



U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, D.C. 20416

<b>AUDIT REPORT</b>
<b>ISSUE DATE: October 6, 1999</b>
<b>Number: 0-01</b>

**To:** Antonio Valdez, District Director  
Fresno District Office

**From:** Robert Seabrooks, Assistant Inspector General  
for Auditing

**Subject:** Audit of an Early Defaulted Loan to  
[ \* ]

Attached is a copy of the subject audit report. The report's one finding has been referred to the Office of Inspector General Investigations Division for potential fraud investigation.

Should you or your staff have any questions, please contact Garry Duncan at 202-205-7732.

Attachment

\* Ex. 6 and 7(c)

**AUDIT OF  
AN EARLY DEFAULTED LOAN TO**

[ \* ]

**AUDIT REPORT NO. 0-01**

**October 6, 1999**

**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.**

\*Ex. 6 and 7 (c)

**AUDIT OF  
EARLY DEFAULTED LOAN TO**

[ \* ]

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**APPENDIX**

A – Audit Report Distribution

\* EX. 6 and 7(c)

## AUDIT SCOPE AND OBJECTIVE

This report provides the conclusions of an audit conducted on a SBA guaranteed loan [redacted] \* [redacted] made by Heller First Capital Corporation (lender) to [redacted] \* [redacted] (borrower). The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA guaranteed loans charged off or transferred to liquidation within 36 months of origination (early default).

The audit objective was to determine whether the early default was caused by lender or borrower non-compliance with SBA requirements. The SBA and lender loan files were reviewed and district office and lender personnel were interviewed. The borrowers' financial and bankruptcy records were analyzed and the borrowers' sales agent and business supplier were interviewed. The audit was accomplished between June and August 1999. Our audit was conducted in accordance with Government Auditing Standards.

## BACKGROUND

SBA is authorized under section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with SBA rules and regulations.

The [redacted] \* [redacted] was processed under Certified Lender Program procedures for a borrower who was buying a service station and convenience store located in [redacted] \* [redacted]. The purpose of the loan was to purchase land, improvements, business machinery, and equipment. SBA provided the lender with a guarantee of 75 percent of the loan amount. The business closed and the borrowers defaulted on the loan in June 1998. The SBA loan was then discharged through bankruptcy in December 1998. All collateral securing the SBA loan was transferred to the lender for liquidation.

## RESULTS OF AUDIT

Our audit showed that the loan default was caused by a lack of repayment ability that was not discovered by the lender because of borrower misrepresentations on the SBA loan application.

### **FINDING The Borrowers' SBA Loan Application did not Disclose all Debts**

The borrowers lacked sufficient cash to repay their SBA guaranteed loan. The lender was unaware of the lack of repayment ability because the borrowers did not disclose all debts in the SBA settlement sheet. To ensure the approval of a SBA guaranteed loan

for the purchase of the business, their real estate agent allegedly advised them to not report all debts. As a result, SBA's loss could be as much as \$330,000 depending on whether the collateral can be sold and how much is received through a sale.

### **Unreported Debts**

The borrowers signed a SBA Form 1050 Settlement Sheet certifying that there were no liens or encumbrances against the real and personal property securing the loan. The escrow settlement sheet showed a business purchase price of \$543,000. The borrowers, however, did not disclose additional business debts totaling \$231,000. The exclusions included:

- *Deed of trust.* In January 1997, a deed of trust with an undisclosed balance of \$81,000 was executed for the installation of fuel tanks to satisfy a Federal requirement. The supplier of the fuel tank upgrade withheld recording the debt until after the SBA loan was disbursed.
- *Promissory note.* In March 1997, the borrowers executed a promissory note for \$150,000 payable to the sellers. The note represented an additional cost of purchasing the business, but was not recorded as such by the seller or shown on the loan application by the buyer.

### **Actual Repayment Ability**

If these debts had been disclosed, the borrowers would not have qualified for a SBA guaranteed loan. The projected business cash flow for 1997, based on the financial history of the business, showed the borrowers had \$63,000 per year to repay annual debts totaling \$49,000. With the two undisclosed debts taken into account, the borrowers actually needed at least \$102,000 per year to pay business debts.

Both the lender and SBA stated they would not have approved the loan if the additional debts had been disclosed. By falsely certifying that no other debts existed, the borrowers obtained a SBA guaranteed loan that they were not eligible to receive.

### **Potential SBA Loss**

A defaulted loan balance of \$440,000 was transferred to liquidation in July 1998. The amount SBA will owe to the lender at purchase could be as much as \$330,000 (based on a 75 percent guaranteed loan) depending on whether the collateral can be sold and what is received for it.

### **OIG Investigation Referral**

The borrowers and real estate agent were referred to the Office of Inspector General Investigations Division for a potential fraud investigation. Therefore, no action by the District Office is required.

### **OTHER MATTERS**

#### **Finders Fee**

The borrowers stated that they paid a \$8,860 finder's fee to the real estate agent's brother. The fee was for locating a lender that would make the loan. Section 120.222, Title 13 Code of Federal Regulations prohibits the payment of such fees by a borrower.

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\*\* EX. 6