENCY RESPONSE

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



Date: DEC 17 2008
To: Debra S. Ritt
Assistant Inspector General for Auditing
Thru: Steven G. Smith [FOIA (b) (6)] (SEE ATTACHMENT)
Chief, BODSPO.
From: Herbert L. Mitchell [FOIA (b) (6)]
Associate Administrator
Office of Disaster Assistance
Subject: OIG Draft Report - The Use of Proceeds from Gulf Coast Disaster Loans
(Project No. 8301)

We have reviewed the draft audit report regarding the Use of Proceeds from Gulf Coast Disaster Loans. The objectives of this audit were to determine whether the Office of Disaster Assistance (ODA) has adequate controls in place to reasonably ensure that the proper documents are secured from the borrowers and adequately reviewed before making subsequent loan disbursements to disaster victims. Thank you for the opportunity to respond to the Draft Report.

The mission of the SBA Disaster Program is to help disaster victims recover from disasters and rebuild their lives by providing affordable and timely financial assistance to homeowners, renters and businesses. Consistent with the mission to provide affordable and expedient disaster assistance, in balance with the need to safeguard taxpayer funds, ODA has receipting requirements that are tied to disbursement thresholds. In addition, the Loan Authorization & Agreement requires the borrowers to retain receipts for a period of three years, allowing for the possibility of detailed audits by proper elements of the government.

I. Disbursement Thresholds

As discussed with the OIG during the exit interview, the Draft Report is incorrect in its description of the disbursement thresholds. Specifically, the report states that "based on SOP 50 30 5, Disaster Assistance Program, ODA was originally required to perform receipt reviews for all subsequent disbursement requests after \$10,000 had been disbursed to borrowers..." As a result, the Draft Report implies that during the response

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to the Gulf Coast storms, ODA modified the requirements for receipt review from \$10,000 to \$50,000. Consequently, based on this incorrect statement, the OIG determined that "this change resulted in no review of over \$74 million of the \$349 million disbursed between October 2005 and October 2007 that would have been subject to review under the original SOP requirements." Based on the above, both parties agreed that it was important to outline the proper disbursement guidelines in place for the validity of the audit findings.

As a matter of record, prior to 1994 ODA receipt review requirements were set at the \$10,000 threshold. In 1994, Area Director's Memo 94-41 raised the requirement to \$25,000 which was incorporated into a revision of SOP 50 30 3. SOP 50 30 5, which is available to the general public online, clearly states that the requirement was \$25,000. After the Gulf Coast Hurricanes, ODA approved more than 160,000 disaster loans to help homeowners, renters and businesses to return to pre-disaster condition. As a result of the extraordinary and catastrophic nature of the Gulf Coast Hurricanes, ODA implemented a pilot program in March of 2006, allowing the disbursement of \$50,000 without the review of receipts. While borrowers were still required to maintain receipts to document the use of loan funds, this temporary policy change did not require the review of receipts prior to the disbursement of \$50,000. On June 19, 2007, the disaster loan making SOP permanently changed the receipt requirements review threshold from \$25,000 to \$50,000. (See Central Office Memos 06-14, 06-43, 07-19, and 07-30).

II. Pilot and Permanent Change to Disbursement Thresholds

We believe that the OIG Draft Report discounts the process involved in both the pilot and the permanent change when it states that ODA relaxed its requirements for reviews of borrower expenditures when faced with processing the large volume of loans associated with the Gulf Coast Hurricanes. As early as 2004, as a result of the increased damage assessments after the hurricane season, we were reassessing our policy to determine whether the initial \$25,000 dollar disbursement threshold was in line with normal inflationary factors, meaning that the cost of projects changed—they were often more expensive and it took more funds to get the project moving. After the Gulf Coast Hurricanes, as we faced the realities and expectations for assistance, \$25,000 disbursements were not deemed sufficient to meet expectations, and therefore we implemented the pilot program allowing the disbursement of \$50,000. This was due in part to the situation in the Gulf coast region which showed that many contractors would not even commit to a major construction project unless the borrower made a substantial down payment on the contract, often exceeding ODA's \$25,000 disbursement limits. The reasons and rationales that held for Gulf Coast Hurricanes were deemed adequate to have one unified policy for all future disasters, and the policy permanently incorporated into SOP 50 30 6. Your characterization that ODA relaxed the requirements fails to take into consideration the legitimate reasons for making this policy change to ensure that borrowers had adequate funds to begin the rebuilding process. It also fails to recognize that ODA was already reassessing our disbursement threshold prior to the Gulf Coast Hurricanes.

While the PDC was acting in accordance with SOP 50 30 6 and Central Office Directives (See Central Office Memos 06-14, 06-43, 07-19, and 07-30), we understand the underlying objective of the audit and recognize the need for further guidance and clarification to our policy to further ensure the appropriate use of funds.

III. Draft Report - Comments

Page 2, Second Paragraph

"The Borrower's Progress Certification (SBA Form 1366)... required borrowers to itemized expenditures made with the loan proceeds and to attach receipts as proof of expenditures. Based on SOP 50 30 5, Disaster Assistance Program, ODA was originally required to perform receipt reviews for all subsequent disbursement requests after \$10,000 had been disbursed to borrowers for estimated property damage to ensure the proper use of proceeds before authorizing further disbursements."

The report incorrectly states the requirements outlined in SBA Form 1366. Form 1366 does not require a borrower to attach receipts as proof of expenditure for items "costing less than \$1,000 each."

The report incorrectly states that SOP 50 30 5 required receipt reviews for subsequent disbursements after \$10,000 has been disbursed. This statement is incorrect since in 1994, Area Director's Memo 94-41 raised the requirement to \$25,000, which was incorporated into a revision of SOP 50 30 3. The requirement was \$25,000 when 50 30 5 was issued. The report incorrectly states that ODA went from a \$10,000 disbursement level without receipts directly to a \$50,000 level in response to the Gulf Storms. This is a factual error which is verifiable and should be corrected.

Bottom of Page 2 and continuing on Page 3

"In March 2006, ODA temporarily changed the ODA's review requirement to those disbursements over \$50,000 in aggregate, and in November 2007, ODA reissued the SOP, making the change permanent, and as a result borrowers were still required to submit certifications and receipts with requests for subsequent disbursements, but ODA is not required to review them unless aggregate disbursements will exceed \$50,000. Consequently, this change resulted in no review of over \$74 million of the \$349 million disbursed between October 2005 and October of 2007 that would have been subject to review under the original SOP requirements."

The report incorrectly states that borrowers were "still required to submit certifications and receipts..." is erroneous as neither the SOP nor ODA directives require borrowers to submit receipts if a loan did not exceed \$50,000. See, for example, SOP 50 30 6 paragraph 95 (c).

Given the factual error in the previous paragraph, ODA has to assume that the statement that "this change resulted in no review of over \$74 million of the \$349 million disbursed between October 2005 and October of 2007" is based upon the erroneously presumed

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change of the receipting level from \$10,000 to \$50,000 rather than from \$25,000 to \$50,000 as is factually correct. No basis for this calculation is otherwise provided.

OIG RECOMMENDATIONS AND AGENCY RESPONSE

1. *Reject Borrower's Progress Certification forms/claims that are unsigned and/or incomplete without making subsequent disbursements.*

ODA Response: ODA agrees with this recommendation.

2. *Revise SOP 50 30 6. to require that a review be conducted of how prior proceeds were used either all, or a sample of, disbursements exceeding \$10,000 to provide the Agency with some assurance that borrowers used prior proceeds appropriately. The SOP should also require that the Borrower's Progress Certification form and supporting receipts be reviewed and signed by ODA to document that a review was made.*

ODA Response: ODA agrees with this recommendation. ODA agrees to review a sample of files to provide the Agency with some assurance that borrowers used prior proceeds appropriately. We also agree that the Borrower's Progress Certification form and supporting receipts will be reviewed. However, since the files are viewed electronically, ODA staff will be required to put notations in the comments section certifying that they have reviewed the Borrower's Progress Certification, including any receipts submitted, in lieu of signing the actual document.

3. *Require site visits or follow-up with vendors when questionable invoices, including quotes for large dollar amounts with no receipts, unsigned certifications or vendor quotes, inadequate certifications, or no official documents, are submitted to verify the accuracy of what the borrower has reported.*

ODA Response: ODA agrees with this recommendation. Rather than require these specific actions in every instance, ODA believes that it may be appropriate to request additional information, clarification or return the documents as possible alternatives. In any event ODA will develop policy guidance and procedures on how to deal with questionable documentation in such instances.

ODA:Lopez-Suarez:112508:S:OIG Audit 8301 - ODA Response Use of Proceeds
CC: Subject Reading Lopez-Suarez

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Date: June 3, 1994

To: All Area Directors, # 94-41

From: Associate Administrator
for Disaster Assistance

Subject: Disbursement Amounts: Revision of #86-29 and 92-29

Under the law disaster loans may only be used to repair, replace or rehabilitate damaged property. In addition, the law provides for a civil penalty of 150 percent of the loan for wrongful misapplication of the proceeds of a disaster loan. For these reasons, and because disaster loans are highly subsidized, we use controlled disbursements, that is we disburse the funds as they are expended or committed by the borrower in accordance with the loan authorization and agreement. In the past, we have been criticized when we have not followed this procedure because borrowers have used the funds for ineligible purposes or placed the funds in CDs which gave the borrower a higher return than the interest the borrower had to pay SBA.

The basic policy is unchanged, that is where, as in many cases, the borrower's need is expressed or obvious, that should govern disbursement. Thus if the borrower has had interim financing, and has completed the repairs or replacements, the amount necessary to repay the interim financing may be disbursed in one amount (joint payee check) as soon as the loan closing requirements have been satisfied. Similarly, where refinancing is involved, the entire amount of the refinancing may be disbursed as soon as the loan closing requirements have been satisfied. Also, if there is a firm contract for real estate repairs or construction which calls for payments on a specific schedule, loan disbursements should be made in accordance with that schedule, using joint payee checks and verification review prior to disbursement, as appropriate. Similarly, where other facts establish the approximate amount of immediate need, they should be used as the basis for determining the amount of disbursement. The purpose of this memo is to revise the dollar amount of disbursements when circumstances in the file do not dictate the appropriate disbursement schedule.

Where the borrower's need is not expressed, is not obvious from the facts of the case, or does not become apparent during loan closing or subsequently, the following schedule should be followed:

1. **Unsecured loans** (Home and physical business loans not exceeding \$10,000 and EIDL not exceeding \$5,000.) Disburse fully upon the return of the note, loan authorization, evidence of flood insurance where appropriate, and other necessary closing documents. In some situations additional conditions have to be satisfied even though the loan is uncollateralized. This includes such things as obtaining an assignment of potential insurance proceeds to avoid duplication, notice of disqualifications, waivers of eligibility, etc.

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2 (a). All secured physical loss loans. When the collateral conditions have been perfected, the initial disbursement may be up to \$25,000. Subsequent disbursement may be made in amounts up to \$25,000 each after the borrower has submitted Form 1366 covering at least 80 percent of the prior disbursements. The amount of the last disbursement may be increased by up to \$2,500 if not doing so would leave an undisbursed amount of less than \$2,500 (i.e., if the loan is for \$52,000, it can be disbursed in 2 installments of \$25,000 and \$27,000 respectively).

2 (b). In disbursement of the real estate portion, contact with the borrower should be maintained by legal, processing, or verification, as appropriate, to ascertain an appropriate disbursement schedule. In case of do-it-yourself repairs, be sure the borrower's schedule is reasonable (i.e., on larger jobs, it may be unusual to order and pay for all materials at the start of the job). Remember that subsequent disbursements require proper use of the Form 1366 (or 300 inspection) for at least 80 percent of the disbursed funds.

3. Secured EIDL. EIDLs should continue to be disbursed as soon as closing requirements are met consistent with the guidance in the "Use of Proceeds" section of the loan authorization and agreement.

(signed) Bernard Kulik

Bernard Kulik

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cc: Subject Reading Kulik ODA Staff

APPENDIX II. AGENCY RESPONSE

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



Date: *DEC 17 2008*
To: Debra S. Ritt
Assistant Inspector General for Auditing
From: Steven G. Smith [FOIA ex. 6]
Chief, EODSPO
Subject: OIG Draft Report – The Use of Proceeds from Gulf Coast Disaster Loans
(Project No. 8301)

I concur with ODA's comments on this report. As discussed during the exit brief with OIG and ODA which I attended, it is important to better address in the final report the issue of receipt reviews. The draft report currently does not do this well and I recommend it be corrected rather than published with a dissenting EODSPO / ODA response.

Much of the issue of receipt review hinges on management changes which were made to the SOP. These changes were staffed, coordinated, appropriately published, and made at authorized levels within SBA. SOP changes will change operating results, and program performance in compliance with these SOP changes is not an operating deficiency as could be implied by the report statement that there was no review of over \$74 million of \$349 million disbursed. An OIG recommendation for senior SBA management review of any SOP change of concern would seem a more appropriate OIG recommendation.

We would like the opportunity to further discuss and review with OIG how this issue will be presented in the final report.

Copy To: Herb Mitchell
AA / ODA

ODA:Lopez-Suarez:112508:S:OIG Audit 8301 - Memo from EODSPO
CC: Subject Reading Lopez-Suarez

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APPENDIX III. EXCERPTS FROM ODA'S POLICY
MEMORANDA AND SOPs ESTABLISHING THE \$10,000
THRESHOLD AND RECEIPT REVIEWS FOR UNSECURED LOANS

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Date: June 3, 1994
To: All Area Directors, # 94-41
From: Associate Administrator
for Disaster Assistance
Subject: Disbursement Amounts: Revision of #86-29 and 92-29

Under the law disaster loans may only be used to repair, replace or rehabilitate damaged property. In addition, the law provides for a civil penalty of 150 percent of the loan for wrongful misapplication of the proceeds of a disaster loan. For these reasons, and because disaster loans are highly subsidized, we use controlled disbursements, that is we disburse the funds as they are expended or committed by the borrower in accordance with the loan authorization and agreement. In the past, we have been criticized when we have not followed this procedure because borrowers have used the funds for ineligible purposes or placed the funds in CDs which gave the borrower a higher return than the interest the borrower had to pay SBA.

The basic policy is unchanged, that is where, as in many cases, the borrower's need is expressed or obvious, that should govern disbursement. Thus if the borrower has had interim financing, and has completed the repairs or replacements, the amount necessary to repay the interim financing may be disbursed in one amount (joint payee check) as soon as the loan closing requirements have been satisfied. Similarly, where refinancing is involved, the entire amount of the refinancing may be disbursed as soon as the loan closing requirements have been satisfied. Also, if there is a firm contract for real estate repairs or construction which calls for payments on a specific schedule, loan disbursements should be made in accordance with that schedule, using joint payee checks and verification review prior to disbursement, as appropriate. Similarly, where other facts establish the approximate amount of immediate need, they should be used as the basis for determining the amount of disbursement. The purpose of this memo is to revise the dollar amount of disbursements when circumstances in the file do not dictate the appropriate disbursement schedule.

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APPENDIX III. EXCERPTS FROM ODA'S POLICY
MEMORANDA AND SOPs ESTABLISHING THE \$10,000
THRESHOLD AND RECEIPT REVIEWS FOR UNSECURED LOANS

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b. Secured Loans.

- (1) We may disburse the first \$10,000 (or \$5,000 for EIDLs) upon receipt of the documents required for an unsecured loan. * K.A.P.S We may disburse amounts larger than \$10,000 (or \$5,000 if EIDL) when the appropriate security instruments and other closing documents have been properly completed. For loans requiring insurance, the borrower must submit evidence of insurance coverage as required by the LAA.

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c. Requirements for Subsequent Disbursements.

- (1) Prior to any subsequent disbursement the borrower must complete and submit SBA Form 1366, "Borrower's Progress Certification." We must review the 1366 and necessary receipts to ensure proper use of proceeds before authorizing further disbursement. Counsel should request progress inspections from Loss Verification when appropriate. We may also require lien waivers in the total amount of all labor and materials used on the R/E repair construction from all contractors, subcontractors, and independent workers involved. Borrowers must support disbursements for equipment, furniture, inventory, etc., by paid invoices.

Effective Date: May 6, 2004

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APPENDIX IV. EXCERPT FROM ODA'S SOP ON REVIEW REQUIREMENTS FOR SUBSEQUENT DISBURSEMENTS OVER \$50,000

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c. Requirements for Subsequent Disbursements.

- (1) Prior to any subsequent disbursement where the aggregate amount of physical loan funds disbursed would exceed \$50,000, SBA must have evidence that funds previously disbursed have been used in accordance with the LAA. This evidence may include one or more of the following:
 - (a) SBA Form 1356, "Borrower's Progress Certification."
 - (b) A joint payee check.
 - (c) Progress inspections by the Loss Verification Departments or by a government entity that, in the opinion of either Loss Verification Department, documents progress in accordance with SBA requirements.
 - (d) Escrow account, in accordance with paragraph 97.
 - (e) Lien waivers in the total amount of all labor and materials used on the RI/repair/construction from all contractors, subcontractors, and independent workers involved.
 - (f) Paid invoices to support disbursements for equipment, furniture, inventory, etc.
 - (g) Other cases in which the Center Counsel determines in writing that the exception to the general rule is necessary to prevent undue hardship and the risk to the agency and the likelihood of misuse are minimal.
- (2) If the borrower requests an advance payment to purchase larger items of M&E, we can disburse against a firm quotation or invoice using a co-payable check.
- (3) We must take reasonable precautions before making the final disbursement on a major construction project to ensure that the project was satisfactorily completed. Examples include receipt audits, conversations with contractors, on-site progress inspections, and in some cases, affidavits from borrowers and/or contractors. Counsel will obtain and follow guidance from the PDC Loss Verification Department throughout the disbursement period whenever major reconstruction is involved and use co-payable checks where possible and appropriate.
- (4) Check the status of the loan and DOB reports before making any subsequent disbursement. We cannot authorize any disbursement unless the loan is current.

Effective Date: November 26, 2007

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