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REPORT TO THE CONGRESS
UNITED STATES GENERAL ACCOUNTING OFFICE 099371

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Need For Improvement In Small Business Administration's Financial Management

This report examines the agency's financial management policies, procedures, and practices and the ability of the agency's accounting system to provide financial information responsive to management needs. The report contains recommendations to the Administrator for:

- improving the usefulness of financial data to aid in exercising financial control over resources and operations and
- improving the financial management system.

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

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To the President of the Senate and the
Speaker of the House of Representatives

This is the seventh in a series of reports to be issued pursuant to Public Law 93-386, which requires us to conduct a full-scale audit of the Small Business Administration. This report discusses the need for improvement in the Small Business Administration's financial management.

We are sending copies of this report to the Director, Office of Management and Budget and to the Administrator, Small Business Administration.

A handwritten signature in black ink, reading "Luther A. Steele".

Comptroller General
of the United States

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ABBREVIATIONS

ADP	Automatic Data Processing
BDE	Business Development Expense
GAO	General Accounting Office
GNMA	Government National Mortgage Association
SBA	Small Business Administration



D I G E S T

Although the Small Business Administration's accounting system generally is operating satisfactorily, it needs to provide more complete, accurate, and timely information useful to management, the Congress, and the public. AGC 2

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

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Find.

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

--The agency sets no ceiling on the number of days accrued interest it will pay to banks on defaulted loans. The longer banks delay in requesting the agency to purchase their defaulted loans, the more interest banks will collect from the agency. In fiscal year 1974 the agency paid more than 180 days of accrued interest on over 1,000 of the 3,400 guaranteed loans it purchased. The agency would have saved \$209,000 in that year if 180 days had been established as the limit on the number of days interest it would pay to banks. The agency would have saved \$370,000 if 105 days had been established as the limit. At the time of GAO's computation the rate paid to banks was limited to 8 percent. Now the rate to be paid by the agency is the same rate of interest as provided for in the note, making the interest costs to the Government even higher. (See pp. 13 to 16.)

Surety Bond
Guarantee
Program

--The accounting records for the Surety Bond Guarantee Program do not show whether all fees due from contractors and sureties were collected. Because of the large volume of fees collected, the agency does not attempt to identify payments with contracts. The agency is studying the feasibility of automating accounting for the program. If accounting is automated, the problem should be solved. (See pp. 17 to 18.)

--When making advances to subcontractors the agency deposits funds in special bank accounts and the subcontractor draws on these funds. Funds were allowed to remain idle because deposits were not timed to coincide with needs of contractors. In one agency region the Government could have saved \$15,000 in interest costs in an 18-month period by timing deposits better. (See pp. 18 to 19.)

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

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

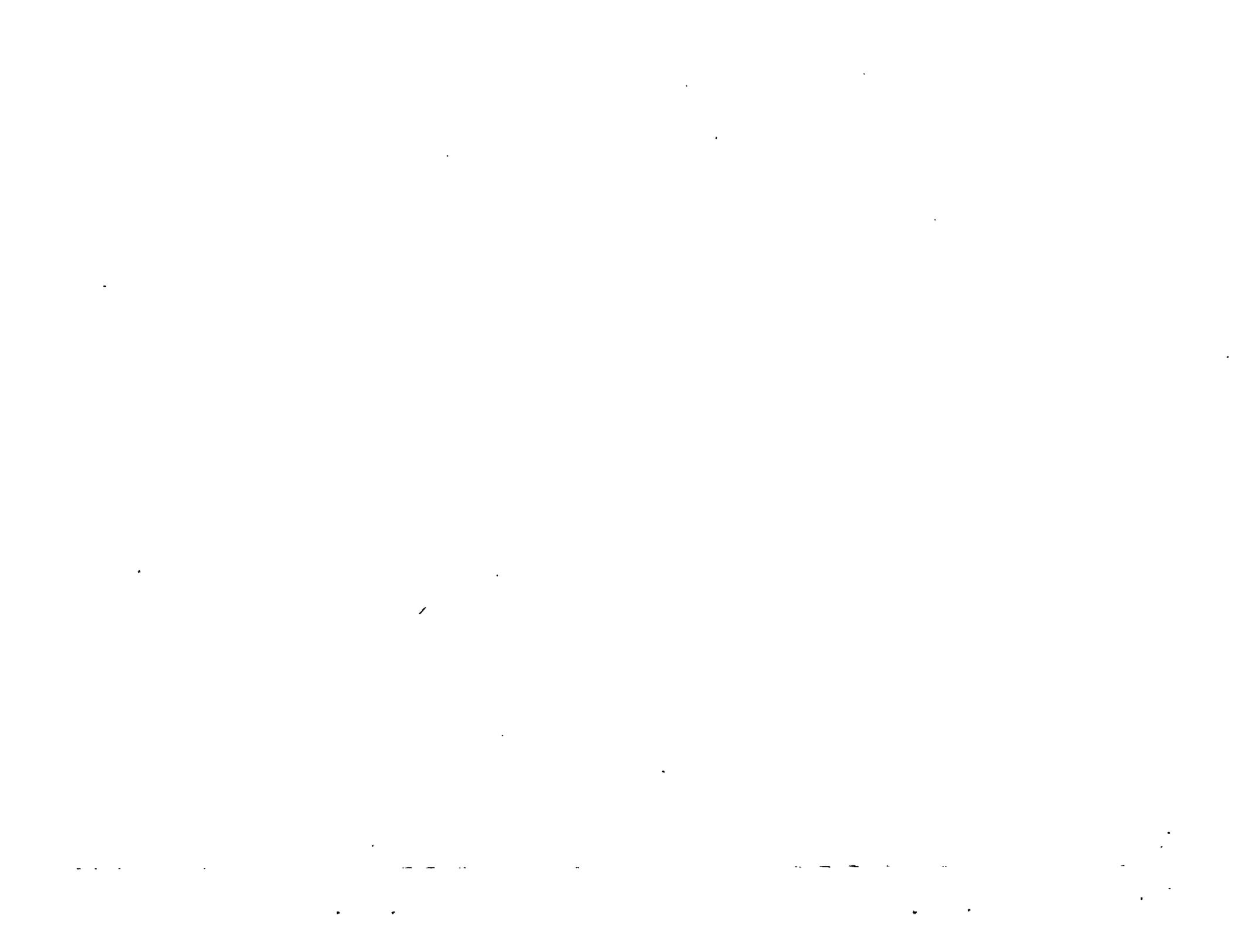
The exceptions are

- lack of provision for estimated losses on accrued interest (see pp. 7 to 8),
- lack of a provision for estimated losses on leases and surety bonds (see pp. 9 to 12), and
- overstatement of the allowance for losses on loans (see pp. 25 to 26.)

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

- The agency did not agree that it should purchase defaulted loans sooner by establishing a limit on the number of days accrued interest it pays to banks. (See pp. 15 to 16.)
- The agency did not agree that it should show a liability in future financial statements for estimated loss on guaranteed loans expected to default which the agency will be required to purchase. (See pp. 11 to 12.)

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



CHAPTER 1

INTRODUCTION

The Small Business Administration (SBA) is an independent Government agency created by the Small Business Act of 1953, 15 U.S.C. §631 (1970), to aid, counsel, and protect the interests of small business concerns and to help disaster victims. In fiscal year 1974 SBA managed three revolving funds which

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

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

Although SBA's accounting system generally is operating satisfactorily, it needs to be improved to provide more complete, accurate, and timely information for management purposes. There is a need to strengthen certain financial management policies, procedures, and practices to promote greater efficiency and economy in SBA operations.

REVOLVING FUND ACTIVITIES

Although SBA is generally thought of as a lending agency, most loans now come from private lenders with SBA guaranteeing repayment. Following are some highlights of the three revolving funds. Additional information on SBA programs is included in appendixes I through V.

	Fiscal years		Cumulative
	1974	1973	through
	(000 omitted)		6/30/74
			(000 omitted)
<u>Business Loan and Investment Fund</u>			
Loans made by SBA	\$ 209,028	\$ 190,806	\$4,121,021
Loans made by banks	1,667,239	1,620,095	7,017,501
Portion of bank loans guaranteed by SBA	1,439,919	1,392,381	5,420,670
Loans purchased by SBA from banks	141,953	91,036	455,245
SBA loans outstanding at June 30	1,531,368	1,404,911	
<u>Disaster Loan Fund</u>			
Loans made by SBA	550,518	1,164,260	2,993,683
Loans made by banks	2,437	1,456	35,906
Portion of bank loans guaranteed by SBA	1,349	976	21,460
Loans purchased by SBA from banks	-	-	13,515
SBA loans outstanding at June 30	1,339,998	1,271,821	
<u>Lease and Surety Bond Guarantees Revolving Fund</u>			

In fiscal year 1974 SBA guaranteed about 280 leases that had rental payments totaling \$119 million exclusive of escrow deposits. SBA received \$2.7 million in fees on these leases. In fiscal year 1974 SBA guaranteed about 9,200 surety bond contracts and received \$1.8 million in fees. SBA was contingently liable for \$570 million on these contracts.

FINANCING

SBA's activities are not intended to be profitable and are financed from appropriations, interest earned

on loans, and fees. SBA pays interest on outstanding cash disbursements into miscellaneous Department of the Treasury receipts at rates determined by the Treasury. These rates consider current average yields on outstanding interest-bearing public debt obligations of comparable maturities.

In fiscal year 1974 the Congress appropriated \$225 million for the Business Loan and Investment Fund. From inception through June 30, 1974, \$2.7 billion had been made available to this fund; \$3 billion to the Disaster Loan Fund; and \$10 million to the Lease and Surety Bond Guarantees Revolving Fund.

Congress makes appropriations to SBA for administrative expenses and also grants SBA authority to transfer money from its revolving funds for administrative expenses in connection with activities financed by these funds. In fiscal year 1974 the Congress appropriated \$22 million and authorized transfer, as necessary, of \$70 million for administrative expenses.

ACCOUNTING RESPONSIBILITIES

The Accounting and Auditing Act of 1950, 31 U.S.C. §66 a (1970), places responsibility for establishing and maintaining adequate systems of accounting and internal control with the head of each executive agency. These systems are required to meet the accounting principles, standards, and related requirements prescribed by the Comptroller General.

The 1950 act requires that the Comptroller General approve accounting systems when they are deemed adequate and conform to his prescribed principles, standards, and related requirements. The Comptroller General approves the accounting system in two stages--the agency's statement of principles and standards and the design of the accounting system. The Comptroller General approved SBA's principles and standards for its accounting system in December 1968 and the design of its accounting system in August 1970. The design approval was updated in June 1975 to include the automatic data processing revisions of the loan collection system.

ORGANIZATION AND MANAGEMENT

Under the guidance of the Assistant Administrator for Administration, the Director, Office of Management Services, designs and installs all SBA accounting systems, and the Director, Office of Budget and Finance, maintains the

accounting systems and is responsible for the related financial reporting functions and budget activities.

SBA's fiscal and accounting services are carried out by about 75 employees in the central office in Washington, D.C. In addition, about 80 employees in Denver, Colorado, carry out a centralized collection and disbursement function under the direction of the central office in Washington.

The loan accounting system is almost completely computerized and is centralized in Washington, D.C., under the Director, Office of Management Services. About 90 employees in two divisions are engaged in automatic data processing functions including the development and operation of SBA's loan accounting applications and other computer-based financial management systems.

CHAPTER 2

NEED FOR FINANCIAL DATA

USEFUL TO MANAGEMENT

The financial data produced by an accounting system must be useful to officials when discharging their responsibilities. Financial information is useful when it can be used as an aid in planning, exercising financial control over resources, and promoting greater efficiency and economy in day-to-day operations. Such data must be promptly presented and clearly reported and its importance properly understood to be of great use.

The kind of data must not be restricted to the internal needs of the agency management. All proper needs must be considered, including those of the President and other executive agencies, the Congress, and the public.

We believe that SBA's management of loan programs and Lease and Surety Bond Guarantee Programs would benefit from financial analyses that show

- collectability of outstanding loans in SBA's and banks' portfolios,
- interest accrued on delinquent loans and loans in liquidation,
- estimated losses based on SBA's obligation to purchase guaranteed loans that default, and
- estimated losses on leases and surety bonds guaranteed by SBA.

NEED FOR GREATER VISIBILITY OF DELINQUENT, DEFERRED, AND REFINANCED LOANS

Management, at any point in time, does not know how many loans in its portfolio have been granted deferments or have been refinanced. Deferment involves temporary discontinuance of principal installments or extension of the payment period. The granting of a deferment changes the status of a loan from delinquent to current. Refinancing occurs when a prior SBA loan is paid off by making a new loan, generally for a larger amount, to the same borrower. Because of the absence of periodic reporting on loans in SBA's portfolio that have been deferred or refinanced, an accurate assessment of troubled loans outstanding is not visible to SBA's management, the Congress, or other interested parties.

A GAO statistical sample of business loans outstanding, as of June 30, 1974, indicated that about 22 percent had been deferred and about 9 percent had been refinanced by SBA. An April 1975 computer run of SBA-serviced loans showed that 35 percent, not including loans in liquidation, would not be fully paid at maturity. On the basis of present repayment terms and maturity dates in the system, SBA estimates that 49,000 loans, with outstanding balances as of April 1975 totaling \$998 million, will have unpaid balances totaling \$157 million at maturity.

SBA gathers statistics monthly on the number of delinquent loans that are cured by deferments and collections. This portfolio management report showed that in fiscal year 1974, 8,000 delinquent loans were cured by deferments and 27,000 delinquent loans were cured by collections. The 8,000 loans cured by deferment represent 13 percent of the loans that were delinquent in fiscal year 1974.

Although the above data is useful to management, there is a need for additional information to evaluate SBA's loan portfolio. SBA's loan accounting system does not furnish data on (1) the number of deferred and refinanced loans and their principal balances and (2) the number of times particular loans have been deferred or refinanced. This information would focus attention to loans classified as current, resulting from repeated deferments or refinancing.

We believe that if information on deferred and refinanced loans was available from year to year, SBA management, the Congress, and others would be more fully aware of changes and trends in collecting SBA's loans.

Recommendation

We recommend that the SBA Administrator develop and report statistical data essential for evaluating the collectability of deferred and refinanced loans and data useful in determining whether SBA's program of granting deferments and refinancing loans is successful.

Agency comments and our evaluation

The SBA Acting Administrator agreed that gathering statistical data for evaluating the collectability of deferred loans would be useful but pointed out it would require revisions to procedures and the automated loan accounting system. Because of uncertainty as to whether

similar data on refinanced loans was essential, the Acting Administrator said the matter would be studied further before a final decision was made.

To avoid undue delay in implementing necessary changes, we suggest that target dates be established

--for planning and testing changes to procedures and to the automated loan accounting system and

--for completing a study on the need for statistical data in evaluating the collectability of refinanced loans.

FINANCIAL STATEMENTS SHOULD SHOW
POTENTIAL INTEREST LOSSES AS AN
OFFSET AGAINST INTEREST INCOME

Under the Comptroller General's Accounting Principles and Standards for Federal agencies, subsection 15.3, agency accounting systems are required to record revenue transactions in accounting records to provide an official record of (1) amounts to be collected or otherwise to be accounted for and (2) revenue-producing operations of the agency in support of financial reports. They are also required by subsection 12.4 to account for receivables estimated to be uncollectable and to disclose such estimates in financial reports.

SBA accrued interest on loans classified as delinquent or in liquidation, although no provision was made for the loss of interest should such loans become uncollectable.

As of June 30, 1974, the accrued interest receivable balance was \$48.5 million. Of this amount, \$26.4 million (54 percent) related to approximately 9,000 loans in liquidation and \$13 million (27 percent) related to approximately 39,000 loans delinquent more than 60 days. Of the 9,000 loans in liquidation, about 1,800 had been in liquidation more than 2 years. Without making any provision in previous years for loss of accrued interest, SBA charged off \$5.5 million in uncollectable interest in fiscal year 1974.

Provision should be made for estimated losses on accrued interest that would offset part of the income resulting from the accrual of interest. Under this procedure, interest earned on loans and SBA's financial condition would be more accurately presented in the financial statements.

Recommendation

We recommend that the SBA Administrator establish a loss account allowance for accrued interest.

Agency comments and our evaluation

The SBA Acting Administrator agreed with this recommendation and stated that an allowance for loss account for accrued interest would be established and adjusted at the close of each fiscal year. The action promised, when implemented, will provide a truer measure of the value of the accrued interest receivable account.

NEED FOR ACCURATE INFORMATION ON CURRENT STATUS OF GUARANTEED LOANS

SBA does not have accurate information on the status of loans made by banks under SBA guarantee. Statistics on the status of all loans is provided to management in a monthly information summary report. Loans made by banks under SBA guarantee are the largest segment of SBA's business loan program, and effective management of the program is compromised by the lack of accurate data on the number and the amount of loans that are delinquent.

SBA has recorded in its computer records loan amounts disbursed by banks and the portion guaranteed by SBA. All guaranteed loans are shown as current in the monthly information summary report. An SBA official explained that banks had not been notifying SBA when loans became delinquent. (For additional informations on delinquent loans see p. 15.)

SBA has adopted a new procedure under which banks report their delinquent loans on SBA-furnished cards. Currently, SBA sends these cards to its field offices so that local loan officers may be aware of delinquent bank loans in their area. An SBA official told us that SBA was considering processing these cards by computer so that it would have current records on all delinquent bank loans. Until such time as these cards are processed through the computer system, the statistics on the status of guaranteed loans in management information summary reports will be inaccurate and of questionable value.

Because SBA lacks accurate information on the status of bank loans, it cannot determine whether the trend in bank loans is toward greater or fewer delinquencies. We believe this information is needed for effective management and control of the guarantee program and for evaluating the collectability of loans.

We suggested that the SBA Administrator adopt procedures for processing delinquent loan cards through SBA's computer system so that SBA can have accurate information on the status of guaranteed loans. The SBA Acting Administrator agreed with this suggestion and SBA's procedures were changed and computerized, effective July 1, 1975.

FINANCIAL STATEMENTS SHOULD INCLUDE
PROVISION FOR POTENTIAL LOSSES
ON LEASES, SURETY BONDS, AND
GUARANTEED LOANS

Principles and standards for Federal agencies issued by the Comptroller General require that all liabilities relating to programs they conduct shall be measured and recorded in agency accounts in the period in which they are incurred so that the financial position of the agency may be fully and properly disclosed.

The body which sets accounting and reporting standards for the private sector--the Financial Accounting Standards Board--has recently taken a similar position regarding accounting for contingencies. The following is quoted from the Board's statement on the accrual of loss contingencies.

"8 An estimated loss from a loss contingency * * * shall be accrued by a charge to income * * * if both of the following conditions are met:

- a Information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements. * * * It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b The amount of loss can be reasonably estimated."

SBA does not present fairly the financial results of its lease and surety bond guarantee programs because it does not provide for costs that will be incurred when SBA is required to honor its guarantees. SBA recognizes its lease and surety bond fees as income in the year in which they are collected but it does not recognize the potential

loss resulting from the guarantees. Further, SBA should show in future financial statements its estimated loss on guarantee loans that it may be required to purchase.

Lease Guarantee Program

To enable small businesses to lease commercial or industrial property, SBA may guarantee the payment of rentals under leases or participate with private insurers in such guarantees. SBA guarantees leases that have terms ranging from 10 to 20 years.

An SBA report on the Lease Guarantee Program showed that income from fees exceeded expenses by \$1.1 million in fiscal year 1974 and by \$3.6 million since inception of the program through June 30, 1974. The upward trend in lease guarantees over the past several years has resulted in increased income. The failure to provide for later probable costs as an offset to this income obscured the true status of the program. GAO's analysis of the Lease Guarantee Program, included in a report to the Congress, "Substantial Losses Projected for the Small Business Administration's Lease Guarantee Program" GGD-75-101, dated October 9, 1975, estimated net losses of about \$17 million by the end of fiscal year 1987 on leases issued through fiscal year 1974.

SBA is considering establishing a reserve for losses on defaulted leases. We believe such a reserve should be established at the time the lease is guaranteed.

Surety Bond Guarantee Program

To enable small and emerging contractors to obtain bid, performance, and payment bonds, SBA guarantees sureties for a maximum of 90 percent of their losses if the bonds are breached.

An SBA financial report on the Surety Bond Guarantee Program showed that, from inception of the program through June 30, 1974, expenses have exceeded income by \$3.2 million.

Before submission of actual claims, sureties notify SBA when defaults occur and provide SBA with an estimate of the loss. SBA is considering establishing an estimated liability for future claims on the basis of information furnished by sureties. If such a policy had been in effect and if SBA had recorded its estimated liabilities on defaulted bonds based on information furnished by sureties, expenses would have exceeded income by \$8.8 million--\$5.6 million more than the \$3.2 million SBA showed through June 30, 1974.

Although the method SBA is considering would be an improvement in the financial reporting, we believe that SBA should estimate its probable losses and estimated liabilities at the time it guarantees a surety bond since it has sufficient experience with the programs to provide a basis for such estimates.

Guaranteed loans

SBA furnished us with data which we have included as footnotes to the financial statements. (See pp. 34 to 36.) SBA is required to purchase loans made wholly by banks under SBA guarantee when borrowers default. After June 30, 1974, the method of calculating allowance for loss requirements was changed. (See pp. 25 to 26.)

The footnotes to the fiscal year 1974 financial statements show \$3.5 billion as the outstanding portion of bank disbursed loans under SBA guarantee and commitments to guarantee \$647 million in undisbursed loans. SBA estimates it may be required to purchase \$245 million in bank loans that default.

We believe the estimated loss on guaranteed loans SBA probably will be required to purchase should be shown as a liability in future financial statements.

Agency comments and our evaluation

According to the SBA Acting Administrator, several major sureties said it was the generally accepted practice in the industry to establish reserves at time of default. SBA's procedures were predicated on this industry practice. Because of the similarities between the surety bond program and the lease program, the same procedures were applied to the lease program. The Acting Administrator indicated, however, that if the GAO continued to believe the reserve should be established at the time the guarantee was issued, then SBA would develop the necessary procedures, systems, and studies to gather the required information.

The SBA Acting Administrator did not agree that a reserve for losses should be established for guaranteed loans that SBA anticipates it will be required to purchase. He considered such a reserve would be a valuation of an asset that did not exist--the loans made by banks and

guaranteed by SBA were not SBA loans until the guarantees were exercised.

We continue to believe that estimating probable losses and liabilities for both leases and surety bonds at the time the guarantees are made is preferable to waiting until defaults occur. Since SBA collects its fees at the time the guarantees are issued, income and expense would be more closely matched in the same period. Furthermore, the managers of these programs and the public would be alerted sooner to the potential for losses rather than after notice of default.

We also continue to believe that provision should be established for losses and a corresponding liability for the guaranteed loans SBA estimates it will be required to purchase because of defaults. We consider that as of the date of financial statements it is probable that SBA has incurred a liability and the loss can be reasonably estimated. SBA's experience with recoveries and chargeoffs of purchased defaulted loans provides, in our opinion, a basis for making such estimates.

Recommendation

We recommend the SBA Administrator establish a provision for losses and a corresponding liability for guaranteed leases and surety bonds expected to default and for guaranteed loans SBA estimates it will be required to purchase because of defaults.

CHAPTER 3

NEED TO STRENGTHEN SBA'S

FINANCIAL OPERATIONS

A satisfactory financial management system includes among its objectives the promotion of efficiency, effectiveness, and economy of operations, the safeguarding of assets against waste or loss, and assurance that all revenues applicable to agency operations are collected or accounted for. We believe that improved financial management can contribute to

- reduced interest costs,
- correction of interest charges to certain victims of disasters,
- elimination of uneconomical recordkeeping on uncollectable small loans,
- assurance that surety bond fees due SBA are collected,
- disclosure of costs of interest-free advances to subcontractors,
- savings to the Government by timing disbursements to needs of 8(a) subcontractors, and
- timely writeoffs of uncollectable advances.

OPPORTUNITY TO REDUCE INTEREST COSTS ON DEFAULTED GUARANTEED LOANS

Some banks unduly delay submitting their defaulted loans to SBA. The longer banks delay in requesting SBA to purchase defaulted loans, the more interest banks collect from SBA. We estimated that the delays in submitting defaulted loans have resulted in a cost to SBA of from \$209,000 to \$371,000 in fiscal year 1974. These costs were incurred because SBA had not established a limit on the number of days' interest it would pay to banks. A reasonable limitation would result in recurring annual savings.

Upon demand by banks, SBA purchases the guaranteed portion (usually 90 percent) of the outstanding balances of defaulted loans and pays interest through the date of purchase. During fiscal year 1974, most of the purchases involved an 8 percent rate. Effective September 1, 1975,

the Federal Regulations were changed to allow SBA to pay accrued interest to date of purchase at the rate of interest provided in the note.

SBA pays interest to the Treasury on its net outstanding disbursements, including amounts disbursed to banks to purchase loans. The interest rates are set by the Treasury taking into consideration current yields on outstanding marketable public debt obligations of comparable maturities as calculated for the month of June. During fiscal year 1974 SBA paid the Treasury 6-3/4 percent for its disbursements for business and economic opportunity loans and 7 percent for local development loans. The difference between interest rates SBA pays banks and the Treasury represents an additional cost to the Government.

SBA paid more than 180 days of accrued interest on over 1,000 of the 3,400 guaranteed loans it purchased from banks in fiscal year 1974. In 10 cases SBA paid more than 3 years in accrued interest to banks. Earlier purchase of these guaranteed loans would have saved SBA considerable interest.

We discussed the matter of paying interest for an excessive number of days on guaranteed loans with SBA portfolio management officials. The guarantee agreement provides that a bank may demand SBA purchase the guaranteed portion of a loan that has been in default for at least 60 days provided the bank notified SBA in writing of the default at 30 days. SBA officials said that an additional 15 days was needed for response time, making a total of 105 days as the practical minimum number of days' interest to be paid on purchased defaulted loans (30 days of interest that was due from the borrower to date of default plus 60 days provided for in the guarantee agreement plus 15 days response time). They indicated that SBA was concerned about giving banks and borrowers every opportunity to cure defaults and would, therefore, consider establishing guidelines setting a limit of 180 days on the interest SBA would pay to banks.

A 105-day limit on the payment of interest on guaranteed loans in fiscal year 1974 would have resulted in a savings of about \$371,000 to the Government in interest on about 2,000 loans SBA purchased.

A 180-day limit would have resulted in a savings of about \$209,000 in interest. Banks were paid \$1.5 million in interest for the number of days loans were held in excess of 180 days.

Agency comments and our evaluation

The SBA Acting Administrator did not agree that SBA should establish a limit on the number of days of accrued interest SBA should pay to banks. Establishing such a limit would, according to the Acting Administrator, abrogate SBA's policy of cooperating with lenders to assist borrowers to cure defaults and bring their loans current. In his opinion, lenders would demand that SBA purchase defaulted loans whenever such loans reached or approached the established maximum and would result in a tremendous increase in outlays and servicing responsibility. Further, SBA's interest cost to participating banks was offset by the interest cost payable to the Treasury on the amount purchased.

We believe that the SBA Acting Administrator has not demonstrated that SBA's policy of not establishing any limit on the number of days accrued interest it will pay to banks has been effective in helping borrowers cure their defaults. SBA does not have statistical data that would show how many borrowers in default were able to cure the defaults and whether such extensions resulted eventually in a significant number of borrowers paying off their loans. If the extensions are not resulting in repayment of loans, SBA's outlay and servicing responsibilities would not increase but occur sooner. Furthermore, SBA's interest cost to participant banks is not entirely offset by the interest cost to the Treasury. As mentioned previously SBA would have saved either \$371,000 or \$209,000 in interest cost, depending on whether SBA had a limit of 105 days or 180 days in fiscal year 1974.

On February 19, 1976 the Comptroller General in decision B-181432 held that under current Federal Regulations and the terms of the standard guarantee agreement SBA lacked authority to purchase guaranteed loans in case of noncompliance by lending institutions with the 30-day notice requirement.

While the decision requires that 30-day notice of default be given by lending institutions, it does not impose any limit on the period the defaulted loan can be carried by lending institutions. Until the lending institution requests SBA to honor its guarantee the lending institution will continue to earn interest at the rate provided in the note, and SBA will be required to pay the interest when it purchases the note.

SBA recently estimated that from fiscal year 1976 through fiscal year 1980, the change in interest rates

from 8 percent to the note rate will result in additional interest costs of between \$4.6 million and \$5.7 million. The increase in interest costs makes it even more imperative that a limit be established on the number of days interest SBA pays to banks.

Recommendation

We recommend that the SBA Administrator institute a study to determine how many borrowers in default were able to cure their defaults and the time it took. Based on this study, we recommend that the SBA Administrator establish a limit on the number of days accrued interest that may be paid to banks on defaulted loans.

OVERCHARGES OF INTEREST TO DISASTER VICTIMS

As a result of an error in the application of forgiveness credits, certain borrowers were paying more interest than SBA was entitled to have. The interest overcharges related to loans disbursed to victims of disasters that occurred in calendar year 1971. The extent of the overcharges cannot be determined without SBA making a review of borrower accounts. We believe the overcharges may amount to at least several hundred thousand dollars.

The Congress enacted the Disaster Relief Act of 1970, 42 U.S.C. §4451 (1970) since transferred to 15 U.S.C. 636 a (Supp. IV, 1974), forgiving a part of the SBA loans received in connection with major disasters declared by the President. The act provided

- forgiveness of loan amounts in excess of \$500 with a maximum forgiveness of \$2,500 and
- interest on disaster loans at rates to be determined on the basis of current market yields on marketable obligations of the Government but not to exceed 6 percent.

The forgiveness credit was to be effective as of the date of the initial loan disbursement, and no interest was to be charged on the amount of the loan forgiven. SBA had not completed applying the forgiveness credits to all loans eligible under the Disaster Relief Act when new legislation was enacted--15 U.S.C. §636(b)(Supp. III, 1973)--to

- delete the stipulation that the forgiveness credit was applicable only to amounts in excess of \$500,
- reduce the interest rate to 3 percent, and

--make SBA-declared disasters eligible for the forgiveness credit.

These changes were effective and were to be applied as of August 16, 1972, to calendar year 1971 disaster loans.

A sampling of SBA's disaster loan portfolio showed several instances where forgiveness credits that should have been applied as of the date of loan disbursement under the Disaster Relief Act of 1970 were incorrectly applied as of August 16, 1972. As a result, interest charged by SBA on these loans from the date of disbursement to August 16, 1972, was in error.

SBA officials were aware of the problem and corrected individual errors when brought to their attention by borrowers.

Agency comments and our evaluation

The SBA Acting Administrator said that identification and correction of the errors would be costly, running into thousands of dollars. He considered SBA's procedures of correcting errors as they were discovered (400 accounts had been adjusted) to be the most efficient and practical way of handling the situation. The SBA Acting Administrator said a costly automation data processing effort would be required and, computing, adjusting and processing corrections would require a manual effort costing more than the amount of the average adjustment.

Because of the relatively nominal individual amounts involved and the high cost of identifying the overcharges, we believe that the approach being taken by SBA is practical and reasonable.

ACCOUNTING FOR SURETY BOND GUARANTEE PROGRAM NEEDS IMPROVEMENT

The accounting records for the Surety Bond Guarantee Program do not show whether all fees SBA should have collected were in fact received. Under current procedures, payments are listed manually as they are received by SBA's cashier. Because of the large volume of transactions, this listing can not be used to verify whether SBA collected all fees.

Accounting procedures and controls have not kept pace with the rapid growth of the Surety Bond Guarantee Program. The number of contracts guaranteed has increased from about 5,600 in fiscal year 1973 to about 9,200 in fiscal

year 1974. Since each contract involves a payment from a contractor and a surety, about 18,400 collections were recorded manually in fiscal year 1974. Because of the large volume of collections SBA does not attempt to identify payments with contracts to verify that all fees were collected. In view of the statutory requirement that the Administrator fix appropriate fees with respect to this program, it is our view that SBA is required to take steps to insure that such fees are collected in all instances.

SBA is conducting a study on the feasibility of automating accounting for this program. If the accounting is automated, SBA should be able to determine whether all fees owed have been collected.

POTENTIAL SAVINGS THROUGH CAREFUL TIMING OF ADVANCES TO SUBCONTRACTORS

The Treasury requires that careful attention be given to the timing of advance payments to minimize their impact on the public debt level and financing cost. We found, however, that SBA's central office was depositing funds in special commercial bank accounts for the full amount of approved advances. No effort was made to coordinate the timing of deposits with amounts to be withdrawn by section 8(a) subcontractors. As a result, the Government was paying interest to borrow money while funds were allowed to remain idle in banks.

SBA's Business Loan and Investment Fund is used to finance advances to section 8(a) subcontractors. Advance payments may be made according to 41 U.S.C. §255 (1970) only when there is adequate security and when they are in the best interest of the Government.

SBA deposits advance payments to subcontractors in noninterest-bearing bank accounts. As discussed, SBA does not charge the subcontractors interest on their advances. We estimate that it cost the Government over \$350,000 in fiscal year 1974 and \$365,000 for the first 6 months of fiscal year 1975 for interest it paid on funds advanced to section 8(a) subcontractors.

A test made in SBA's New York regional office showed that the Government could have saved \$15,000 in the 18-month period ended December 31, 1974, if funds had not been allowed to remain idle in banks. In one case, over \$100,000 was left on deposit in a bank for more than 6 months. Most of the potential savings (\$10,000 of the \$15,000) were on advances of over \$250,000.

The advance program has been growing rapidly. The outstanding dollar amount of advances to section 8(a) subcontractors increased from \$4 million at June 30, 1973, to \$7.4 million at June 30, 1974, and to \$12.7 million at December 31, 1974.

Treasury Fiscal Requirements Manual, chapter 2000, part VI states that if a program agency has, or expects to have, a continuing relationship of at least 1 year with a recipient organization involving annual advances aggregating at least \$250,000, the agency shall use the letter-of-credit method. SBA does not use letters of credit.

Where letters of credit are not used because the disbursements do not meet the Treasury's criteria, we believe consideration should be given to disbursing advances of over \$250,000 in two or three installments.

Agency comments and our evaluation

The SBA Acting Administrator agreed to our suggestion regarding disbursing advances of \$250,000 or more, in two or three installments. The only exception would be when the entire advance was required for the purchase of material or equipment on a one-time basis.

The SBA Acting Administrator said that standard operating procedures were being amended to implement this suggestion. Although we consider this procedure, if implemented, to be a constructive step toward reducing the Government's interest cost, we believe that using the letters-of-credit method should be given priority.

Recommendation

We recommend that the SBA Administrator require the use of letters of credit on advances of \$250,000 when such use is in conformance with Treasury Fiscal Requirements Manual.

NEED TO ESTABLISH GUIDELINES FOR DETERMINING WHEN ADVANCES TO SUBCONTRACTORS SHOULD BE WRITTEN OFF

Assets are overstated when uncollectable receivables are not written off. We found that SBA had not established guidelines for determining when advances to section 8(a) subcontractors should be treated as uncollectable and written off.

We identified five advances of doubtful collectability totaling \$316,000 at June 30, 1974. Most of the firms involved had gone bankrupt or out of business. In one

instance involving a bankrupt firm, the section 8(a) contract had been terminated in February 1972 but the \$110,000 advance was still being carried by SBA as an asset at June 30, 1974. In another instance, an SBA regional office wrote to the central office about the uncollectability of \$32,800 remaining from a \$40,000 advance because the company had gone out of business. SBA's accounting division had not written off this advance because it was not properly authorized to write off uncollectable advances.

SBA has taken action, as a result of our discussions with SBA officials, to determine officially that the advances we noted were definitely uncollectable--a necessary step before an advance can be written off.

Recommendation

We recommend that the SBA Administrator establish guidelines for determining when uncollectable advances to section 8(a) subcontractors should be written off.

Agency comments and our evaluation

The SBA Acting Administrator agreed with the recommendation and said guidelines and procedures would be developed to write off uncollectable advances. This action, if implemented, should provide SBA with a more accurate record of its receivables.

NEED FOR INTERNAL AUDITS OF SBA'S FINANCIAL STATEMENTS

The Accounting and Auditing Act of 1950 places the primary responsibility for the accuracy and validity of Federal agency financial reports in the top management of each agency. Management's assurance that the financial reports are reliable should be based primarily on the accounting and internal control system. The internal control system should include not only the procedures devised for accounting for the agency's activities but also the internal audit function which would provide agency management with assurance that the financial reports prepared from the accounts are reliable.

In 1974 the Comptroller General issued a pamphlet entitled "Internal Auditing in Federal Agencies" to provide guidance to agencies in developing internal audit organizations and procedures. This publication states that the internal auditor should examine financial transactions, including the receipt and disbursement of public funds, accounts, and financial reports to the extent necessary to determine whether:

- The agency is maintaining effective control over revenues, expenditures, assets, and liabilities.
- The agency is properly accounting for its resources, liabilities, and operations.
- The agency's financial reports contain accurate, reliable, and useful financial data and are fairly presented.
- The agency is complying with the requirements of applicable laws and regulations.

SBA's Internal Audit Division has made various audits and examinations directed to specific operations and segments of financial activities. However, SBA's Internal Audit Division has not audited SBA's financial statements for the past 5 years. An audit of financial statements is needed to assure management that the financial management system and reports are reliable.

Recommendation

We recommend that the SBA Administrator have the Internal Audit Division audit SBA's financial statements, including evaluations of prescribed policies, procedures, and internal controls.

Agency comments and our evaluation

The SBA Acting Administrator said SBA recognized the importance of internal audits of all its programs and functions, including the audit of financial statements. However, with limited audit resources, the SBA also recognized that these resources had to be used in areas of the greatest concern. Therefore, the cycle for the audit of financial statements has been less than normal. However, in audit planning for fiscal year 1977, this audit would be given strong consideration.

We consider the audit of the SBA's financial statements to be of prime importance and should, therefore, be made periodically. If SBA does not delay in making such an audit, and if audits are conducted periodically thereafter, we believe it will be fulfilling this aspect of its audit responsibilities.

CHAPTER 4

CORRECTIVE ACTION TAKEN BY SBA DURING GAO AUDIT

We found, with some exception, that SBA's computerized accounting system for SBA-disbursed loans was generally reliable. The loan accounting system processed about 3.6 million loan transactions in fiscal year 1974, each involving one of 270 different processing alternatives. These transactions were processed simultaneously in individual loan accounts and in general ledger control accounts. In October 1974 SBA's automated reconciliation of general ledger and subsidiary accounts was improved by enabling individual loan discrepancies to be identified, facilitating the correction of differences between the general ledger and individual loan accounts. In our opinion, SBA development and use of this advanced technique for assuring the reliability of data being processed is a commendable achievement.

Although we were favorably impressed with SBA's computer operations, we believe there was a need to strengthen its management. Other matters that we noted involved the presentation of trust activities in SBA's published financial statements, the return to the Treasury of interest earned on investments of the Lease and Surety Bond Guarantees Revolving Fund, and the change in the method of computing allowances for losses. These matters are discussed below.

IMPROVEMENT IN MANAGEMENT OF COMPUTER ACTIVITIES

Although SBA's automatic data processing (ADP) operations are generally carried out satisfactorily, the overall direction given to this activity and SBA's organizational structure needed strengthening.

The ADP function is critical to the continuity of SBA's operations because the major part of SBA's transactions are processed by computer. The ADP activity costs were \$4.3 million in fiscal year 1974.

SBA lacked a formal ADP steering committee. Such a committee or comparable body, consisting of top management officials representing ADP user organizations, was needed to establish policies and objectives of the ADP activity and to have responsibility for such matters as

- approving short- and long-range plans,
- evaluating proposed projects,

- designating project priorities,
- approving agency policies for automatic data processing, and
- monitoring progress in meeting objectives.

The decisionmaking process dealing with requests for changes to existing ADP applications and for development of new applications was slow and cumbersome. Three or more levels of review often were required before a decision was made. The users' requests for ADP services were sometimes reinterpreted and modified to the point of distorting the purposes of the requests.

Furthermore, users complained about the slow response to requests. For example, the Office of Budget and Finance made a written request for ADP services on December 11, 1974, to permit the processing of partial bank disbursements for guaranteed loans and to simplify the edit checking of input data. The request specified a completion date of December 31, 1974. The Data Management Division estimated the necessary computer program modifications would require 110 staff-hours. As of July 1975, work had not been started on this request.

SBA's organizational structure resulted in a diffusion of responsibilities. The Office of Management Services included two divisions, the Data Management Division and the Systems Division, that had personnel performing similar functions. Both divisions employed systems analysts engaged in various studies of SBA's loan accounting system. In our opinion, SBA's organizational structure contributed to divisional rivalry, problems in communication, and duplication of effort. We considered this structure incompatible with the objective of establishing responsibility commensurate with authority.

Some of these conditions are similar to those reported by SBA's Internal Audit Division in its "Report of Audit on a Survey of Automatic Data Processing (ADP) Systems" issued in December 1974.

In July 1975 the SBA Administrator reorganized the Office of Management Services. Under the reorganization plan an ADP steering committee has been established along the lines we suggested and the systems analysts have been put into one division.

REVISED PRESENTATION OF TRUST
ACTIVITIES IN PUBLISHED
FINANCIAL STATEMENTS

In its prior published financial statements, SBA showed a liability for the payment of participation certificates and, as an offset, included among its loans receivable, the amount of loans sold to the Government National Mortgage Association (GNMA) as trustee. GNMA is the agency responsible for paying off the participation certificates as they mature, not SBA. The inclusion of these items in SBA's financial statements resulted in SBA overstating both its assets and its liabilities.

SBA with other agencies, participates in two trusts managed by GNMA. As a participant, SBA conveyed title to the loans but retained control and administration of these loans. The trustee sold to private investors participation certificates backed by these loans. SBA used the proceeds from these sales to reduce the use of Government funds for its programs.

SBA prepares two sets of financial statements. Semiannual statements are prepared for the Treasury in a format prescribed by the Treasury. Under this format the obligation for paying off participation certificates is treated as an SBA liability. SBA prepares calendar year statements for inclusion in its annual report. Following the Treasury format, SBA's published statements showed the obligation for payment of participation certificates as a liability and include among assets loans sold to GNMA. The amount sold to GNMA is disclosed in a footnote.

We suggested an appropriate accounting treatment to SBA so that assets and liabilities relating to participation certificates would not be overstated in future published annual statements. SBA agreed with our suggestion, and the financial statements included in this report reflect the change. Accordingly,

- the liability to retire \$344.2 million in participation certificates was not included in SBA's statements,
- SBA disclosed the amount of its total loan portfolio and showed as a deduction a total of \$362.3 million in loans conveyed to GNMA, and
- SBA showed its equity of \$18.1 million in the conveyed loans as an asset (\$362.3 million minus \$344.2 million).

INTEREST EARNED ON INVESTMENTS OF LEASE AND SURETY BOND FUND RETURNED TO THE TREASURY

We found that SBA's Lease and Surety Bond Guarantees Revolving Fund was improperly enhanced by \$508,545. This amount was the interest earned between 1969 and 1974 by investing part of the funds' initial capital in public debt securities.

During this period the law, 15 U.S.C. §694 (1970), specifically prohibited the investment of the fund's initial capital, reading in part as follows:

"Moneys in such fund not needed for the payment of current operating expenses or for the payment of claims arising under such programs may be invested in bonds or other obligations of, or bonds or other obligations guaranteed as to principal and interest by, the United States; except that moneys provided as initial capital for such fund shall not be so invested but shall be returned to the fund * * *."
(underscoring supplied)

In August 1974 this provision was amended so that the underlined portion now reads "except that moneys provided as capital for the fund shall not be so invested".

Although some SBA officials questioned the propriety of investing the fund's initial capital and SBA began liquidating its investments, no action was taken to restore to the Treasury the interest SBA had illegally earned.

As a result of our discussions with SBA officials, SBA restored \$508,545 to the Treasury's general fund. All investments of initial capital have been liquidated.

METHOD OF COMPUTING ALLOWANCE FOR LOSSES CHANGED

The allowance for losses of \$481 million as of June 30, 1974, covered both SBA-disbursed loans and loans disbursed by banks under SBA guarantee. We could not determine from SBA records what portion of the \$481 million related to loans disbursed by banks.

After June 30, 1974, SBA changed its method of computing its allowances for loss requirements. Under the new method only loan balances that are a part of SBA's assets will be used in the computation. In connection with this change SBA also computed the amount that it would have had

in its allowance for losses account had the new method been in use since inception of SBA's loan programs. Based on this calculation, SBA determined that its allowance for losses account as of June 30, 1974, should be reduced by \$300 million. The adjustment was made in fiscal year 1975.

CHAPTER 5
SCOPE OF EXAMINATION AND
OPINION ON FINANCIAL STATEMENTS

We have examined the following SBA statements.

- Schedule 1. Combined comparative statement of financial condition at June 30, 1973 and 1974.
- Schedule 2. Combined comparative statement of income, expense and retained earnings for the fiscal years ended June 30, 1973 and 1974.
- Schedule 3. Statement of changes in financial position for fiscal year ended June 30, 1974.

The statements are presented on a combined basis for SBA's Business Loan and Investment Fund, Disaster Loan Fund, and Lease and Surety Bond Guarantees Revolving Fund.

This is the first time we have examined SBA's financial statements. Our purpose was to render an opinion on the statements for the fiscal year ended June 30, 1974. Our examination was conducted at SBA's central office in Washington, D.C., the Financial Operations Division, Denver, Colorado, the New York regional office, and the New Orleans district office.

Our examination was made in accordance with generally accepted auditing standards and included such tests and other auditing procedures as we considered necessary in view of the effectiveness of the system of internal control. We examined SBA's financial management policies, procedures, and practices and reviewed the ability of SBA's accounting system to provide financial information responsive to management needs. We also audited SBA's accounts for fiscal year 1973 to insure that fiscal year 1974 accounts were maintained on a basis consistent with that of the preceding year.

Except for SBA's lack of provision for estimated losses on accrued interest (pp. 7 to 8) and on leases and surety bonds (pp. 9 to 12), and the overstatement of the allowance for losses (pp. 25 to 26), the accompanying financial statements (schs. 1 through 3) in our opinion, present

fairly the financial position of SBA at June 30, 1974,
and the results of its operations and the changes in
financial position for the year then ended, in conformity
with the principles and standards of accounting prescribed
by the Comptroller General of the United States.

SCHEDULES

SCHEDULE 1

SCHEDULE 1

SMALL BUSINESS ADMINISTRATION
BUSINESS LOAN AND INVESTMENT FUND
DISASTER LOAN FUND

LEASE AND SURETY BOND GUARANTEES REVOLVING FUND

COMBINED COMPARATIVE STATEMENT OF FINANCIAL CONDITION

AT JUNE 30, 1974, AND 1973

June 30, 1974

June 30, 1973

(000 omitted)

ASSETS

BEST DOCUMENT AVAILABLE

LOANS RECEIVABLE:				
Business Loan and Invest-				
ment Fund:				
Loans	\$1,531,368		\$1,404,910	
Less loans subject to				
participation sales trust	<u>285,613</u>	\$1,245,755	<u>324,476</u>	\$1,080,434
Disaster Loan Fund:				
Loans (note 1)	1,339,999		1,271,820	
Less loans subject to par-				
ticipation sales trust	<u>76,660</u>	1,263,339	<u>89,808</u>	1,182,012
Equity in loans sold to trusts		<u>18,121</u>		<u>20,495</u>
		2,527,215		2,282,941
Less allowance for losses				
(note 2)		<u>480,996</u>		<u>353,789</u>
		2,046,219		1,929,152
CASH:				
With U.S. Treasury (note 3)	862,963		1,275,588	
In transit, in banks, and				
on hand	<u>79,349</u>	942,312	<u>219,207</u>	1,494,795
OTHER ASSETS:				
Investments in U.S. Govern-				
ment securities	4,014		5,537	
Accrued interest and				
guaranty fees receivable	54,194		44,806	
Notes and judgments receivable	48,155		48,420	
Accounts receivable	26,247		20,836	
Assets acquired in liquida-				
tion of loans and lease				
guarantee commitments	11,087		12,163	
Interest collections held				
by or for trustee	4,871		4,760	
Undistributed expenditures	<u>1,261</u>	<u>149,829</u>	<u>981</u>	<u>137,503</u>
Total assets		<u>\$3,138,360</u>		<u>\$3,561,450</u>

The notes following schedule 3 were prepared by GAO and should be considered in reading this schedule.

BEST DOCUMENT AVAILABLE

	<u>June 30, 1974</u>		<u>June 30, 1973</u>	
	(000 omitted)			
LIABILITIES				
ACCRUED LIABILITIES:				
Interest payable to U.S. Treasury	\$ 186,941		\$ 137,070	
Interest payable on participation certificates	9,293		9,202	
Other	<u>316</u>	\$ 196,550	<u>315</u>	\$ 146,587
OTHER LIABILITIES:				
Accounts payable	4,974		3,269	
Trust and deposits	931		891	
Unapplied remittances	<u>17,273</u>	<u>23,178</u>	<u>14,783</u>	<u>18,943</u>
Total liabilities (note 4)		<u>219,728</u>		<u>165,530</u>
INVESTMENT OF THE U.S. GOVERNMENT				
Capital appropriations since July 1, 1966	3,724,000		3,499,000	
Capital transfer from former SBA revolving fund	<u>1,555,679</u>	5,279,679	<u>1,555,679</u>	5,054,679
Retained earnings or (deficit):				
Disaster Loan Fund				
From operations	(359,717)		(262,988)	
From forgiveness credits pursuant to Disaster Relief Acts (notes 1 and 5)	<u>(1,023,798)</u>		<u>(678,471)</u>	
	(1,383,515)		(941,459)	
Business Loan and Investment Fund	(977,885)		(719,685)	
Lease and Surety Bond Guarantees Revolving Fund	<u>353</u>		<u>2,385</u>	
Total deficit		<u>(2,361,047)</u>		<u>(1,658,759)</u>
Net investment		<u>2,918,633</u>		<u>3,395,920</u>
Total liabilities and investment		<u>\$3,138,360</u>		<u>\$3,561,450</u>

SMALL BUSINESS ADMINISTRATION

COMBINED COMPARATIVE STATEMENT OF INCOME, EXPENSE, AND RETAINED EARNINGS

FOR THE FISCAL YEARS ENDED JUNE 30, 1974 AND 1973

	June 30, 1974		June 30, 1973	
	(000 omitted)			
INCOME:				
Interest earned on loans and debentures:				
Business Loan and Investment Fund	\$ 85,700		\$ 81,514	
Disaster Loan Fund	<u>25,315</u>	\$ 111,015	<u>22,163</u>	\$ 103,677
Fees:				
Loans (note 6)	14,773		22,134	
Contractors' bonds (note 6)	1,237		638	
Sureties' bonds (note 6)	605		329	
Examinations and licenses	234		234	
Closings	<u>32</u>	16,881	<u>62</u>	23,397
Income from investments:				
Participation sales fund	5,571		3,245	
U.S. Government securities (note 7)	<u>353</u>	5,924	<u>267</u>	3,512
Other:				
Lease guarantee premiums	2,674		2,464	
Profit from sale and income earned on acquired collateral	840		840	
Miscellaneous	<u>402</u>	<u>3,916</u>	<u>50</u>	3,354
Total income		<u>137,736</u>		<u>133,940</u>
EXPENSE:				
Interest to U.S. Treasury on net disbursements:				
Business Loan and Investment Fund	99,552		86,283	
Disaster Loan Fund	<u>87,389</u>	186,941	<u>50,787</u>	137,070
Administrative	75,650		84,953	
Interest on participation certificates	23,905		26,513	
Business development expense, section 8(a) subcontracts	6,008		5,017	
Sureties' claims	4,655		511	
Losses from sale and expenses incurred on acquired collateral	2,213		1,516	
Rental payments on defaulted leases	1,348		620	
Bank service fees	1,131		1,349	
Other program expenses	<u>131</u>	<u>115,041</u>	<u>296</u>	<u>120,775</u>
Total expense		<u>301,982</u>		<u>257,845</u>
Total operating loss		(164,246)		(123,905)
Provision for losses on loans and other assets		(194,570)		(187,159)
Net loss		(358,816)		(311,064)
DEFICIT AT BEGINNING OF YEAR	(1,658,759)		(919,912)	
ADJUSTMENTS:				
Appropriations for trust fund insufficiencies	1,855		3,932	
From forgiveness credits pursuant to Disaster Relief Acts	<u>(345,327)</u>	<u>(2,002,231)</u>	<u>(431,715)</u>	<u>(1,347,695)</u>
DEFICIT AT END OF YEAR		<u>(\$2,361,047)</u>		<u>(\$1,658,759)</u>

The notes following schedule 3 were prepared by GAO and should be considered in reading this schedule.

SMALL BUSINESS ADMINISTRATION

STATEMENT OF CHANGES IN FINANCIAL POSITION

(000 omitted)

FUNDS PROVIDED:

Decrease in cash balance	\$552,483
Appropriations	226,855
Gross income from operations	137,736
Net change in other assets and liabilities	<u>41,872</u>
	<u>\$958,946</u>

FUNDS APPLIED:

Forgiveness credits pursuant to Disaster Relief Acts	\$345,327
Operating expenses	301,982
Net increase in loans receivable	262,000
Redemption of participation certificates	<u>49,637</u>
	<u>\$958,946</u>

The notes following schedule 3 were prepared by GAO and should be considered in reading this schedule.

GAO NOTES TO FINANCIAL STATEMENTS

1. Disaster loans

The disaster loan balance of \$1,340 million as of June 30, 1974, was overstated by \$52 million because SBA had not completed its automatic processing of forgiveness credits that borrowers were entitled to under legislation enacted in 1972, 15 U.S.C. §636(b) (Supp. III, 1973).

2. Allowance for losses

The allowance for losses balance as of June 30, 1974, of \$481 million was reduced in the following fiscal year by \$300 million. (See pp. 25 to 26.)

3. Cash with the Treasury

As of June 30, 1974, \$572 million was reserved for undisbursed authorizations and commitments for loans.

4. Contingent liabilities and commitments

As of June 30, 1974, the outstanding portion of bank-disbursed loans guaranteed by SBA was \$3.5 billion. As of that date SBA had commitments to guarantee \$647 million in undisbursed loans. SBA estimates it may be required to purchase \$245 million in bank loans that default.

As of June 30, 1974, SBA had commitments to make direct loans totaling \$305 million and to make joint loans with banks (immediate participation loans) that would require SBA to disburse \$23 million.

As of June 30, 1974, SBA also was contingently liable for \$337 million on about 1,000 outstanding policies under its Lease Guarantee Program and for \$706 million on about 10,000 contracts under its Surety Bond Program. Before September 1974 SBA reduced the amount of its contingent liability for its Surety Bond Program upon notification that the contracts were completed. Because SBA was not notified in many cases when contracts were completed, SBA believed it was overstating its contingent liability. According to sureties, contracts of the average size of SBA's contracts were completed within 10 months. SBA began in September 1974 to reduce its contingent liability on contracts by 10 percent each month on the basis of this information. On this basis, SBA estimated it was contingently liable for about \$244 million on about 6,100 uncompleted bond contracts as of December 31, 1974.

SBA has been named as a defendant in a number of legal actions. Its General Counsel estimated that SBA has a contingent liability for about \$1 million on these actions.

5. Forgiveness credits

Congress has enacted legislation canceling, within certain limitations, borrowers' debts for disaster loans. Accordingly, SBA has processed forgiveness credits pursuant to:

	Amount (000 omitted)
The Disaster Relief Act of 1969 42 U.S.C. §1855eee (Supp. V, 1969), since repealed	\$ 70,630
The Disaster Relief Act of 1970 42 U.S.C. §4451 (1970), as transferred to 15 U.S.C. §636a (Supp. IV, 1974)	198,618
15 U.S.C. §636(b) (Supp. III, 1973)	<u>754,550</u>
	<u>\$1,023,798</u>

As indicated in note 1, SBA did not complete the processing of \$52 million in additional credits.

6. Fees

Loans

In January 1973 SBA changed its policy on the fees banks pay to SBA to guarantee loans. Previously, banks were required to pay fees semiannually for the life of a loan. Banks now pay a one-time fee on newly initiated loans and could, if they wish, convert their prior loans to a one-time fee basis. Fees in fiscal year 1974 were lower than fiscal year 1973 because of this conversion. SBA took all one-time fees into income in the year in which they are billed although the loans SBA guarantees have maturities that extend up to 15 years.

Surety bonds

SBA's accounting records for its Surety Bond Guarantee Program were such that we were unable to assure

ourselves that all fees SBA should have received were collected. (See pp. 17 to 18.)

7. Income from investments in U.S. Government securities

Of the \$353,000 earned in investments in fiscal year 1974, \$273,000 was returned to the Treasury in fiscal year 1975. The \$273,000 was part of \$508,545 returned to the Treasury. (For further comments see p. 25.)

APPENDIXES

SBA REVOLVING FUNDSBUSINESS LOAN AND INVESTMENT FUNDLoan program

Business--To aid small business concerns who need funds for purposes such as financing plant construction, acquisition of machinery and working capital.

Economic opportunity--To provide management and financial assistance to low income or disadvantaged persons who have the capability and desire to own their own businesses.

State development companies--To make loans to State development companies organized by acts of State legislatures to assist in development of business concerns, including small businesses.

Local development companies--To make loans to local development companies organized to improve a community's economy through projects that assist small businesses.

Displaced business--To help small business concerns that have suffered economic injury as the result of displacements by federally financed construction.

Trade adjustment assistance--To help companies adjust to changing economic conditions resulting from increased competition from imported articles.

Handicapped assistance--To aid nonprofit organizations employing handicapped persons and to aid small businesses owned by handicapped persons.

Small Business Investment companies--To provide financial assistance to small business investment companies that provide venture capital, long-term financing, and management assistance to small firms.

Procurement Assistance:

Section 8(a)--To help small business firms disadvantaged by economic and social conditions to obtain Federal contracts for goods, services construction, and research and development.

DISASTER LOAN FUND

To aid homeowners, business firms, and nonprofit institutions who have suffered property losses from floods and other catastrophies, and business firms that have suffered economic injury from such physical disasters. To make loans to small firms to enable them to comply with new health and safety standards imposed by various Federal statutes or State laws.

LEASE AND SURETY BOND GUARANTEES REVOLVING FUND

Leases--To enable small businesses to lease commercial or industrial property, SBA may guarantee the payment of rentals under leases or participate with private insurers in such guarantees.

Surety bonds--To enable small and emerging contractors to obtain bid, performance, and payment bonds, SBA guarantees sureties up to 90 percent of their loss if the bonds are breached.

LOAN TYPES CURRENTLY IN USEGUARANTEED LOANS

These loans are made by financial institutions to small businesses under agreement with SBA. This agreement provides that if the borrower defaults on the loan, SBA will purchase its guaranteed percentage (up to 90 percent) of the loan balance, plus interest from the date of last payment. These loans are made bearing interest rates within SBA's established rates.

IMMEDIATE PARTICIPATION LOANS

These loans are made in part by the financial institution and in part by SBA. The SBA share of a participation loan is normally limited to 75 percent of the total loan amount. The interest rate on the financial institution's share of the loan is set by the institution within the maximum rate established by SBA. SBA is prohibited by law from entering into a participation loan unless a guaranteed loan is unavailable.

DIRECT LOANS

A direct loan is a loan made by SBA using only Federal funds. Interest rates on direct loans are the same as described above for participation loans. SBA is prohibited by law from making a direct loan unless an immediate participation loan is not available.

SCHEDULE OF LOANS OUTSTANDING

	Loans outstanding			
	at June 30, 1973		at June 30, 1974	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
BUSINESS LOAN AND INVESTMENT FUND:				
Business Economic Opportunity State and Local Development	19,917	\$ 530,272	18,951	\$ 556,500
Displaced Business Trade Adjust-ment Assist-ance	18,183	197,826	19,378	225,503
Handicapped Assistance	2,731	279,061	3,127	313,037
Small Business Investment Company	2,318	189,670	2,562	218,149
Reconstruction Finance Corporation	3	2,886	1	1,440
	-	-	17	808
	660	205,133	677	215,924
	23	63	2	7
Total-- Business Loan and Invest-ment Fund	43,835	\$1,404,911	44,715	\$1,531,368
DISASTER LOAN FUND:	207,541	1,271,820	156,672	1,339,998
Total	<u>251,376</u>	<u>\$2,676,731</u>	<u>201,387</u>	<u>\$2,871,366</u>

<u>Loans in a liquidation status</u> <u>at June 30, 1974</u>		<u>Share of outstanding bank</u> <u>loans guaranteed by SBA</u> <u>at June 30, 1974</u>	
<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
(dollars in thousands)			
4,145	\$190,007	57,462	\$3,046,863
3,029	40,133	6,887	97,298
132	16,761	550	54,830
50	4,782	26	1,423
-	-	-	-
-	-	4	255
35	5,972	613	276,461
-	-	-	-
7,391	\$257,655	65,542	\$3,477,130
<u>1,219</u>	<u>22,313</u>	<u>42</u>	<u>6,291</u>
<u>8,610</u>	<u>\$279,968</u>	<u>65,584</u>	<u>\$3,483,421</u>



BEST DOCUMENT AVAILABLE

SCHEDULE OF LOAN DISBURSEMENTS

	Disbursements in fiscal year 1974				Disbursements in Fiscal Year 1973				Cumulative disbursements through June 30, 1974									
	By SBA		By Banks		By SBA		By Banks		By SBA		By Banks		Total					
	Number of loans	Amount	Number of loans	Amount	Number of loans	Amount	Number of loans	Amount	Number of loans	Amount	Number of loans	Amount	Number of loans	Amount				
	-dollars in thousands-																	
BUSINESS LOAN AND INVESTMENT FUND:																		
Business 7 (a)	1,147	\$ 40,074	18,695	\$1,513,776	19,842	\$1,553,850	1,941	\$ 62,776	22,821	\$1,481,314	24,762	\$1,544,090	71,426	\$2,572,335	89,928	\$6,482,449	161,354	\$ 9,054,784
Economic Opportunity	3,101	58,877	2,083	46,871	5,184	105,748	3,906	62,737	3,177	53,631	7,083	116,368	26,666	364,397	11,257	190,362	37,923	554,759
State and Local Development Company	494	54,351	161	22,717	655	77,068	383	37,648	150	19,184	533	56,832	3,465	437,433	654	111,077	4,119	548,510
Displaced Business	330	39,305	4	1,217	334	40,522	258	24,469	8	1,816	266	26,285	2,902	281,039	30	14,743	2,932	295,782
Trade Adjustment Assistance	-	-	-	-	-	-	-	175	-	-	-	175	4	3,935	-	-	4	3,935
Handicapped Assistance	17	811	4	458	21	1,269	-	-	-	-	-	-	17	811	4	458	21	1,269
Small Business Investment Company	32	15,610	65	82,200	97	97,810	5	3,001	52	64,150	57	67,151	2,027	461,072	634	218,412	2,661	679,483
Total Business Loan and Investment Fund	5,121	209,028	21,012	1,667,239	26,133	1,876,267	6,493	190,806	26,208	1,620,095	32,701	1,810,901	106,507	4,121,022	102,507	7,017,501	209,014	11,138,522
DISASTER LOAN FUND	71,423	550,518	11	2,437	71,434	552,955	202,032	1,164,260	12	1,456	202,044	1,165,716	491,763	2,993,683	1,539	35,906	493,302	3,029,589
Total	76,544	\$759,546	21,023	\$1,669,676	97,567	\$2,429,222	208,525	\$1,355,066	26,220	\$1,621,551	234,745	\$2,976,617	598,270	\$7,114,705	104,046	\$7,053,407	702,316	\$14,168,111

SCHEDULE OF LOANS PURCHASED BY SBA FROM BANKS

	<u>Purchased in</u> <u>fiscal year 1974</u>		<u>Purchased in</u> <u>fiscal year 1973</u>		<u>Cumulative through</u> <u>June 30, 1974</u>	
	<u>Number</u> <u>of</u> <u>loans</u>	<u>Amount</u>	<u>Number</u> <u>of</u> <u>loans</u>	<u>Amount</u>	<u>Number</u> <u>of</u> <u>loans</u>	<u>Amount</u>
	—————(dollars in thousands)—————					
BUSINESS LOAN AND INVESTMENT FUND:						
Business 7(a)	2,481	\$126,504	1,555	\$80,938	8,319	\$384,368
Economic Oppor- tunity	886	11,810	668	8,052	3,034	36,817
State and Local Development	24	3,489	13	1,897	59	7,659
Small Business Investment Company	<u>1</u>	<u>150</u>	<u>1</u>	<u>150</u>	<u>124</u>	<u>26,401</u>
Total Business Loan and In- vestment Fund	3,392	141,953	2,237	91,037	11,536	455,245
DISASTER LOAN FUND	-	-	-	-	1,357	13,515
Total	<u>3,392</u>	<u>\$141,953</u>	<u>2,237</u>	<u>\$91,037</u>	<u>12,893</u>	<u>\$468,760</u>



OFFICE OF THE ADMINISTRATOR

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

DEC 22 1975

Mr. Victor L. Lowe
Director, General Government Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

Enclosed are our comments, as requested, on the draft report entitled "Examination of Financial Operations for Fiscal Year 1974 Shows Need for Improvements in Financial Management."

We appreciate the opportunity to comment on this report and if you need any additional information, please advise.

Sincerely,

Louis F. Laun
Acting Administrator

Enclosure

"Recommendation [pp. 6 to 7] [See GAO note 1, p. 54.]

We recommend that the SBA Administrator develop and report statistical data essential for evaluating the collectibility of deferred and refinanced loans and data useful for determining whether SBA's program of granting deferments and refinancing loans is successful."

Response

We agree with the recommendation concerning the accumulation of data on deferred loans; however, this will require revisions to our procedures and to the automated loan accounting system. With regard to accumulating similar data on refinanced loans, we are not certain that this data is essential; however, we will review this matter further before a final decision is made.

"Recommendation [p. 8] [See GAO note 1, p. 54.]

We recommend that the SBA Administrator establish an allowance for loss account for accrued interest."

Response

We agree with this recommendation. An allowance for loss account for accrued interest will be established and adjusted at the close of each fiscal year.

"Recommendation [pp. 8 to 9] See GAO note 1, p. 54.]

We recommend that the SBA Administrator adopt procedures for processing delinquent loan cards through SBA's computer system so that SBA can have accurate information on the status of guaranteed loans."

Response

We agree with this recommendation and, in fact, this procedure was changed and computerized effective July 1, 1975.

"Recommendation [pp. 11 to 12] [See GAO note, p. 54.]

We recommend that the SBA Administrator establish a provision for losses and a corresponding liability for guaranteed leases and surety bonds expected to default and for guaranteed loans SBA estimates it will be required to purchase because of default."

Response

As noted in the report, reserves for default payments relative to the lease and surety bond guaranty programs are being established. However, instead of setting up the reserve when notice of default is received, the report is recommending that the reserve be established when the guaranty is issued.

In discussions with several major sureties, we were informed that it is the generally accepted practice in the industry to establish reserves at the time of default. Therefore, our procedures were predicated upon industry practice. Because of the similarities of the lease guaranty program to the surety bond programs, the same reasoning was extended.

If you continue to believe that the reserves should be established at the time the guaranty is issued, then we will develop the necessary procedures, systems and studies to capture the required information.

As to the recommendation of establishing a reserve for losses for guaranteed loans that we anticipate we will purchase, exception is taken. Such a reserve would constitute an asset valuation account. We would have a charge to income for and an offset to an asset that does not exist. There is no sound basis for such action.

"Recommendation [pp. 15 to 16] [See GAO note 1, p. 54.]

We recommend that the SBA limit the number of days of accrued interest that may be paid to banks on defaulted guaranteed loans to 90 days - the period currently provided for in the guaranty agreement - plus a reasonable response time."

Response

While there is no "90 day provision" in the guaranty agreement relative to the payment of accrued interest, the guaranty agreement does provide that the lender shall have the right to make demand on SBA to purchase its guaranteed percentage of a loan that has been in default for at least 60 days, provided the lender notified SBA, in writing, of the default at 30 days.

To limit the accrued interest payable to a lender upon demand for SBA to honor its guaranty would work in direct opposition to our mandate to hold down Agency outlay by reducing bank purchases. To tell our participating lenders that we will pay no more than 90 days (or 120 days, 150 days, or whatever) accrued interest upon purchase of a defaulted guaranty loan, would mean many lenders would make demand for purchase whenever any defaulted loan reached (or approached) the established maximum.

Our policy of cooperating with our participating lenders to effect cures of defaulted loans would be abrogated by establishing a maximum on the number of days accrued interest we would purchase. Under our present procedures, upon receipt of notice from the lender that an account is 30 days past due, field personnel contact the lender and we jointly offer all possible assistance (including Management Assistance resources) to the borrower to help him overcome his problems in bringing the loan current. Many times, the difficulty is seasonal or of a short term nature and it is, in the judgment of the lender and SBA, the repayment can and will be resumed in "X" number of months in the future. In such a situation, a deferment is granted and the loan reclassified as "current." If the situation then deteriorates to the extent that the lender must request SBA's purchase of that loan, we would then purchase more than 105 days (the report recommended maximum) accrued interest.

If the report's recommendation were adopted, we would be precluded from trying, in cooperation with the lender, to cure defaulted loans by either collection or deferment and would be required to purchase and service those defaulted loans reaching (or approaching) the established maximum number of days accrued interest which we would purchase. The result would be a tremendous increase in outlays and servicing responsibility. In any event, SBA's interest cost to the participant is offset by the interest cost payable to the Treasury.

"Recommendation [p. 17] [See GAO note 1, p. 54.]

We recommend that the SBA Administrator have disaster loan files involving loans disbursed to victims of disasters occurring in calendar year 1971 reviewed, borrowers' accounts corrected, and refunds made where appropriate."

Response

We believe that our current procedure of correcting errors as discovered to be the most efficient and practical manner of handling this situation in view of the uncertainty and the cost factors involved with the report's recommendation.

As noted, the report stated that the extent of the overcharges cannot be determined without a thorough and what we know to be a costly review. The report states that the "overcharges may amount to at least several hundred thousand dollars." (Underscoring furnished.) Conversely, the amount could be insignificant considering the fact that approximately 400 accounts have been adjusted.

In discussions with your representatives, we were informed that the average amount of the overcharge is \$39.00 per borrower. In order to identify any remaining loans requiring adjustment (1) a costly ADP programming and processing effort would be required and (2) a manual effort of computing, adjusting and processing corrections costing more than the amount of the average adjustment would also be necessary.

Since we could possibly be spending thousands of dollars needlessly, it is our position that corrections for any errors be processed as discovered. [See GAO note 2, p. 54.]

"Recommendation [p. 19] [See GAO note 1, p. 54.]

With regard to funds advanced to section 8(a) subcontractors, we recommend that the SBA Administrator determine the feasibility of:

- depositing advances to special bank accounts in amounts limited to meet subcontractors monthly needs
- using letter of credit procedures for advances over \$250,000 or
- disbursing advances of over \$250,000 in two or three installments."

Response

We agree with the recommendation of disbursing advances of over \$250,000 in two or three installments. The only exception would be if the entire advance was required for the purchase of material and/or equipment on a one time basis.

We will take the necessary steps to amend our Standard Operating Procedure 60-41-1 to implement this recommendation.

"Recommendation [p. 20] [See GAO note 1, p. 54]

We recommend that the SBA Administrator establish guidelines for determining when uncollectable advances to section 8(a) subcontractors should be written off."

Response

We agree with the GAO recommendation and will develop and implement the guidelines and procedures to write off uncollectable advance payments.

"Recommendation [p. 21] [See GAO note 1]

We recommend that the SBA Administrator have the Internal Audit Division audit SBA's financial statements, including evaluations of prescribed policies, procedures and internal controls."

Response

This agency has recognized the importance of internal audits of all its programs and functions, including the audit of financial statements. However, with limited audit resources, we also recognize that these resources must be utilized in areas of the greatest concern to this agency. Therefore, the cycle for the audit of financial statements has been less than normal. However, in our audit planning for Fiscal Year 1977, this audit will be given strong consideration.

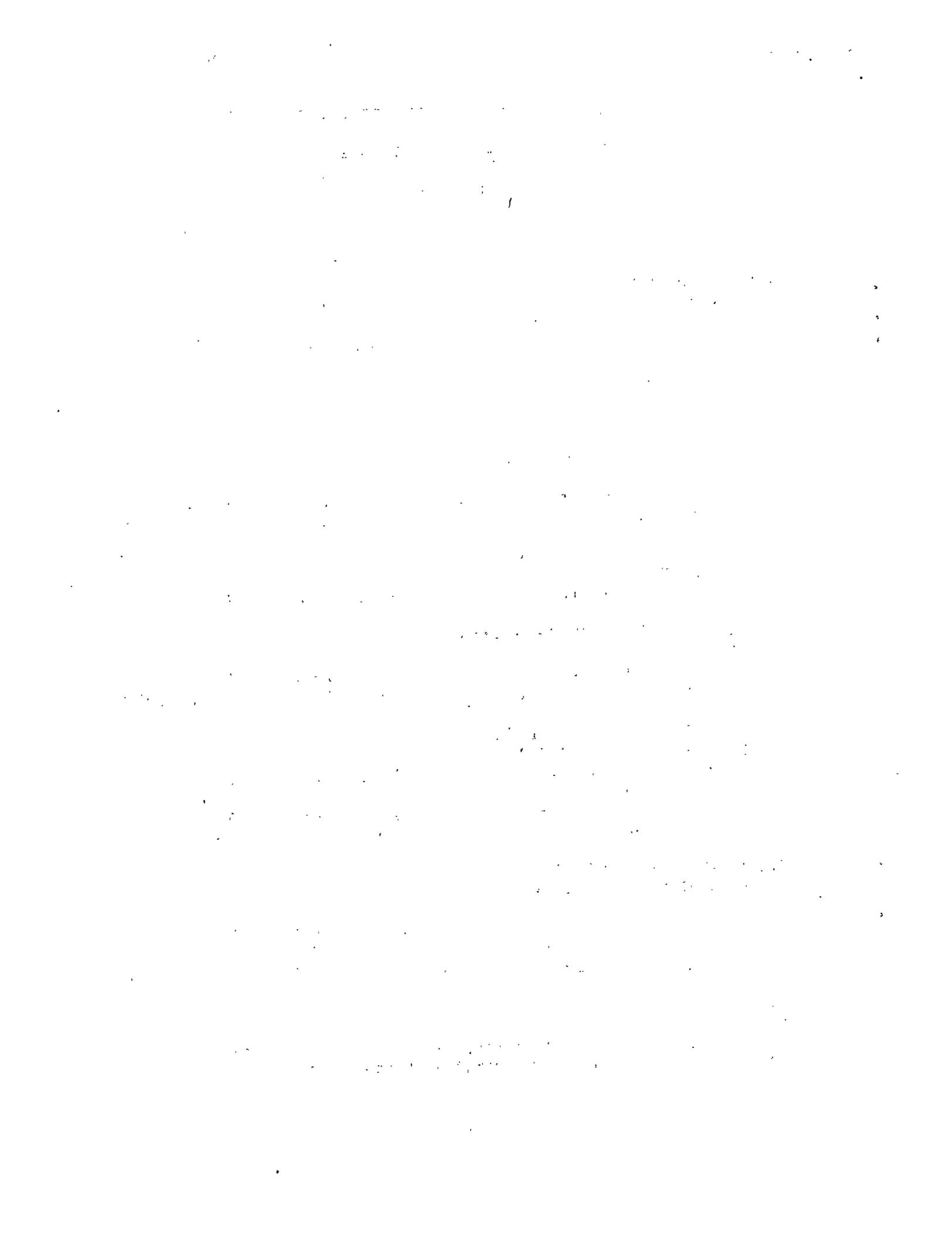
GAO notes:

1. Bracketed number references in this appendix correspond to pages of this report.
2. Deleted comments relate to matters which were presented in the draft report but were omitted from this final report.

PRINCIPAL SBA OFFICIALS RESPONSIBLE FOR
ADMINISTERING ACTIVITIES DISCUSSED IN
THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
ADMINISTRATOR:		
Mitchell P. Kobelinski	Feb. 1976	Present
Louis F. Laun (acting)	Oct. 1975	Feb. 1976
Thomas S. Kleppe	Jan. 1971	Oct. 1975
DEPUTY ADMINISTRATOR:		
Louis F. Laun	Sept. 1973	Present
Anthony Chase	Feb. 1971	Sept. 1973
ASSISTANT ADMINISTRATOR FOR ADMINISTRATION:		
Herbert T. Mills (acting)	Oct. 1975	Present
Ronald G. Coleman	May 1972	Oct. 1975
DIRECTOR, OFFICE OF BUDGET AND FINANCE:		
Herbert T. Mills	Mar. 1967	Present
DIRECTOR, OFFICE OF MANAGEMENT SERVICES:		
Schermen D. Price	Nov. 1972	Present
Schermen D. Price (acting)	Aug. 1972	Nov. 1972
ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT:		
John T. Wetlach	Sept. 1975	Present
Ronald C. Coleman (acting)	Feb. 1975	Sept. 1975
Einar Johnson (acting)	Jan. 1975	Feb. 1975
David A. Wollard	Feb. 1973	Jan. 1975
ASSOCIATE ADMINISTRATOR FOR PROCUREMENT ASSISTANCE.		
(note a):		
Harold K. Fletcher	July 1974	Present
Louis F. Laun (acting)	Mar. 1974	July 1974
Marshall J. Parker (acting)	May 1970	Mar. 1974

^{a/} Before July 1974, this position was the Associate Administrator for Procurement and Management Assistance.



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