

**Improved Examination Quality Can Strengthen  
SBA's Oversight of Small Business Investment Companies**





**U.S. Small Business Administration  
Office of Inspector General  
Washington, D.C. 20416**

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**FINAL REPORT TRANSMITTAL  
REPORT NUMBER: 13-22**

**DATE:** September 30, 2013

**TO:** Pravina Raghavan, Acting Associate Administrator, Office of Investments and Innovation

**SUBJECT:** Improved Examination Quality Can Strengthen SBA's Oversight of Small Business Investment Companies

This final report presents the results of our audit of the Small Business Administration's (SBA) examinations of Small Business Investment Companies (SBICs). Our initial objectives were to determine the extent to which the SBA (1) conducted SBIC examinations in accordance with the law, rules and regulations, and SBA policies and procedures, (2) used SBIC examinations to mitigate the risk of financial loss, and (3) managed the SBIC examination process effectively and efficiently. During our initial survey work, we identified deficiencies in the management of the SBIC examination process, which caused us to focus our work on objective three. As a result, we developed a reporting objective to identify key challenges the Office of Investments and Innovation (OII) faced in executing its SBIC examination function.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

We request that you provide your management decision for each recommendation on the attached SBA form 1824, *Recommendation Action Sheet*, by October 30, 2013. Your decision should identify the specific actions taken or planned for each recommendation and the target dates for completion.

We appreciate the courtesies and cooperation of the SBA extended to the staff during this audit. Please direct any questions to me at (202) 205-6586 or Terry Settle, Director, Credit Programs Group at (703) 487-9940.

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/s/  
Robert A. Westbrook  
Deputy Inspector General



## EXECUTIVE SUMMARY:

### *Improved Examination Quality Can Strengthen SBA's Oversight of Small Business Investment Companies*

Report Number 13-22

#### **What OIG Audited**

Small Business Investment Companies (SBICs) are private investment firms licensed by the Small Business Administration (SBA), pursuant to authority granted by the Small Business Investment Act of 1958 (Act). The SBIC program bridges the gap for entrepreneurs who need capital and are unable to obtain it through traditional sources of financing. The SBIC program provides SBA-guaranteed leverage to SBICs that, in turn, make loans and equity investments in qualifying small businesses. As of March 31, 2013, there were 296 SBICs in active operation. Of those 296 SBICs, 252 were indebted to the SBA for more than \$9.3 billion.

The SBA is required to examine all SBICs at least every two years to assess (1) whether licensees are complying with the Small Business Investment Act of 1958 and implementing regulations, (2) the financial condition of licensees and SBA's financial vulnerabilities, and (3) the accuracy of information submitted to the SBA. These examinations are conducted by the Office of SBIC Examinations (OSE) within the Office of Investments and Innovation (OII).

Our initial objectives were to determine the extent to which the SBA (1) conducted SBIC examinations in accordance with the law, rules and regulations, and SBA policies and procedures, (2) used SBIC examinations to mitigate the risk of financial loss, and (3) managed the SBIC examination process effectively and efficiently. During our initial survey work, we identified deficiencies in the management of the SBIC examination process, which caused us to focus our work on objective three. As a result, we developed a reporting objective to identify key challenges the OII faced in executing its SBIC examination function.

#### **What OIG Found**

We determined that while the SBIC examination function generally addressed the requirements of the Act and Agency policy, improvements can be made. Our review found that examinations were conducted at least every two years as required by the Act. Further, our review indicated that SBICs were generally checked for regulatory violations as prescribed by the Act and Agency policy.

However, we found that improvements of SBA processes could enhance the extent to which the Office of SBIC Examinations identifies business conditions and practices prohibited by the Act and Agency policy.

The SBA's focus on the frequency of examinations as a strategy for reducing risk did not include a compensating control to ensure that examinations conducted would result in accurate assessments of regulatory compliance. With a greater emphasis on quantity, the OSE runs the risk that the review of an SBIC may be inaccurate or incomplete. To this point, the significant decrease in examination reports with findings may indicate that the quality of these assessments has suffered.

Outdated guidance and incomplete examination checklists also affected the quality of the SBIC examination process. The examiners were impacted by challenges in the areas of strategic planning and the absence of training and technology upgrades to help keep pace with the changing industry requirements. Further challenges included poor communication and insufficient funding. These challenges, coupled with the emphasis on quantity, have resulted in examiners not identifying all findings.

#### **OIG Recommendations**

We recommended that the Acting Associate Administrator for the Office of Investments and Innovation:

- (1) Create and execute a plan to improve the internal operations of the examination function.
- (2) Update and improve the existing examination checklist.
- (3) Assess the costs of the examinations function and prepare cost-benefit analyses for several funding options, to cover all examination costs.

#### **Management Response and Actions Taken**

The SBA agreed with Recommendations 2 and 3 and disagreed with Recommendation 1. During the course of this audit, the SBA updated and submitted for clearance, SOP 10 09, *SBIC Examinations Guidelines*. This update will address many of the concerns raised by the OIG as outlined in this report.

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## Introduction

This report presents the results of our audit of the Small Business Administration's (SBA) examinations of Small Business Investment Companies (SBICs). Our initial objectives were to determine the extent to which the SBA (1) conducted SBIC examinations in accordance with the law, rules and regulations, and SBA policies and procedures, (2) used SBIC examinations to mitigate the risk of financial loss, and (3) managed the SBIC examination process effectively and efficiently. During our initial survey work, we identified deficiencies in the management of the SBIC examination process, which caused us to focus our work on objective three. As a result, we developed a reporting objective to identify key challenges the Office of Investments and Innovation (OII) faced in executing its SBIC examination function.

To answer our reporting objective, we reviewed the Small Business Investment Act of 1958, Part 107 of Title 13 Code of Federal Regulations, and applicable Standard Operating Procedures (SOPs). We also reviewed SBA's 2011 – 2016 Strategic Plan and the Agency's Small Business Investment Company Program Annual Report for FY 2012. We obtained and analyzed historical performance and cost data related to the examination function.

We judgmentally selected a sample of 3 examinations from a universe of 141 examinations performed by the Atlanta Field Office between October 1, 2010, and August 10, 2012. The SBICs examined by the Atlanta office represented approximately \$4.24 billion in indebtedness to the SBA. Using an Office of Inspector General (OIG) review methodology—that we prepared based on applicable SOPs—we reviewed Atlanta office examination files to assess whether the examinations covered the required laws, regulations, policies, and procedures.

We interviewed the three regional managers and 6 of the 17 examiners responsible for evaluating SBICs. We interviewed representatives of four leveraged SBICs. We also interviewed senior officials in the OII at SBA Headquarters in Washington, DC. Finally, we interviewed budgetary officials in the Office of Investment and Innovation. See Appendix I for full details of our methodology and list of sampled SBIC examinations.

Our review focused on SBA's Office of SBIC Examinations (OSE), the office that has functional responsibility for examining licensees for statutory and regulatory compliance in this multi-billion dollar investment program.

We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

## Background

Small Business Investment Companies (SBICs) are private investment firms licensed by the Small Business Administration (SBA) pursuant to authority granted by the Small Business Investment Act of 1958 (Act). The SBIC program bridges the gap for entrepreneurs who need capital and are unable to obtain it through traditional sources of financing. The SBIC program provides SBA-guaranteed leverage<sup>1</sup> to business investment firms that in turn make loans and equity investments in qualifying small businesses.

The SBIC Program has primarily used two approaches to provide funding:<sup>2</sup> the Debenture Securities Program and the Participating Securities Program. Investment funds have been licensed as Standard Debenture licensees since the program was founded in 1958. Debenture licensees provide later stage or expansion capital to cash-flow positive or nearly cash-flow positive companies and are eligible for SBA leverage capped at \$150 million.<sup>3</sup> Debentures have a repayment term of 10 years and provide for semi-annual interest payments and a lump-sum principal payment at maturity.

Conversely, the SBA's Participating Securities Program began in 1994 to better match how SBICs were funded with the equity needs of entrepreneurs. Participating securities have 10-year maturities and prioritized payments (interest) paid only to the extent that an SBIC has positive earnings. Depending on whether an SBIC was a corporation or a partnership, SBICs issued participating securities as preferred stock, income bonds, or a preferred limited partnership interests. The SBA eliminated the Participating Securities Program in 2004 due to projected losses in excess of \$2.7 billion.

The SBIC program is managed within the SBA by the Office of Investments and Innovation, which is responsible for licensing, overseeing the regulatory compliance of, assessing the financial condition of, guaranteeing leverage to, and liquidating SBICs. As of March 31, 2013, there were 296 SBICs in active operation, 252 of which were indebted to the SBA for more than \$9.3 billion in SBA-guaranteed leverage.<sup>4</sup> The SBA charges upfront and annual fees on the leverage that SBICs draw. These fees are used, in part, to offset losses; however, the vast majority of SBICs fully repay their SBA-guaranteed leverage.

In fiscal year 2012, SBICs provided \$3.1 billion in financing to over 1,000 small businesses. The SBA maintains that the SBIC Program operates on a zero subsidy basis and, historically, at no cost to taxpayers. This aspect of the program has not been audited by the OIG. In its 2011-2016 Strategic Plan, the SBA reported that it intended to double the amount of long-term capital deployed in the SBIC Program from the average of \$750 million to \$1.5 billion per year by Fiscal Year (FY) 2016. As of June 30, 2013, the SBA reported that it had issued an average of \$1.7 billion in debenture leverage commitments, and therefore exceeded its goal.

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<sup>1</sup> Leverage means financial assistance provided to an SBIC licensee by the SBA.

<sup>2</sup> The SBA also provides capital under its "Other Funds" category. These are referred to as Specialized SBICs.

<sup>3</sup> For every one dollar an SBIC raises from a private investor, the SBA will typically provide two dollars of debt capital or leverage, subject to a cap of \$150 million.

<sup>4</sup> Some SBICs do not receive SBA-guaranteed leverage or financial assistance. These "non-leveraged" investment funds nonetheless play an important role in both attracting private capital and investing in small businesses in need of financing. These non-leveraged funds have typically been attractive to bank investors, for whom investments in SBICs presumptively qualify towards Community Reinvestment Act Credit. As of FYE 2012, there were 44 Non-Leveraged SBICs in the program.

The Act and SOPs require the SBA to examine all SBICs at least every two years to ensure they are performing well financially, and are complying with the legal requirements governing the SBIC Program. The Act further directs the SBA to determine if seven specific violations exist within the operations of SBICs. Agency policy requires examiners to determine if two additional violations exist. The nine violations are listed and explained in detail in Appendix II. The Office of SBIC Examinations (OSE), within the Office of Investments and Innovation (OII), is tasked with examining SBICs for potential violations. The violations identified by the OSE can result in SBICs being transferred to the OII's Office of SBIC Liquidation for recovery of funds paid by the SBA. The OII's Office of SBIC Operations, which is responsible for the daily oversight and continuous monitoring of SBICs, also identifies program violations and other non-compliance issues.

### **The Office of SBIC Examinations**

The Office of SBIC Examinations, according to Standard Operating Procedure (SOP) 10 08, *Examination Guidelines*, is responsible for (1) determining whether licensees are complying with the Small Business Investment Act of 1958 and implementing regulations, (2) assessing the financial condition of licensees and SBA's financial vulnerabilities, and (3) ensuring the accuracy of information submitted to the SBA.

The SBA's statutory authority to conduct examinations allows the Agency to collect fees to cover the costs of performing these examinations. Examination fees are based upon the SBICs' assets at cost, with adjustments in the form of discounts or add-ons for outstanding examination findings, responsiveness, type of organization, and locations of files.

The OSE is headed by a Director in Washington, D.C. who plans, directs, and coordinates the SBA's program for examining SBICs through three examination managers and 16 examiners assigned to regional offices located in Atlanta, Georgia; New York, New York; and San Francisco, California. An additional examiner located in West Virginia reports to the Director. Examination managers supervise the workflow and daily activities of examiners who schedule and perform examinations using a checklist to guide efforts and capture results. They also review the examiner's work papers and draft reports. The managers also report examination results and findings to the Office of SBIC Operations. Although OSE examiners identify findings, the Office of SBIC Operations has the final decision about the validity of those findings and the extent to which they will be included in the final reports issued to the SBICs for corrective action. Findings are classified as Category One, which represents the nine more serious violations, or Category Two, which covers all other less serious non-compliances that may appear under "Other Matters" in the examination report.<sup>5</sup> During fiscal year 2012, the SBA issued 233 examination reports, identifying 17 Category One findings and 16 Category Two findings.

### **Nature of Limited or Omitted Information**

We did not limit or omit information from this report.

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<sup>5</sup> See Category One violations in detail in Appendix II.

## Review of Internal Controls

The SBA's internal control systems SOP<sup>6</sup> provides guidance on the implementation and maintenance of effective systems of internal control as required by OMB.<sup>7</sup> According to OMB, effective systems of internal control improve the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal controls.

To assess internal controls during the survey phase of the audit, we assessed the control environment in which the Office of SBIC Examinations functioned and reviewed the activities and processes used to execute the office's responsibilities. We also completed a logic model to record concerns in the areas of inputs, activities, outputs, and outcomes for the SBIC Examinations function. We found weaknesses in the management of the SBIC examination process, including challenges in the areas of SBIC examination quality, guidance, planning, training, technology, communication, and funding. Cumulatively, the weaknesses we identified diminished the SBA's ability to identify regulatory violations and other non-compliance issues in the operations of SBICs.

## Results

We determined that while the SBIC examination function generally addressed the requirements of the Act and Agency policy, improvements can be made. Our review found that examinations were conducted at least every two years as required by the Act. Further, our review indicated that SBICs were generally checked for regulatory violations as prescribed by the Act and Agency policy. However, we found that improvements could enhance the extent to which the Office of SBIC Examinations identifies business conditions and practices prohibited by the Act and Agency policy.

### Improved Examination Quality Can Strengthen SBA's Regulatory Oversight of SBICs

The SBA's reliance on the frequency of examinations as a strategy for reducing risk did not include a compensating control to ensure that examinations conducted would result in accurate assessments of regulatory compliance. With a greater emphasis on quantity, the OSE runs the risk that the review of an SBIC may be inaccurate or incomplete.

Outdated guidance and incomplete examination checklists also affected the quality of the SBIC examination process. The examiners were impacted by challenges in the areas of strategic planning and the absence of training and technology upgrades to help keep pace with the changing industry requirements. Further challenges included poor communication and insufficient funding. These challenges coupled with the emphasis on quantity have resulted in examiners not identifying all findings.

### While Examination Cycle Time Has Decreased, Reports with Findings Have Also Decreased

Our analysis found that the SBA required examinations to be completed more frequently than statutorily mandated, which reduced the average examination cycle time. At the same time, the

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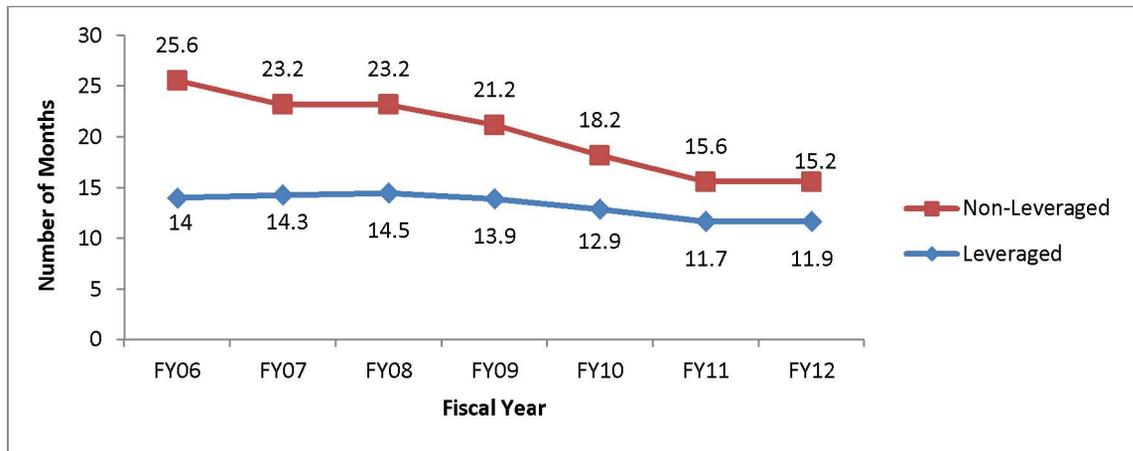
<sup>6</sup> SOP 00 02, *Internal Control Systems*.

<sup>7</sup> US Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, 2004.

percentage of reports with findings also decreased. The SBA claimed the reduction in findings occurred due to more frequent examinations and stronger standards for entry into the program. For example, in its Fiscal Year (FY) 2012 Annual Report, the SBA noted that it conducted more frequent examinations and had fewer reports with findings, thereby indicating that regulatory compliance had improved. Additionally, a senior OIG official stated that the number of findings had decreased due to the better quality of SBICs and training received by SBICs regarding policies and procedures. However, we identified other factors that could have contributed to the decline in findings.

The Act requires the SBA to examine each licensee at least every two years,<sup>8</sup> but SBA policy requires examinations that are more frequent.<sup>9</sup> For example, as of August 2012, examinations for leveraged SBICs were occurring at 11.9-month intervals, while examinations for non-leveraged SBICs were occurring at 15.2-month intervals, as reflected in Figure 1.

Figure 1 SBIC Examinations Cycle Time (in Months)



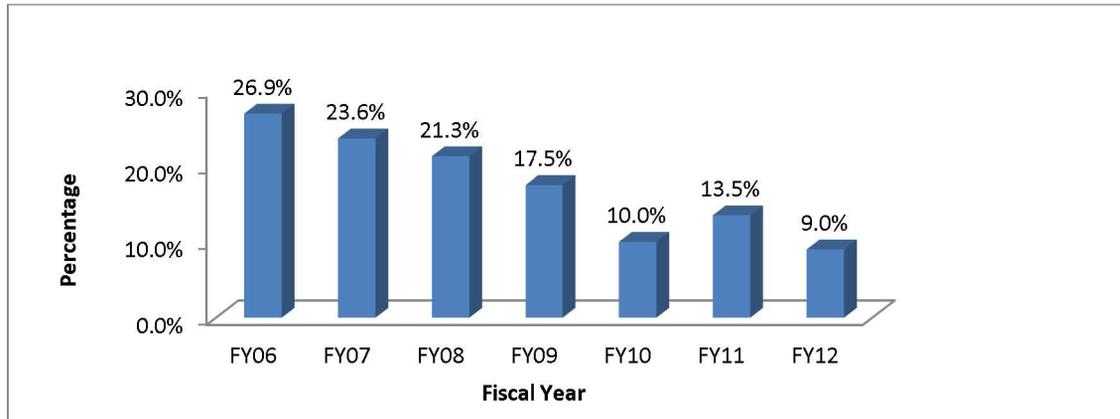
Source: Generated by OIG with data obtained from the OIG.

As the time between examinations has generally decreased over the past six years, the percentage of findings has also decreased. Specifically, since 2006, the average time between examinations decreased by greater than 15 percent for leveraged SBICs and 40 percent for non-leveraged SBICs. The percentage of reports that yielded findings of regulatory violations for both leveraged and non-leveraged SBICs combined, decreased by nearly 67 percent, from 26.9 percent to 9 percent, during this same period, as shown in Figure 2.

<sup>8</sup> Section 310(b)

<sup>9</sup> SOP 10 08 requires leverage SBICs be examined annually and non-leveraged on an 18-24 month cycle.

Figure 2 Percentage of Total Reports with Findings



Source: Generated by OIG with data obtained from the OII.

SBA Management stated that the decrease in findings was due to an improvement in the quality of SBICs as a result of more frequent examinations and more stringent licensing requirements. However, we determined that there are specific challenges faced by examiners that are contributing towards the decline in findings as discussed below.

#### **Quality Suffered in Response to Risk Reduction Strategy of Increasing Examination Frequency**

The Office of Examinations' strategy of focusing on examination frequency was reflected in the annual guidance distributed to examination managers. This guidance emphasized the number of examinations to be completed. Further, individual performance standards clearly stressed volume. Specifically, the performance standards showed a direct relationship between the number of examinations performed and the performance ratings of examiners and examination managers. For example, a GS-11 examiner was expected to complete a minimum of 12 examinations in order to receive a rating of 3. To receive a rating of 4, the examiner had to complete a minimum of 13 examinations. A rating of 5 required the completion of a minimum of 14 examinations. Quality was not a measurable benchmark in terms of employee performance. In fact, emphasis was placed on the quality of the written product as opposed to the quality of the examination process itself.

Importantly, in interviews conducted with examination managers, examiners, and SBICs, the issue of time allowed to conduct examinations was a concern. Specifically, four examiners told us that the quality of the exams could be improved if more time was allotted. They stated more thorough examinations could be performed and more findings possibly produced. One examiner told us that their manager pushed for a "no findings" report due to time constraints. An examination manager stated that due to the broad scope of the examination, the examiner does not have sufficient time to identify some of the more complex findings. Another examination manager and examiner said that additional time would permit more detailed reviews. Additionally, one senior OII official stated that examiners missed violations—such as improper management fees—that had been recurring for several years. Liquidations staff eventually discovered the violations only after the licensee was transferred to liquidation. Another senior OII official stated that examiners missed violations such as conflicts of interest, inaccurate valuations and overline investments.

## **Outdated Guidance and a Deficient Examination Checklist Affect Examination Quality**

At the time of our audit, SBA guidance for examining SBICs was outdated and did not ensure that major regulatory violations were addressed. The SBA's SOP 10 08, *SBIC Examinations Guidelines*, which defined the purpose of examinations, had not been updated since its issuance in 1997. The SBA's SOP 10 09, *SBA Internal Examination Guidelines* also had not been updated since 1998. This SOP instructed the examiners to focus on nine Category One violations, as follows:

- (1) Unlawful Activities Not Contemplated by the Act,*
- (2) Relending, Foreign, Passive or other Prohibited Investments, Including Prohibited Real Estate Financings,*
- (3) Prohibited Conflicts of Interest,*
- (4) Overline Investments*
- (5) Short Term Financing,*
- (6) Excessive Cost of Money,*
- (7) Control of Small Business,*
- (8) Inappropriate Distributions,*
- (9) Impairment and Valuation Issues*

The Office of SBIC Examinations created a checklist in 2001 for examiners to perform their work. Our review of the six-page checklist found that it did not align with the nine Category One violations. The checklist contained 41 specific actions for examiners to complete. However, the focus of the checklist was unclear and violations were not explicitly listed. For example, to address Conflicts of Interest, SOP 10 09 required examiners to review the terms of financings, review the disposition of assets, obtain credit reports, obtain confirmations from portfolio concerns, and consider visiting small business that appear to be in a conflict of interest situation. However, the only SOP action mentioned on the checklist was "review disposition of assets," and the checklist did not mention "Conflict of Interest." Similarly, the checklist did not explicitly list the following Category One violations and did not contain all the elements necessary to examine the violations as stated in the SOP:

- Activities Not Contemplated by the Act
- Prohibited Control of a Small Business
- Short Term Financings
- Overline Investments
- Relending, Foreign, Passive or Other Prohibited Investments, including Prohibited Real Estate Financing; and
- Excessive Cost of Money

Furthermore, we observed that although the steps required in the SOP to identify "Inappropriate Distributions" were in the checklist, this violation was not titled anywhere within the checklist.

Six of the nine managers and examiners we interviewed told us that the checklist was outdated and did not reflect the current environment for identifying findings. Several examiners confirmed our analysis that the nine Category One violations were not specifically covered by the checklist. One examiner said these violations should be explicitly stated in the checklist for

new and inexperienced examiners. The guidance governing the examinations process has not been updated since 1998 and the checklist since 2001. The outdated policies and procedures, according to staff, did not reflect the changes that have occurred in the program. For example, according to an examination manager, examiners no longer review the prohibited control of a small business and short-term financing, which are two of the nine Category One violations, because of the rarity of these violations. During the course of the audit, senior officials in the OII stated they recognize that the SOPs should be updated and were in the process of making revisions to SOP 10 09. However, they said the checklist was not an issue because everything was covered and there was consistency across the offices in conducting examinations.

Given the gaps in the checklist, statutory and regulatory violations and other non-compliance issues may not be identified and the SBA's ability to assess the financial condition of licensees and SBA's financial vulnerability may be hindered. In addition, the SBA's ability to ensure the accuracy of information that licensees submit to the Agency might be impaired. Furthermore, the checklist gaps could result in a lack of consistency in the approach that SBIC examiners use and the conclusions that they reach.

Additionally, incongruence between SOPs and the checklist increases opportunities for unidentified violations that impact the quality of examinations. For example, one senior OII official stated that examiners missed violations such as improper management fees that had been recurring for several years. Liquidations staff eventually discovered the violations only after the licensee was transferred to liquidation. Another senior OII official stated that examiners missed violations such as conflicts of interest, inaccurate valuations and overline investments.

### **Challenges That Impacted Examiner Effectiveness**

We found that although the SBA had a strategic plan which included goals, strategies, and performance measures for the OII, neither the OII nor the OSE had its own plan to provide direction at the operational level. We also found that examination staff was not receiving the training necessary to develop and maintain the skills needed to keep pace with industry changes, including private equity and venture capital. Furthermore, while the SBA planned to invest in technology for the OII to reduce program risks, the SBIC examination activity was not included in the strategy. We also identified communication challenges that represent missed opportunities for a more effective SBIC examination process. Finally, while the SBA has continued to exercise its statutory authority to collect examination fees, we determined the fees were not sufficient to keep pace with rising costs.

### **Strategic Planning**

An OII senior official told us that the OII's goals are generally guided by the SBA's strategic plan. Neither the OII nor the OSE had their own plan. The senior official stated that SBIC examinations are an Agency goal because they are a statutory requirement. The senior official further stated that the OII creates goals at the director level annually, but does not formally track these goals.

According to the Office of Management and Budget (OMB), a strategic plan is a valuable tool for communicating to agency managers, employees, and other stakeholders a vision for the future.

It should be used to align resources and guide decision-making to accomplish established priorities and improve outcomes. Further, it should inform agency decision-makers about the need for major new acquisitions, information technology, human capital development, evaluations, and other investments.<sup>10</sup>

Although functional offices within the Agency were not required to develop a plan, in the absence of a plan for the OII, we observed the following:

- Managers and employees are not aware of the vision for the Office of SBIC Examinations
- Inconsistency, in terms of examination focus across offices
- Lack of priority regarding technology and training needs

The OII could use the Agency's strategic plan as a framework to develop its own plan to measure the performance of its components, to include the OSE. For example, the Agency outlined various approaches and strategies in its strategic plan to improve its performance. These strategies included providing employees with business, technical and analytical training; linking employees' annual performance plans to results oriented organizational goals; deploying technologies to enable employees to quickly and efficiently perform daily duties; and lastly, improving employee engagement and utilization.

### **Training Challenges**

Insufficient training impedes examination staff in developing and maintaining the necessary skills to keep pace with changes in the industry. Managers expressed concerns regarding the need for more training. For example, one manager expressed concern regarding the extent to which the staff had the appropriate skills and education to perform the work. Another manager believed that training in Forensic Accounting could benefit the examination process. Examiners could also benefit from training in the area of private equity, according to a seasoned examiner. Guidelines for SBIC Examinations require that examiners be able to demonstrate proficiency in financial analysis and accounting principles, standards, and techniques. Further, examiners are also required to have a thorough knowledge of regulatory and statutory requirements pertaining to the SBIC program and the examination process; however, management did not provide ongoing training to maintain proficiency in these areas. For example, examiners did not receive a formal introduction to the private equity industry through training. Therefore, examiners were not aware of what was new in the financial risk arena, which changes frequently. One examiner stated that SBICs are much more sophisticated than when the examiner initially began his or her career in 2000. As such, the examiner feels that the staff needs to participate in targeted training to help them keep up with changes in the field and the business and technological advancements of the SBICs.

### **Technology Challenges**

Another area of concern was related to technology. As previously discussed, examinations are used to implement the SBA's statutory mandate to review SBICs for violations of the Act, and compliance with Agency and program requirements. In its strategic plan, the SBA acknowledged

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<sup>10</sup> OMB A-11, Preparation, Submission, and Execution of the Budget.

the need to invest in technology to create tools to collect financial data and monitor risk and performance to reduce investment program risk. However, the SBIC examination activity was not included in the description of measures to reduce risk.

The Clinger-Cohen Act of 1996 requires agencies to establish goals for improving the efficiency and effectiveness of agency operations through the effective use of information technology.<sup>11</sup> Management and staff from the OII expressed the need for, and benefit of, technology such as electronic work papers (e.g. Team Mate). For example, files that were once shipped between offices and exposed to loss or damage could be scanned for review by appropriate examination staff. An examiner told us that electronic work papers would be a significant asset to the examination process and would be a good way to incorporate standardization into the process while bringing the three offices in line with one another.

The former Associate Administrator for the OII acknowledged the need for improved technology, but stated that due to budgetary priorities, it was not feasible anytime soon. Additionally, SBIC representatives expressed their concerns about SBA's technology, in terms of efficiency and security. For example, an SBIC official expressed the need for updated technology for examinations, such as audit software similar to financial auditing organizations. Another SBIC official expressed concerns about data security because of limited technology. The official also stated that he wanted to provide all required documents through a cloud storage device and was surprised that examiners did not have a paperless method for collecting data.

### **Communications Challenges**

Communication is critical to the OSE because the office has staff in multiple locations. According to OMB A-123, "information should be communicated to relevant personnel at all levels within an organization. The information should be relevant, reliable, and timely."

We identified challenges that impacted the effectiveness of the OSE's communications. For example:

- *Examiners' Input on New Processes:* The OSE in Washington, DC, disseminated information to field staff about policy changes via email through examination managers. The lack of direct or in-person communication with examiners limited the opportunity for examiners to provide input. Our interviews with examiners reflected that this impacted employee morale.
- *Lack of Knowledge Sharing:* The ability for examination staff to share knowledge is constrained. We found that there is limited communication from headquarters to the field and among SBIC examination field offices. In addition, an OII official said that the OII no longer holds regional or national meetings due to budget constraints. Staff told us that when these types of meetings occurred in the past, they used them as an opportunity to share ideas, information, and trends. We identified a lack of communication, both vertically and horizontally, which could have impaired consistency in operations, limited knowledge transfer, and negatively impacted synergy among

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<sup>11</sup> US Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, 2004, p. 11.

peers in the examination function. As the SBICs get more sophisticated, knowledge sharing becomes even more important. One examiner told us it would be beneficial, for example, to hear about specific issues that other examiners have encountered.

## Funding Challenges

Resources are critical to carrying out the mission of the OSE. Congress provided for a source of funding for the SBIC examinations activity in the Act. The Act authorized the SBA to collect fees from SBICs to cover costs associated with the examination function. Importantly, we reviewed the CFR and confirmed with SBA officials that examination fees have not changed since 1998.<sup>12</sup> While the SBA has continued to exercise its statutory authority to collect fees, we determined the actual fees collected were not sufficient to keep pace with rising costs.

- a. Based on 2012 figures, inflation has increased by 37 percent since 1998.<sup>13</sup> Therefore, all else being equal, an SBIC that paid \$5,000 for an examination in 1998 should pay approximately \$7,100 for the same examination today.
- b. Federal government salaries, benefits, travel, and related costs have continually increased since 1998 and therefore, it is reasonable to expect examinations fees would increase to mitigate the costs associated with the examination function as allowed by the Act. An OII senior budget official believed that SBICs were already incurring enough of a financial burden without paying additional examination fees.

Despite inflation and government-wide budget cuts, SBA management has chosen not to increase examination fees, which may have impaired OSE's ability to meet the intended purpose of examinations. Without proper training and technology examiners may not effectively identify all regulatory violations as intended by the Act. For example, OII program officials stated that budgetary constraints affected their ability to provide examination staff with training and technology necessary to keep pace with the challenges of a complex and ever-evolving venture capital industry.

In FY 2012, the SBA collected \$1.84 million in fees, which offset just over half or 54 percent of the \$3.4 million in examination costs for that year. Further, SBA staff confirmed our analysis that the cost of conducting examinations far exceeds the examination fees they collect.

For FY 2013, the OSE implemented a mandated budget cut that limited examination-related travel.<sup>14</sup> By implementing the mandated budget cuts, the OSE reduced its FY 2013 travel budget from \$228,737 to \$160,000. If fees do not cover the cost of examinations, the SBA should consider exercising its statutory authority to increase them.

## Conclusion

The Office of SBIC Examinations, while meeting statutory requirements, could significantly enhance its oversight of SBICs by improving its examination process, a risk-mitigation function essential to the SBIC program. The policy to focus on quantity is not sufficient to ensure that

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<sup>12</sup> 13 CFR 107.692, Examination Fees.

<sup>13</sup> Source: US Department of Labor, Bureau of Labor Statistics Inflation Calculator.

<sup>14</sup> OMB M-12-12, Promoting Efficient Spending to Support Agency Operations, May 11, 2012.

examiners are able to identify and address violations by SBICs. Also, outdated guidance and incomplete examination checklists further impacted the quality of the examination process. Although the OSE has implemented a systematic method for prioritizing its examinations, a number of other challenges adversely impacted its ability to fully achieve the goal of assessing (1) compliance with the Act and implementing regulations, (2) the financial condition of licensees and SBA's financial vulnerabilities, and (3) the accuracy of information SBICs submit to the SBA. These challenges include the lack of an organizational level strategic plan, inadequate training, outdated technology, poor communication, and limited funding. This has resulted in inconsistent examinations and examiners not identifying all findings.

To improve and sustain the performance of the SBIC examination function, the SBA will need to evaluate the operations of the SBIC examination function. This evaluation should help to identify approaches toward overcoming the challenges that the OIG has identified in the areas of quality assurance, guidance, planning, training, technology, communication, and funding. During the course of this audit, the SBA updated and submitted for clearance, SOP 10 09, *SBIC Examinations Guidelines*. This update will address many of the concerns raised by the OIG in this report and we commend the Agency for this progress.

## **Recommendations**

We recommend that the Acting Associate Administrator for the Office of Investments and Innovation:

1. Create and execute a plan to improve the internal operations of the examination function. The plan should include quality driven goals and performance indicators that the OII will use to monitor, assess, and balance the quantity and quality of the SBIC examination function and its operations. It should also include a plan for better communication.
2. Update and improve the existing examination checklist to: (1) better align with and reference SOP guidance for examinations; (b) ensure focus on Category One violations, and (3) ensure consistency across the three SBIC examination offices.
3. Assess the costs of the examination function and prepare cost-benefit analyses for several funding options, including a potential increase in examination fees, in order to improve training and technology, and cover other examination costs.

## Agency Comments and OIG Response

On August 23, 2013, we provided a draft of this report to the Acting Associate Administrator for Investment and Innovation for comment. On September 23, 2013, the Agency submitted a formal response, which is included in its entirety, less Exhibits, in Appendix III.

### Summary of Management Comments

The SBA agreed with two of the three recommendations in the report and disagreed with one. Management stated that Recommendation 1 was based on discrepancies and/or inaccuracies within the report. Management stated that it has historically and actively managed optimal internal operations, strived for quantity and quality in its processes, and promoted open communication. In response to Recommendations 2 and 3, the SBA agreed to (1) update and improve the existing examination checklist and (2) assess the costs of the examination function and prepare cost-benefit analyses for several funding options, including a potential increase in examination fees, in order to improve training and technology, and cover other examination costs.

The SBA stated that the title of the report was misleading as it asserted that examination quality was lacking and the oversight of SBICs was not as strong as it should be. The SBA claimed that the OIG's conclusion regarding the emphasis on quantity and the lack of compensating controls to ensure the accuracy of examinations was inaccurate. The SBA stated there was no documentation indicating there was a quality issue with examinations or that time constraints were causing a reduction in quality. The SBA provided email exhibits to refute the OIG's conclusion. The emails provided examples of directives to SBIC Examination Managers including factors, such as quality, to be met when conducting examinations. The SBA also provided observations demonstrating why the significant decrease in examination reports with findings may have resulted from factors other than decreased examination quality. These observations included two recent regulatory changes, a more rigorous licensing process and a more thorough and transparent examination process. The SBA stated that the number of examinations completed by an examiner is only one component in deriving an examiner's numerical performance rating. Management provided an October 2, 2012, email directing examination managers to consider other factors, such as quality, in determining the examiners' numerical ratings for fiscal year 2013.

The SBA noted that it has been revising and updating SOP 10 08 and a revised SOP 10 09 is pending publication. The SBA stated that the examination checklist would be updated to better correspond and correlate with the revised SOP. Furthermore, the SBA stated that it would schedule an annual review of the checklist and enhance and update it as necessary.

The SBA provided email exhibits to demonstrate that (1) there was communication as to the goals strategies and conditions within the Office of SBIC Examinations, (2) it endeavored to provide training to its staff, and (3) requested technological upgrades. The SBA acknowledged that due to resource limitations, none of the training requests were approved and the technology requests were not funded.

The SBA noted that the Director of Examinations is in constant communication with the examination managers and requests status reports to ensure that all offices have opportunities to raise issues and concerns. The SBA provided email communications to demonstrate the communications that occurred.

The SBA claimed we did not provide support for our conclusion that examiners did not identify all findings. The SBA stated that neither prior nor current examination reports were flagged nor referenced for overlooking or missing finding, misstating regulations, failing to follow SOPs, nor failing in form or content to have shortcomings.

### **OIG Response**

We continue to support our conclusion and the title of our audit report that improved examination quality can strengthen SBA's oversight of Small Business Investment Companies. This title is supported by sufficient and appropriate evidence obtained during the audit. The evidence was collected based on our review of examination guidance and the actual performance standards of examiners. Furthermore, we based our conclusion and title on evidence obtained during interviews with senior OII officials, examination managers, examiners, and SBICs who raised concerns about the quality of examinations.

We continue to support our conclusion that the SBA's focus on the frequency of examinations as a strategy for reducing risk did not include a compensating control to ensure that examinations conducted would result in accurate assessment of regulatory compliance. Strong testimonial evidence was obtained during this audit in support of this conclusion. Specifically, we interviewed examination managers, examiners, and SBIC officials who all indicated the quality of examinations could be improved if more time was allotted. We have revised our report to include additional examples in support of our conclusion based on these interviews. We agree that the emails provided by the SBA demonstrate there were communications between the Director of Examinations and examination managers with regard to the quality of examinations. However, our audit evidence demonstrates that these communications were not sufficient to overcome the time constraints and emphasis on quantity felt by the examiners and examination managers.

We continue to support our conclusion that the significant decrease in examination reports with findings may indicate that the quality of examinations has suffered. Our report recognizes that the SBA indicated many factors could have contributed to the decline in reports with findings. Our report simply points out other factors that could have contributed to the decline, such as the focus on the examination frequency, outdated guidance, and an insufficient examination checklist. These conclusions are supported by evidence we obtained from reviewing examination guidance, the examination checklist, and the actual performance standards of examiners. Furthermore, we based our conclusion on evidence obtained during interviews with examination managers and examiners who indicated the time allowed to conduct examinations was a concern and impacted their ability to produce findings. However, to address SBA's comments regarding the decrease in the number of reports with findings, we have revised the wording in our report to clarify the factors identified by the OIG could have "contributed to" rather than "caused" the decline in findings.

In response to SBA's comment that the number of examinations completed by an examiner is only one component in deriving an examiner's numerical performance rating, we reviewed the actual performance standards that demonstrated quality was not a measurable benchmark. While the emails provided by the SBA demonstrate guidance to the examination managers for assessing examination quality, the performance standards themselves should be revised to fully address our finding.

We commend the SBA on their actions to revise the SOPs and update the examination checklist. We appreciate the efforts of the Director of Examinations to communicate the goals and strategies to her examination managers. However, as noted in our audit report, we observed that managers and

employees were not aware of the vision of OSE and that there were inconsistencies in the examinations across offices. Furthermore, we found that the goals established by the Director of Examinations were not formally tracked. As a result, we continue to support our position that the Agency should develop a plan to improve its communication of its strategies and goals for the OSE. We appreciate the efforts of the Director of Examinations to communicate with her managers via email and phone. However, the evidence in our audit report demonstrates that the email and phone communication alone was not sufficient to allow examiners to provide input for examination processes. Additionally, it limited knowledge sharing across offices. We have revised our audit report better explain the communication deficiency we identified.

We continue to support our conclusion that examiners did not identify all findings as is supported by the strong testimonial evidence from two Senior OII officials who provided examples of SBIC violations that were missed during the examination process. These missed violations included improper management fees, conflicts of interest, inaccurate valuations, and overline investments. While this evidence was included in our audit report in the section that discussed the outdated guidance, we have modified our report to clarify that this evidence also supports our conclusion that the examiners did not identify all findings.

**Recommendation 1** - Create and execute a plan to improve the internal operations of the examination function. The plan should include quality driven goals and performance indicators that the OII will use to monitor, assess, and balance the quantity and quality of the SBIC examination function and its operations. It should also include a plan for better communication.

**Management's Comments**

Management did not concur with this recommendation. Management stated that this recommendation was founded on discrepancies within the report and that the program is managed properly to ensure optimum performance, including quality reports and open communication among staff members.

**OIG Response**

We continue to support this recommendation. As discussed above, we observed that managers and employees were not aware of the vision and goals of the OSE. Further, goals established at the director level were not tracked. Our recommendation was based on sufficient and appropriate evidence, including strong testimonial evidence from Senior OII officials, examination managers, examiners, and SBICs. The management decision for this recommendation is considered unresolved and will remain open pending audit follow-up.

**Recommendation 2** - Update and improve the existing examination checklist to: (1) better align with and reference SOP guidance for examinations; (b) ensure focus on Category One violations, and (3) ensure consistency across the three SBIC examination offices.

**Management's Comments**

Management concurred with this recommendation. Given that the new SOP 10 09 is being published, the checklist will be reviewed and updated to better correspond and correlate with the revised SOP. Additionally, the checklist will be reviewed annually to ensure that it is a dynamic document that is enhanced and updated as necessary.

**OIG Response**

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

**Recommendation 3** - Assess the costs of the examination function and prepare cost-benefit analyses for several funding options, including a potential increase in examination fees, in order to improve training and technology, and cover other examination costs.

**Management's Comments**

Management stated it fully supports this recommendation.

**OIG Response**

Management's comments were responsive to the recommendation. The management decision for this recommendation is considered resolved and the recommendation will remain open pending final action.

## Appendix I: Scope and Methodology

To determine if the SBA conducted SBIC examinations in accordance with the Law, rules and regulations, and SBA policies and procedures, we reviewed Section 310 of the Small Business Investment Act of 1958; Code of Federal Regulations, Chapter 13, Section 107; and Standard Operating Procedures (SOPs) 10 06, 10 08 and 10 09.

We judgmentally selected the Office of SBIC Examinations’ Atlanta Field Office and obtained the universe of 141 examinations performed by this regional office between October 1, 2010, and August 10, 2012. The SBICs examined by the Atlanta office represented approximately \$4.24 billion in indebtedness to the SBA. Using a risk-based approach, we judgmentally selected a sample of three examinations conducted by three different examiners based on outstanding SBA leverage amount, date of examination, and number of findings. The SBICs covered by this sample received nearly \$175 million in SBA-guaranteed funding. Using an OIG review methodology—that we prepared based on applicable Standard Operating Procedures—we reviewed Atlanta office examination files to assess whether the examinations covered the required laws and regulations.

To determine if the SBA managed the SBIC examination process effectively and efficiently we reviewed SBA’s 2011–2016 Strategic Plan and the Agency’s Small Business Investment Company Program Annual Report for FY 2012. We obtained and analyzed historical performance and cost data related to the examination function from the Office of Investments and Innovations (OII). We reviewed Agency regulations to assess the SBIC examination fee structure for the past 15 years, adjusted the fees for inflation, and compared fees collected in FY 2012 to what fees would be based on inflation. We also compared fees collected in FY 2012 to the cost of performing examinations in FY 2012. We examined SBIC Program Overview reports and the performance standards of examination staff. We interviewed budgetary officials in the Office of the Chief Administrative Officer. We interviewed the former Associate Administrator and Deputy Associate Administrator for the Office of Investments and Innovations. We interviewed the Director, three regional examination managers, and 6 of the 17 SBIC examiners in Office of SBIC Examinations. Finally, we interviewed the representatives of four SBICs.

**Table 1 SBIC Examinations Reviewed by OIG**

SBIC Name & License No.	Report Date	SBA Leverage	Number of Findings
FOIA Ex. 4	2/23/2012	\$14,600,000	6
FOIA Ex. 4	12/2/2011	\$20,775,000	1
FOIA Ex. 4	6/29/2011	\$139,590,000	4

## **Appendix I: Scope and Methodology**

### **Use of Computer Processed Data**

We obtained computer generated data from the Office of Investments and Innovation (OII) for our judgmental sample of SBICs examined by the Atlanta Field office in FY 2012. We compared the data provided by OII to the source documents for the three examination files reviewed at the Atlanta field Office. Specifically, we verified the licensee number, SBIC name, current regulatory private capital, current leverage from the SBA, the exam manager, the report date, and the scope of the examination.

### **Prior Coverage**

No audits of the Office of Investment and Innovation, SBIC program have been conducted within the last 10 years.

## **Appendix II: The SBIC Program- Nine Major Findings & Category One Violations**

**Activities Not Contemplated by the Act** (Required by Small Business Investment Act of 1958) – 13 CFR 107.500 requires SBICs to engage only in the activities contemplated by the Small Business Investment Act of 1958. “The principle issues of concern in this area include SBICs financing a large business; financing provided by a Specialized SBIC (SSBIC) to a small business that is not owned, controlled, and managed by disadvantaged persons; and SBICs conducting operations of any business other than that for which it was licensed.”

Examiners should analyze the licensee’s financing records and other documentation, including background information on the financed small business and the owners of the small business (SOP 10 09, pg. 13).

**Prohibited Conflicts of Interest** (Required by Small Business Investment Act of 1958) – 13 CFR 107.730 prohibits SBICs from self-dealing to the prejudice of a Small Business, the Licensee, its shareholders or partners, or SBA. Examples of prohibited actions include providing financing to associates or borrowing money from a small business financed by the SBIC.

Examiners should review the terms of financings provided to portfolio concerns, and records pertaining to their principals, owners, and directors. Additionally, examiners should obtain credit reports on entities receiving financing as well as written confirmations from portfolio concerns (SOP 10 09, pg. 13).

**Prohibited Control of a Small Business** (Required by Small Business Investment Act of 1958) – 13 CFR 107.865 allows SBICs to exercise control over a small business for purposes connected to the investment through ownership of voting securities, management agreements, voting trusts, majority representation on the board of directors, or otherwise. However, the period of control is limited to seven years.

Examiners should review the terms of financings made to small business concerns to include post-financing ownership, stock voting rights, shareholders agreements, and board membership or partner rights(SOP 10 09, pg. 14).

**Short Term Financings** (Required by Small Business Investment Act of 1958) – 13 CFR 107.830 requires SBICs to provide financings for a minimum duration of one year.

Examiners should review the terms of the financing to determine whether they result in a prohibited short-term financing (SOP 10 09, pg.14).

**Overline Investments** (Required by Small Business Investment Act of 1958) – 13 CFR 107.740 requires SBICs to diversify their portfolios. SBICs are prohibited from concentrating their assets in any one small business or any affiliated group of small businesses. In general, SBICs are restricted to having a maximum of 30 percent of their regulatory capital in any small business.

Examiners should compare the licensee’s total outstanding financing and commitments to each small business with its appropriate overline limit (SOP 10 09, pg. 14).

## **Appendix II: The SBIC Program-Nine Major Findings & Category One Violations**

**Relending, Foreign, Passive or Other Prohibited Investments, Including Prohibited Real Estate Financings** (Required by Small Business Investment Act of 1958) – 13 CFR 107.720 classifies certain small businesses ineligible for financings. For example, financing to small businesses that are re-lenders or re-investors, passive businesses, or real estate businesses are prohibited.

Examiners should determine the nature of the business from the Dunn and Bradstreet credit report and determine the use of proceeds through visits with the small business owners(SOP 10 09, pg. 14-15).

**Excessive Cost of Money** (Required by Small Business Investment Act of 1958) – 13 CFR 107.855 defines “cost of money” as the interest and other consideration SBICs receive from small businesses. SBICs are restricted in the cost of money they can charge on loans and debt securities.

Examiners should determine the rate of interest and any discount or fee charged on financings provided to portfolio concerns by examining the note and any other financing agreements (SOP 10 09, pg. 15).

**Inappropriate Distributions, Including Improper Dividends and Excessive Expenditures** (Required by SBA SOP 10 09) – Licensees are restricted in the types and amounts of capital and earnings distributions they may make. Any increases in management expenses including salaries, office expenses, travel, etc. must be SBA approved.

Examiners should analyze capital accounts (paid in and earned) for changes since the prior examination (SOP 10 09, pg. 15).

**Impairment and Valuation Issues** (Required by SBA SOP 10 09) – SBICs must comply with the maximum permitted capital impairment percentages outlined in 13 CFR 107.1830. Additionally, licensees must prepare, document, and report the valuations of loans and investments in accordance with the valuation guidelines for SBICS issued by SBA (13 CFR 107.503).

Examiners should review capital accounts, unrealized appreciation and depreciation of the portfolio, and calculate any capital impairment based on regulatory requirements. Additionally, examiners should determine if the portfolio valuations have been completed in accordance with the approved valuation policy and reported to SBA (SOP 10 09, pg. 15)

## Appendix III: Agency Comments

Date: September 23, 2013

To: Robert A. Westbrooks,  
Deputy Inspector General and Office of Inspector General

From: Pravina Raghavan  
Acting Associate Administrator for Investment and Innovation

Subject: Response to Performance Audit Report, "Improved Examination Quality Can Strengthen SBA's Oversight of Small Business Investment Companies"

Dear Mr. Westbrooks:

This memorandum is in response to your August 23<sup>rd</sup>, 2013, Performance Audit Report entitled, "Improved Examination Quality Can Strengthen SBA's Oversight of Small Business Investment Companies". We have reviewed and analyzed this report and welcome the opportunity to reply.

As per the review between ourselves and your staff on the draft report on August 22<sup>nd</sup>, 2013, there are a number of findings and conclusions with which we do not concur. We fail to find documentation within your report that justifies or supports some findings and, therefore, find fault with the resulting conclusions made within the report related to those findings. We will be highlighting the discrepancies and/or inaccuracies within the report and will reference official SBA emails (full texts attached as an addendum to this memorandum) that will serve as supporting documentation to our rebuttal.

Although it is our belief that there are issues with the findings and conclusions within the report, we do agree, with noted comments, with recommendation 2 and 3 of the report. We disagree with recommendation 1 for the reason below.

Recommendation 1 is based on what we believe are discrepancies and/or inaccuracies within the report. It is OII's belief that we have historically and actively managed optimal internal operations, strive for quantity and quality in our processes, and promote open communication. We will be highlighting and supporting this perspective with our rebuttal below under **Observations and Highlights**.

On Recommendation 2, please note that, independent of this Performance Audit Report, the Office of Examinations had already engaged in a project to update SOP's, resulting in SOP 1009 completed 31-July-2013 and pending publication. As is the current practice, all offices require examiners to conduct examinations with all rules and regulations applied for possible violations.

On Recommendation 3, we fully support this recommendation with the additional complementary statement that the statute indicates that the examination fees "shall be deposited in the account for salaries and expenses of the Administration, and are authorized to be appropriated solely to cover the costs of examinations and other program oversight activities." Besides covering direct examination functions and costs, program oversight activities could include technological upgrades to equipment (Laptops, Printers, etc), software acquisition (Team Mate), and improvements to the website which would benefit everybody.

## Observations and Highlights – Executive Summary

The title of the report, “Improved Examination Quality Can Strengthen SBA’s Oversight of Small Business Investment Companies”, asserts that examination quality is lacking and that the oversight of Small Business Investment Companies (SBIC’s) is not as strong as it should be. Neither of these conclusions are supported nor documented within the report. Neither prior or current examination reports were flagged nor referenced for overlooking or missing findings, misstating regulations, failing to follow SOP’s, nor failing in form or content to have shortcomings. We believe this title to be misleading and not in conformity with fact and request that the title be changed to one that is consistent with the findings, conclusions and recommendations that are supported by specific and demonstrable documentation within the report.

In your cover letter to this report you highlight that “During our initial survey work, we identified significant deficiencies in the management of the SBIC examination process...”(Paragraph 1, Sentence 3), but did not specify, highlight, or document the findings which support or lead to this statement. Additionally, in the Executive Summary, this statement is modified to state, “During our initial survey work, we identified deficiencies in the management of the SBIC examination process...”(Paragraph 3, Sentence 2). We contend that there are no deficiencies, significant nor otherwise. The only reference to a deficiency we could find within the report was on page 6, at the bottom of the page, a section title “Outdated Guidance and a Deficient Examination Checklist Affect [sic] Examination Quality

In paragraph 4, sentence 4, of the Executive Summary, SBA processes are highlighted for improvement that “could enhance the extent to which the Office of SBIC Examinations identifies business conditions and practices prohibited by the Act and Agency policy”. The processes in question are not highlighted, opportunities to enhance the identification business conditions or practices prohibited by the Act and Agency policy are not referenced, nor is there documentation justifying this statement.

Paragraph 5 of the Executive Summary, is inaccurate.

Please see exhibit I, an email dated Tuesday, December 04, 2012 7:14am, Subject: FY’13 Goals, exhibit II, an email dated Thursday, October 14, 2010 8:58am, Subject: FY’11 Goals, and exhibit V, email dated Monday, December 10, 2012 9:02 AM, Subject: RE: Performance for Team. These emails stipulate not just frequency or numerical goals but clearly and extensively state other factors that are to be met (Quality, Timeliness, Following Procedures, Working Papers, Need to follow SOP’s, Communication Skills, etc). Additional emails between the Director of Examinations and Examination Managers, stipulating these points are available. These emails rebut the first two sentences of this paragraph, “The SBA’s focus on the frequency of examinations as a strategy for reducing risk did not include a compensating control to ensure that examinations conducted would result in accurate assessments of regulatory compliance. With a greater emphasis on quantity, the OSE runs the risk that the review of an SBIC may be inaccurate or incomplete.”

Concerning the third sentence of this paragraph, “To this point, the significant decrease in examination reports with findings may indicate that the quality of these assessments has suffered.”, this supposition can be refuted by at least five observations:

1. Regulatory changes which may impact violations in the past few years are:

04/04/2012: Conflicts of Interest and Investment of Idle Funds  
(Allows certain associate investments for follow-on investments without violating conflict of interest. Also provides increased flexibility on idle fund investment.) 107.730 & 530 [PDF](#) | [HTML](#) | [More](#)

04/14/2009: Leverage Eligibility and Portfolio Diversification Requirements (Increases leverage maximum and increases overline maximum) 107.1160 & 1810 [PDF](#) | [HTML](#) | [More](#)

2. A more rigorous licensing process ensures that licensees are vetted and reviewed more thoroughly and therefore lead to higher quality of licensees and a reduction in violations. See exhibit "Leveraged Debenture SBICs Performance".
3. Setting higher standards in 2002, a rigorous MAQ that many in the industry say is as good as the private sector, larger, more sophisticated funds allowing for better quality managers.
4. A more thorough and transparent exam process has led to improvement in regulatory compliance by the licensees.
5. Thorough, comprehensive and high quality examinations as conducted by the Office of Examinations, promote an environment of diligence and care at the Licensee which promotes an environment where Licensees strive to eliminate and minimize operations and activities which could generate findings. Findings, if any, are reviewed with the licensee so as to educate them and endeavor to ensure that future examinations are finding free.

Please note that we believe the role of the Office of Examinations is not to strive to find a minimal amount of findings per year or per examination, it is to work in partnership with the licensee to ensure they comply with the rules and regulations of the program. We believe that this strategy is working and this is another component in the reduction of findings. This should be considered a positive, not a negative event.

Concerning paragraph 6, sentence 1, please note that the Office of Examinations, independent of this Performance Audit Report, has been working on revising and updating SOP 1008, SBIC Examinations Guidelines (11/25/97), and submitted the revision, SOP 1009 SBIC Examinations Guidelines, for comment by the Office of Inspector General on July, 2013. All exchanges between various areas, including the Office of Inspector General, were completed by 31-July-2013, and the new guidelines are pending publication (Exhibit III, Request from Director of Examinations to SBA Administrator for final approval of SOP 1009).

The exam checklist is an internal confidential document used by the examiners as a guideline to enumerate areas that need to be reviewed and is to be used in conjunction with the SOP to ensure a comprehensive, accurate and thorough examination. The checklist is not intended to represent a comprehensive scope of an examination, and should not be the sole basis or substitute the SOP as the basis of an examination. Given that the new SOP 1009 is being published, the checklist will be reviewed and updated as well so as to better correspond and correlate with the revised SOP. Additionally, the Director of Examinations is scheduling processes to ensure annual review of the checklist to ensure that it is a dynamic document that is enhanced and updated as necessary.

Concerning paragraph 6, sentence 2, there is no reference, examples or specifics as to what challenges in the areas of strategic planning is being highlighted. On the contrary, by reviewing Exhibit I and II, it can be seen that there is communication as to the goals, strategies and conditions within the Office of Examinations.

The Office of Examinations, has endeavored to provide training to its' staff as they request it and SBA resources will allow. See exhibit VIII, email dated Monday, June 04, 2012 9:11 AM, Subject: FW: Training Needs Survey – SBA Employees and exhibit IX, email dated Monday, April 15, 2013 12:37 PM. On the subject of technology upgrades, the Office of Examinations has made efforts to price and acquire software (TeamMate) and the supporting hardware numerous times over the years. See exhibit X, email dated Wednesday, March 19, 2003 11:47 AM, Subject RE: BUDGET, and exhibit XI, email dated Fri 10/21/2008 7:28 AM, Subject: TeamMate. Due to resource limitations, none of our requests were approved. Additionally, on a yearly basis, Managers have been requesting technological upgrades to equipment (PC's Laptops, Printers, etc), which are subject to budgetary constraints and are normally denied. This year, 2013, several new laptops have been approved and purchased for the examiners. See exhibit XIII, email dated Tuesday, August 13, 2013 11:35 AM, Subject RE: Request for upgraded laptops for examiners – Deborah D. Cotton – Justification for a laptop. Although technology requests were not funded, the Office of Examinations has endeavored to internally develop technological tools to compensate and automate some processes and activities. See exhibit XII, email dated Thursday, March 21, 2013 8:50 AM, Subject <blank>.

Concerning paragraph 6, the first portion of sentence 3, "Further challenges include poor communication...", please note that the Director of Examination is in constant email contact with the Regional Managers, and request status reports on a weekly basis so as to ensure that all offices have the opportunity to raise issues and/or concerns to the Director. Open exchanges between the Director and the Managers occur via emails, phone calls, and occasional conference calls are organized with the Director, Managers and Examiners. Please see exhibit IV, email dated

Wednesday, April 04, 2012 7:03am, Subject: RE: FY 2012 GoalOwner goals and Authorizing Official Signature on TA, exhibit V, email dated Monday, December 10, 2012 9:02am, Subject: RE: Performance for Team, exhibit VI, email dated Thursday, March 21, 2013 8:50AM, Subject: <blank>, and exhibit VII, email dated Wednesday, July 27, 2011 7:42AM, Subject: RE: SBIC Caseload Analysis among Regions, as examples of emails illustrating open and frank communications. Numerous other emails are available if further documentation is requested.

Concerning paragraph 6, the second portion of sentence 3, "...and insufficient funding", we support this statement.

Concerning paragraph 6, sentence 4, the referenced challenges have been address above; the middle part of this sentence as been addressed in our response to paragraph 5 above.

The latter part of paragraph 6, sentence 4, "...have resulted in examiners not identifying all findings." Is not supported and not been documented, to the contrary, as noted earlier, neither prior or current examination reports were flagged nor referenced for overlooking or missing findings, misstating regulations, failing to follow SOP's, nor failing in form or content to have shortcomings. Additionally, paragraph 5, sentence 3, clearly states that the reduction in findings "**may indicate**" an issue (not proven) while this sentence presents it as if it were a proven fact. We find this highlighted portion to be unsupported by documentation or evidence that confirms this statement.

### **Observations and Highlights – Body of Report**

Page 4, Paragraph 2, Sentence 3 and 4, please refer to our response to paragraphs 4, 5 and 6 of the Executive Summary above, and the supporting documentation referenced. We find no supporting documentation or evidence for these statements and believe they are based on conjecture. Additionally, an inferred correlation between a reduction in the number of findings and the quality of examinations is a conclusion that does not follow from its premise.

Page 4, Paragraph 3, Sentence 4, please refer to our response to paragraph 4 of the Executive Summary above.

Page 4, Paragraph 4, please refer to our response to paragraph 5 of the Executive Summary above, and the supporting documentation referenced. Please note, there is more documentation available proving that the Office of Examinations does not solely rely on the frequency of examinations as a strategy for reducing risk. It is one of the factors, among multiple, which are utilized to manage and control risk and exposure to the SBA. Among others are a more thorough and transparent exam process has led to improvement in regulatory compliance by the licensees and thorough, comprehensive and high quality examinations to promote an environment of diligence and care at the Licensee which promotes an environment where Licensees strive to eliminate and minimize operations and activities which could generate findings and an effort to educate licensees.

Page 4, Paragraph 5, please refer to our response to paragraph 6 of the Executive Summary above, and the supporting documentation referenced. Please note, there is no documentation that examiners have not identified all findings. This is based on a conjecture without supporting documentation.

Page 5, Paragraph 1, last sentence, "However, we identified other factors that **could** have caused the decline in findings". This sentence makes clear that there is conjecture and uncertainty by the OIG on the reason for the decline in findings. This is consistent with the last sentence of paragraph 5 of the Executive Summary, yet in paragraph 6 of the Executive Summary 6, the reduction in findings over time is stated as a fact and is actually contra-indicated by this statement.

Page 6, Paragraph 1, Sentence 2, a correlation between non-specified challenges and a decrease in findings is not supported by documentation, additionally, the premise "...SBA's emphasis on the quantity of SBIC examinations at the expense of more detailed reviews" is strongly refuted by our response to paragraph 6 of the Executive Summary above, and the supporting documentation referenced (Exhibit I and Exhibit II).

Page 6, Paragraph 2, we strongly refute this paragraph. As can be seen from our response to paragraph 6 of the Executive Summary above, and the supporting documentation referenced (Exhibit I and Exhibit II, also Exhibit V, more documentation available if requested), the number of exams completed by an examiner is one component in the

evaluation of an examiner and it was not an absolute evaluation but it was utilized to be “**consider**” for a certain numerical rating, not a requirement. Quoting from Exhibit 1:

“We should also consider that the ratings include:

- Quality and quantity of the exams.
- Depth of the analysis performed by the examiner
- Amount of time that the examiner spent on their review and on the issuance of the report.
- Written material being grammatically correct, clear and accurate.
- Effective communications skills.

“

Also see, exhibit V, Element 3: Job Specific.

Page 6, Paragraph 3, please note this paragraph is based on conjecture. There is no documentation indicating there is a quality issue with examinations or that time constraints are causing a reduction in quality of examinations. On the issue of time allocated for examinations, experience past examinations (with and without findings) have shown that 3 weeks per examination is an optimal allocation per examination. Conversely, if technological resources were made available, there also could be time savings realized (assuming that training to utilize the technological resource was provided as well as support services). SBA resource constraints have imposed hiring limits on the number of examiners. Additional examiners would enable an increase in the time allotted for examinations but this increase in examiners would also require and increase in technological, travel and administrative resource allocated to the Office of Examinations.

Please note, Although Page 6, Paragraph 3, sentence 4, is hearsay from one examiner, but if supporting statements from other sources and collaborating documentation can be presented, the Director of Examination would like to ensure that this not a continuing issue.

Page 6, Paragraph 4, continuing to Page 8, Paragraph 3, please refer to our response to paragraph 6 of the Executive Summary above, and the supporting documentation referenced. On Page 8, Paragraph 3, please provide documentation validating the individual statements of the two senior OII officials so as not be considered hearsay.

Page 8, Paragraph 4, through Page 10, Paragraph 2, please refer to our response to paragraph 6 of the Executive Summary above, and the supporting documentation referenced.

Page 10, Paragraph 3, Section titled “Communication Challenges”, please refer to our response to paragraph 6 of the Executive Summary above, and the supporting documentation referenced.

Page 11, Section titled “Conclusion” forward, based on our rebuttal, see all of the above, we find that a number of conclusions are without basis.

Page 12, Section titled “Recommendations”, response the recommendations are noted on the first page of this document.