



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416**

**MEMORANDUM
AUDIT REPORT**

Issue Date: August 22, 2000

Number: 0-24

To: Jane Palsgrove Butler, Associate Administrator
Office of Financial Assistance

From: Robert G. Seabrooks, Assistance Inspector General
for Auditing

Subject: Memorandum Audit Report – Audit of the Y2K Loan Program

BACKGROUND

The Y2K Loan Program, authorized by the Small Business Year 2000 Readiness Act (Act), Public Law 106-8 in April 1999, was established to: (i) help small businesses become Y2K compliant through the repair and acquisition of information technology systems (hardware and software) and the purchase of consulting and other third party services and related expenses, and (ii) provide relief for business economic injury resulting from Y2K problems occurring after January 1, 2000.

Loans approved under the Y2K loan program were eligible for a SBA guarantee of 90 percent on amounts of \$100,000 or less and 85 percent on amounts over \$100,000. As of March 31, 2000, 104 loans totaling \$8.2 million were approved under the program. As of the same date, no applications were received for business economic injury relief. The program ends December 31, 2000. This audit was done because the Act requires the OIG to periodically review a representative sample of Y2K loans to mitigate the risk of fraud and ensure safety and soundness of the program.

AUDIT SCOPE AND OBJECTIVE

This report provides results of the audit. Five loans, valued at \$992,000, were judgmentally selected for review. Our sample selection criterion was based on the loan amount, geographical location, type of loan processing, and credit report information.

The audit objective was to determine whether Y2K loans were processed, disbursed, and proceeds used in accordance with the Act. For the five loans selected, we reviewed: (1) repayment ability; (2) character & creditworthiness; (3) eligibility; (4) compliance with the loan authorization and law; and (5) use of proceeds. We conducted on-site reviews of lender files and borrower financial records, and held discussions with vendors and appropriate SBA officials. The audit fieldwork was accomplished between February and April 2000. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF REVIEW

Our audit disclosed that, with one exception, the loans were generally processed, disbursed, and proceeds used in accordance with the Small Business Year 2000 Readiness Act. The exception was a loan for which part of the proceeds became ineligible for the Y2K program after loan closing. Additionally, our audit disclosed minor noncompliances with SBA's policies and procedures for three loans in the areas of equity injections and monitoring of disbursements.

Undisbursed Funds for a Loan are not needed for Y2K Compliance

For loan number [FOIA Ex.4] undisbursed loan funds of about \$346,000 will not meet the usage criteria set forth for the Y2K Loan Program. The lender acknowledged that the remaining funds were no longer needed for Y2K compliance problems. To bring its computer system into Y2K compliance, the borrower engaged a firm to replace the entire computer system prior to January 1, 2000. Due to problems with the initial contractor, a second firm was subsequently hired to complete the system upgrade. Because of the approaching year-end deadline, the second contractor rewrote the system software in lieu of replacing the entire system. This work was substantially completed at year-end. As of April 20, 2000, the lender had disbursed about [FOIA Ex.4].

The Act states that a small business concern that receives a loan guaranteed under the Act shall only use the proceeds to address the Year 2000 computer problems. Further, SBA Procedural Notice 5000-603 states that there can be no mixed use of proceeds in a Y2K loan. The Notice also states that if a borrower needs loan proceeds for non-Y2K purposes, a separate companion loan must be processed.

We recommended in a separate report that the Massachusetts District Office require the lender to limit disbursements for the loan to the amount needed for Y2K purposes. The District office agreed with our conclusions and will instruct the lender to cancel the undisbursed balance.

Equity Injections

For two loans of [FOIA Ex.4] the lenders did not verify that equity injections were made. In lieu of requiring a cash injection, the lender accepted invoices from the borrower for purchases of equipment. The lenders believed these purchases satisfied the equity injection requirement even though the purchases were paid with company funds. For both loans, the loan agreement required an equity injection be made prior to first disbursements of the loan proceeds.

Disbursement and Monitoring of Loan Proceeds

For one loan totaling [FOIA Ex. 4] the lender improperly disbursed and inadequately monitored the use of loan proceeds. In lieu of using joint-payee checks as required by the Settlement Sheet, SBA Form 1050, the lender deposited the funds directly into the borrower's bank account. Additionally, the lender did not obtain appropriate documentation regarding the use of loan proceeds. At the time of our visit, approximately \$33,000 in loan proceeds was expended or billed to the borrower for Y2K purchases. The lender stated that it was more feasible to deposit the funds directly into the borrower's bank account as opposed to issuing joint-payee checks. The lending loan officer stated that he would wait until all funds were spent by the borrower prior to making a request for supporting documentation for expenditures.

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The findings in this report are the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

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