



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

AUDIT REPORT
ISSUE DATE: June 24, 2003
REPORT NUMBER: 3-31

TO: Terri Denison, District Director
Georgia District Office

FROM: Robert G. Seabrooks, Assistant Inspector General for Auditing
Office of the Inspector General [FOIA Ex. 6]

SUBJECT: Audit of an Early Defaulted Loan to A&S Business, Inc.

Attached is a copy of the subject audit report. The report contains one finding and one recommendation. A response received from your office indicating agreement with the finding and recommendation has been synopsized 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 recommendation 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 to the recommendation within 30 days of the date of this report using the attached SBA Form 1824, Recommendation and Action Sheet. The form should be sent to:

Audit Manager

SBA OIG/Atlanta Field Office

233 Peachtree Street, NE, Suite 1803

Atlanta, Georgia 30303

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

Attachments

AUDIT REPORT
EARLY DEFAULTED LOAN TO
A&S BUSINESS, INC. d/b/a CITGO FOOD MART
DULUTH, GEORGIA
AUDIT REPORT NUMBER 3-31

June 24, 2003

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding and recommendation 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

**EARLY DEFAULTED LOAN TO
A&S BUSINESS INC. d/b/a CITGO FOOD MART
DULUTH, GEORGIA**

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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 Summit National Bank (lender) is a financial institution authorized by SBA to make guaranteed loans under the Preferred Lenders Program (PLP). Under this program, the lender is allowed to process, close, service, and liquidate SBA guaranteed loans with reduced requirements for documentation and prior approval.

In March 2002, the lender approved an SBA loan (number 525 015 4000) for \$295,000 to A&S Business, Inc. d/b/a Citgo Food Mart-Duluth (borrower) using PLP procedures. The purpose of the loan was to refinance \$285,000 of borrower debt and provide \$10,000 for expenses. The borrower defaulted in July 2002 with the loan transferred to liquidation in September 2002. SBA paid \$225,324 to honor the guaranty in October 2002.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the lender and borrower materially complied with SBA's requirements when originating, closing, and liquidating the loan. The loan was judgmentally selected for review based on its expected loss as part of the Office of the Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 36 months of origination (early default). We reviewed SBA's and the lender's loan files for compliance with requirements found in SBA's guidelines and the loan authorization. We interviewed SBA and lender personnel and a vendor. The audit was performed in February 2003 in accordance with generally accepted Government Auditing Standards.

RESULTS OF THE AUDIT

FINDING The Lender did not Comply with SBA Loan Guidance

The lender did not ensure that: (i) financial information submitted by the borrower was accurate; (ii) the borrower had repayment ability; and (iii) the required equity injection was adequately supported. The lender's use of questionable financial information coupled with incorrect loan repayment calculations caused the SBA to make an erroneous payment of \$225,324 to honor the loan guaranty.

The lender did not question the validity of the borrower's financial statements

In support of its loan application, the borrower submitted a financial statement showing equipment valued at \$180,000. Although the equipment was pledged as collateral for the loan and comprised 31 percent of the borrower's total assets, the lender did not obtain a list of equipment with applicable serial numbers or otherwise determine what equipment comprised the \$180,000. The lender's loan file contained a lease agreement between the [FOIA Ex.4] (landlord) and [FOIA Ex.4] (original tenant and seller of the business) which stated that "In consideration of the terms and conditions of this Lease, Landlord does hereby lease and rent to Tenant . . . the following described property:

"All of the trade equipment (hereinafter called 'Trade Equipment') owned by Landlord located in, attached to or used in connection with the Premises, including, but not limited to, coolers, freezers, ice machine, counters, shelves, deli equipment, gasoline dispensers and underground storage tanks and the pipelines appurtenant thereto."

At the loan closing, the borrower provided a listing of 12 pieces of equipment but the value for each piece was not provided. After the loan defaulted, the lender valued this equipment at about \$20,000. In its liquidation plan the lender stated, "we relied upon the balance sheet dated October 31, 2001 and certified by *(name deleted)* for the collateral valuation. When the landlord evicted our borrower we were advised that all outside equipment, specifically pumps, canopies and tanks were never conveyed as a part of the original sale and they remain the property of the landlord." The lender filed a civil suit against the principals of the borrower claiming intentional misrepresentation regarding ownership of the equipment.

If the lender had done more than just rely on the representations of the borrower, it would have been aware of the landlord's claim of equipment ownership and the impact this had on the borrower's financial statements. Since the borrower did not own the equipment, the financial statements were inaccurate.

Title 13 of the Code of Federal Regulations (CFR), Part 120.524(a) (3) and (4) states that SBA is released from liability on its guaranty when the lender's improper action or inaction has placed SBA at risk and when the lender has failed to disclose a material fact regarding a loan.

The borrower lacked repayment ability

The lender's determination of the borrower's repayment ability was based on questionable financial information and was inaccurately calculated. Specifically, the historical financial data may not have been reliable and the projected financial data contained errors.

Historical repayment ability

The lender computed historical repayment ability using financial statements that may have had a material error. As cited in the prior paragraph, ownership of the business equipment was claimed by the landlord. If the equipment was not owned by the borrower, then the assets listed on the balance sheet were overstated. In order for the balance sheet to balance, there would have to be corresponding adjustments to one or more other accounts on the balance sheet. Additionally, the lender should have noted that the profit and loss statement did not include depreciation for the \$180,000 of equipment. This was a further indicator that the financial statements may not be accurate. We found no evidence that the lender questioned the borrower about these discrepancies. Without resolution of these discrepancies, the financial statements were not a sufficiently reliable source from which to compute historical repayment ability.

Projected repayment ability

The repayment ability determination for the projected fiscal year was incorrect. The lender made the following errors when computing the borrower's repayment ability.

- When calculating the borrower's repayment ability, \$45,653 of annual debt was excluded. This debt owed to the seller for a \$150,000, 4-year note, was initially required to have a standby agreement which would have precluded repayment until the SBA loan was paid off. Between the loan's approval and closing dates, however, the lender agreed that the seller debt would not be placed on standby. Thus, this resulted in an additional debt service of \$45,653 per year that should have been included in the repayment calculation.
- The borrower submitted projected financial statements that did not show that interest expense for the SBA note was deducted from gross income. Instead, the lender added the interest expense of \$21,756 for the note back to net income to determine cash flow available to service debt.

The following table provides a computation of the borrower's repayment ability based on the aforementioned facts that shows a cash flow deficit for the first projection year.

Repayment Ability Determination

	Projected Cash Flow per Lender	Projected Cash Flow Per OIG
Net Profit	\$ 72,355	\$ 35,599
+ Interest Expense	<u>\$ 21,756</u>	<u>\$ 36,756</u>
= Cash Flow	\$ 94,111	\$ 72,355
- Cash Flow needed	<u>\$ 87,213</u>	<u>\$ 87,213</u>
Excess or deficiency	\$ 6,898	\$-14,858

Part 120.150 of 13 CFR states that loans must be so sound as to reasonably assure repayment. Chapter 4, paragraph 1. d., SOP 50 10 (4) (E) states, in part, that the best evidence of repayment ability is sufficient cash flow from prior operations to retire the anticipated annual fixed obligations of the business and, if historical cash flow does not demonstrate repayment ability, a realistic projection of future earnings must be used. Regardless of whether historical or projected performance is the basis for repayment, all expenses must be considered when evaluating repayment ability.

Equity injection was not properly verified

To support the \$25,000 equity injection required of the borrower, the lender used a confirmation letter obtained from a creditor stating that a note for \$25,000 had been repaid. The lender's representative stated that a copy of the cancelled check (s) or other evidence to support the equity injection had not been obtained. The confirmation letter was not adequate evidence since it did not show the source of the funds. These funds could have come from business operations and not the personal funds of the principals, as required.

Section H. 4. of the Loan Authorization required the lender to obtain, prior to disbursement, evidence of a cash equity injection by the borrower of at least \$25,000 for operating capital.

RECOMMENDATION

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

- 1.A Seek recovery of \$225,324 from The Summit National Bank, less any subsequent recoveries, for loan number 525 015 4000.

Management's Comments

The District Director stated that after a thorough review of the loan, the Georgia District Office agreed with our finding and conclusion and will contact Summit National Bank to seek recovery of \$225,324.

Evaluation of Management's Comments

Management comments are responsive to the recommendation.

MANAGEMENT RESPONSE

DATE: June 16, 2003

FROM: Terri L. Denison
District Director
Office of District Director

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing
Office of Inspector General

SUBJECT: Draft Report-Early Defaulted Loan to A&S business, Inc.

After a through review of the Loan PLP 52501540-00, A&S Business dba Citgo Food Mart, the SBA Georgia District Office agrees with your findings and conclusion. The Georgia District Office will contact Summit National Bank and seek recovery of \$225,324.

Terri L. Denison
District Director
Office of District Director
(404) 331-0100 [FOIA Ex.6]

AUDIT REPORT DISTRIBUTION

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