



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

<b>AUDIT REPORT</b>
<b>ISSUE DATE: May 22, 2003</b>
<b>REPORT NUMBER: 3-27</b>

**To:** Terri L. Denison, District Director  
Georgia District Office

**From:** Robert Seabrooks, Assistant Inspector General  
For Auditing [FOIA Ex. 6]

**Subject:** Audit of an Early Defaulted Loan to Club Rarity

Attached is a copy of the subject audit report. The report contains one finding and two recommendations. A response received from your office indicating agreement with the finding and recommendations has been synopsised in the report and included as an appendix.

The finding in this report is the conclusion of the Office of Inspector General, Auditing Division. The finding and recommendations are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution. Please provide your management response for the recommendations to our office within 30 days of the date of this report using the attached SBA Forms 1824, Recommendation and Action Sheets.

Should you or your staff have further comments or questions, please contact Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 6].

Attachments

**AUDIT REPORT**  
**EARLY DEFAULTED LOAN TO CLUB RARITY**  
**ATLANTA, GEORGIA**  
**AUDIT REPORT NUMBER 3-27**  
**May 22, 2003**

**This finding in this report is 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.**

**AUDIT REPORT**

**AUDIT OF  
AN EARLY DEFAULTED LOAN TO  
CLUB RARITY**

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## **BACKGROUND**

The Small Business Administration (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 regulations, policies, and procedures. SBA is released from liability on a loan guaranty, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the loan agreement, or did not make, close, service, or liquidate a loan in a prudent manner.

The Business Development Corporation of Georgia, Inc. (the lender) is a Small Business Lending Company authorized by SBA to make guaranteed loans under the Preferred Lenders Program (PLP). Preferred lenders are allowed to process, close, service, and liquidate guaranteed loans with reduced requirements for documentation and prior approval by SBA.

On October 23, 2001, SBA Loan Number 500-008-4000 was approved in the amount of \$1,027,500 to Club Rarity (borrower) using PLP procedures. The purpose of the loan was to refinance \$776,600 of debt, purchase \$36,679 of equipment, finance \$91,735 for building improvements, and provide \$78,430 of working capital. The loan was disbursed in full in November 2001 with the borrower defaulting in October 2002. The loan was transferred to liquidation status in November 2002 with a principal balance of \$1,021,845. Subsequently, the lender arranged a workout situation to allow a transfer to current status. As of February 2003, the outstanding principal balance of the loan had been reduced by \$5,655.

Club Rarity, a nightclub in Atlanta, Georgia, was the trade name of BDKJ, LLC (the operating company) which leased its space from Bits and Bottles, Inc. (the eligible passive company).

## **AUDIT OBJECTIVE AND SCOPE**

The objective of the audit was to determine if the lender and borrower originated, disbursed, and liquidated the loan in accordance with SBA rules and regulations. The loan was selected based on dollar value and elapsed time between loan approval and date transferred to liquidation status (24 months or less). An evaluation was made to determine if a loss exceeding \$50,000 to SBA was expected. We examined SBA and the lender loan files for noncompliances, interviewed SBA, lender, and other loan-associated personnel, and the borrower's principal. The audit was conducted during January and February 2003 in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### **FINDING The Lender did not Comply with Loan Authorization Requirements**

The lender did not originate the loan in accordance with the terms of the SBA loan authorization. Specifically:

- Loan proceeds were disbursed without adequate documentation.
- Internal Revenue Service (IRS) verification requirements were not complied with.
- The borrower was not lawfully operating the business.

The lender has now executed a loan workout agreement with the borrower so a request has not been submitted for SBA to honor the guaranty. If the loan defaults in the future, the aforementioned noncompliances provide a basis for SBA denying liability on the guaranty in accordance with Title 13 of the Code of Federal Regulations (CFR), Part 120.524.

#### **1. Loan proceeds were disbursed without adequate documentation**

The lender disbursed loan proceeds of \$128,414 to reimburse the borrower for expenditures incurred prior to loan approval. The expenditures included \$91,735 for renovations and \$36,679 for equipment purchases. In support of the expenditures, the borrower submitted a list with attached borrower generated receipts and an affidavit to support \$52,250 of renovations and \$17,658 of equipment purchases. The inappropriate documentation did not account for \$39,485 of renovations and \$19,021 of equipment purchases, or 46 percent of the loan proceeds disbursed for these purposes.

The loan Authorization stated that the lender must document that the borrower used the loan proceeds for the purposes stated. In addition, SBA Form 1050, Settlement Sheet, required the lender to certify that the loan proceeds were used for authorized purposes. A representative of the lender stated that they considered documentation for expenditures incurred prior to loan approval to be similar to documentation for an equity injection, i.e., documentation for an equity injection includes copies of paid receipts, invoices, or canceled checks. Because the lender did not obtain adequate documentation, SBA cannot be assured that loan proceeds totaling \$128,414 were used for authorized purposes.

#### **2. IRS verification requirements were not complied with**

The lender did not verify the accuracy of financial data used to support the decision to make the loan.

- **The most recent tax year verification not requested from IRS** The lender did not request verification of the borrower's financial data for the most recent full year of operations (calendar year 2000). The loan application submitted in October 2001 was supported by financial data from the borrower for the period 1997 to July 2001. The loan authorization required that the lender submit IRS Form 4506 to the IRS to obtain Federal income tax information for the last 3 years. The lender requested IRS verification of borrower financial data for calendar years 1997, 1998, and 1999.

An IRS verification of financial data obtained by the OIG for calendar year 2000 showed discrepancies when compared with the calendar year 2000 financial data submitted with the loan application. Examples of the discrepancies included:

	<u>Financial Statements</u>	<u>IRS Transcript</u>	<u>Percent Variance</u>
<b>Gross Receipts or Sales</b>	\$ [FOIA Ex. 4]	\$ [FOIA Ex. 4]	- 49
<b>Gross Profit</b>	[FOIA Ex. 4]	[FOIA Ex. 4]	- 42
<b>Net Profit (Loss)</b>	[FOIA Ex. 4]	[FOIA Ex. 4]	- 112
<b>Interest Expense</b>	[FOIA Ex. 4]	[FOIA Ex. 4]	+ 49
<b>Depreciation Expense</b>	[FOIA Ex. 4]	[FOIA Ex. 4]	+ 28

The lender's omission of the 2000 tax year from the IRS Form 4506 was not consistent with the terms of the loan authorization and SBA's policies and procedures.

- Discrepancy not reported** The lender did not report a discrepancy between the tax information received from the IRS and tax returns submitted with the loan application. On October 17, 2001, the lender requested IRS verification for the 1999 tax return that the borrower submitted with the loan application. The IRS responded on October 25, 2001, that it had no record of a filing for the 1999 tax year. This discrepancy was not reported to SBA although the loan proceeds were disbursed. We subsequently submitted another Form 4506 requesting verification for the 1999 tax return and received the same response. Section H.4.a of the loan authorization stated that the lender must compare the tax information received from the IRS with the financial data or tax returns submitted with the loan application and relied upon in approving the loan. Subpart A, Chapter 6, Section 4 (f) of SOP 50 10 4 states that if a discrepancy exists, the lender must notify SBA and not disburse any loan proceeds until the discrepancy is resolved. Allowing the discrepancy to go unreported was not consistent with the terms of the loan authorization and SBA's operating procedures.

### 3. The borrower was not lawfully operating the business

The loan authorization required that, prior to any disbursement of loan proceeds, the lender must obtain evidence that the borrower had all licenses necessary to lawfully operate the business. The lender obtained evidence that the borrower had a license to sell alcoholic beverages; however, the lender did not obtain evidence that the borrower had the appropriate business registration required for transacting business within the City of Atlanta. All businesses operating within Atlanta were required to register with the business tax division each year and pay registration fees. A representative of the City stated that the borrower had not registered with the business tax division during the years 2001 or 2002. The borrower's financial information showed that the borrower operated during 2001, despite a City ordinance which stated that penalties would be imposed upon each entity which failed to apply for and obtain an appropriate business registration and pay all required taxes and fees. The absence of the appropriate business registration could have impacted the continuation of the business.

## **RECOMMENDATIONS**

We recommend that the District Director, Georgia District Office, take the following actions:

- 1.A        Notify the lender that SBA can be released from honoring the guaranty due to the noncompliances discussed in the report if a purchase request is received.
  
- 1.B        Annotate the SBA file for loan number 500-008-4000 and flag the Guaranty Tracking System noting the deficiencies discussed in this report.

## **Management Comments**

The District Director stated that her office reviewed the draft report on the Club Rarity Loan and concurred with the facts and findings contained in the draft report, as well as the recommendations.

## **Evaluation of Management's Comments**

We accept the District Director's comments.

**MANAGEMENT COMMENTS**

-----Original Message-----

From: Denison, Terri L.

Sent: Monday, May 19, 2003 3:48 PM

To: Duncan, Garry L.

Subject: Early Loan Default Audit-- Club Rarity

We have reviewed the draft report on the Club Rarity Loan. We concur with the facts and findings contained in the draft report as well as the recommendations.

Terri L. Denison

District Director

SBA Georgia District Office

Phone (404) [FOIA Ex. 6]

PC Fax (202) [FOIA Ex. 6]



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