



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

AUDIT REPORT
ISSUE DATE: August 19, 2003
REPORT NUMBER: 3-36

TO: Herbert Austin, Acting District Director
New York District Office

FROM: Robert G. Seabrooks, Assistant Inspector General for Auditing
Office of the Inspector General /s/

SUBJECT: Audit of an Early Defaulted Loan to P. O'Reilly Enterprises, 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
P. O' REILLY ENTERPRISES, INC.
FREEPORT, NEW YORK
AUDIT REPORT NUMBER 3-36
AUGUST 19, 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
P. O'REILLY ENTERPRISES, INC.
FREEPORT, NEW YORK**

Table of Contents

	Page
Background	1
Audit Objective and Scope.....	1

RESULTS OF AUDIT

Finding and Recommendation

The Lender Provided a Loan to a Borrower Lacking Repayment Ability.....	2
---	---

APPENDICES

- A- Management Response
- B- Report Distribution

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 process, service, and liquidate loans in accordance with Administration rules and regulations. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations, the loan authorization, or does not make, close, service, or liquidate the loan in a prudent manner.

First International Bank (lender), acquired by UPS Capital Company in August 2001, was authorized by SBA to make guaranteed loans under the Preferred Lender's 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.

P. O' Reilly Enterprises, Inc. (borrower) located in Freeport, New York, distributed and serviced high performance sport and pleasure boats. The business, which was established in 1994, also sold related parts and accessories.

In December 1999, the lender approved a \$1.5 million SBA guaranteed loan (number 343 767 4004) to the borrower, using PLP processing procedures. The purpose of the loan was to purchase real estate and equipment, pay off a line of credit, and provide closing costs. The loan proceeds were disbursed in December 1999 and March 2000. The loan was placed in liquidation in September 2000 and purchased from the secondary market in November 2000. The liquidation of the collateral is complete and the loss to SBA is \$282,447.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine whether the early default was caused by the lender or borrower noncompliance with SBA's requirements. We judgmentally selected the loan for review based on its dollar value and elapsed time from approval to liquidation. It was part of a universe of 32 PLP loans processed by the lender during the period October 1, 1999 to September 30, 2002, that were transferred to liquidation within 24 months of approval. We reviewed SBA's and the lender's loan files and interviewed lender personnel. The audit was conducted from November 2002 through March 2003 in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

FINDING The Lender Provided a Loan to a Borrower Lacking Repayment Ability

The lender approved and disbursed a \$1.5 million SBA guaranteed loan to a borrower whose cash flow was not sufficient to service the proposed debts. Consequently, SBA made an erroneous payment of \$282,447 when it honored the guaranty.

Negative Cash Flow from Operating Activities

Title 13 of the Code of Federal Regulations, Part 120.150 states that in assessing a loan's soundness, there must be reasonable assurance that loan repayment can be made. In making this assessment, consideration must be given to: (i) the strength of the business; (ii) past earnings; (iii) ability to repay the loan with earnings from the business; and (iv) the potential for long-term success.

SOP 50 10(4), paragraphs 4.1.d and e (1) and (2), state that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process and that historical earnings and cash flow are the best bases upon which to gauge repayment ability. They also state that if historical cash flow does not demonstrate repayment ability, a realistic projection of future earnings must be used. The projections must be tested against industry averages and historical operations to assess feasibility and any significant variations should be explained. The cash flow analyses for this loan demonstrated that, for the 3 years prior to loan approval, the borrower did not have adequate cash available to service the proposed debt. Details follow.

Rule of Thumb Analysis

In calculating the borrower's total debt service, the lender used a figure of \$177,000 to represent the borrower's total non-SBA debt. Approximately 89 percent of this amount was interest from floor plan (inventory) financings of \$157,000. The lender estimated that the borrower would only pay 50 percent of the inventory interest per year for each floor plan loan. The lender gave the explanation that this was reasonable and in line with historical interest expense. This estimate indicates that the borrower's inventory would be on hand an average of 180 days (6 months) before it was sold and the debt repaid. However, the lender calculated the borrower's average annualized inventory on hand at 225 days for calendar year 1998 and 325 days for 1999. Therefore, the 6-month estimate does not appear reasonable. There was no documentation in the files showing that the borrower had only paid 50 percent of the interest of floor plan loans in previous years.

The lender decreased non-SBA loan interest expense by \$14,000 from the previous year's amount of \$172,000 without justification. This estimate was not representative of the trend in the borrower's interest expense over the previous 3 years. During that period, the interest expense increases ranged from \$35,000 to \$80,000.

The OIG re-calculated the borrower's historical net cash flow using the rule-of-thumb method and included 100 percent of the annual interest due on the floor plan loans. This re-calculation, included in the following chart, showed that the borrower did not have sufficient cash to service the proposed debts.

Rule of Thumb Cash Flow

	1998	1999(5 months)
Net Income	(3,000)	\$ 99,000
+ Interest Expense	172,000	*4,000
+ Depreciation Expense	68,000	0
+ Rent	153,000	83,000
- Cap X (25% of depreciation)	(17,000)	0
Cash Flow Available to Service Debts	\$373,000	\$ 186,000
Lender's Debt Service Calculation		
Annual SBA Debt	**\$ 163,000	69,000
Annual Other Debt	\$ 177,000	74,000
Total Cash Needed to Service Debts Per Lender	\$ 339,000	\$ 143,000
OIG's Debt Service Re-calculation		
Annual SBA Debt	\$ 166,000	\$ 69,000
Annual Other Debt	\$ 333,000	\$ 139,000
Total Cash Needed to Service Debts Per OIG	\$ 499,000	\$ 208,000

* The lender used \$112,000 for interest expense in its rule-of-thumb calculation; however, the income statement shows \$4,000 and the lender cites \$4,000 for interest expense in its narrative in the credit memo

** Mathematical error made by the lender, annual SBA debt should be \$166,000

The lender also provided a projected rule-of-thumb cash flow analysis on SBA Form 4-I, Lender's Application for Guaranty. The projected cash flow analysis showed sufficient cash flow to service the proposed SBA debt, but did not include the borrower's other debt. When the other debt is included, the borrower did not have sufficient projected cash flow to service all debt.

Statement of Cash Flows Analysis

The lender also calculated the borrower's historical net cash flow using the Statement of Cash Flows Method. This method showed that the borrower did not have sufficient historical cash flow from operations to service the proposed debt. The lender did not provide a projected cash flow analysis using the statement of cash flows. Details of the statement of cash flows are shown below.

Statement of Cash Flow

	1998	1999 (5 months)
Net Sales	\$ 5,874,000	\$ 2,479,000
Current Receivables	(73,000)	(1,000)
Cost of Good Sold	(4,831,000)	(1,758,000)
Inventory	(1,409,000)	(789,000)
Accounts Payable	188,000	(146,000)
Selling, General & Admin. Expenses	(637,000)	(535,000)
Other Operating Expenses	(169,000)	(83,000)
Prepays	(20,000)	20,000
Accrued Expenses	0	0
Other Current Assets/Liabilities	329,000	152,000
Other Income	0	0
Other Liabilities	0	0
Net Cash After Operations	(748,000)	(661,000)
Cash Needed to Service Debts	\$ 499,000	\$208,000

Recommendation

We recommend the District Director, New York District Office, take the following action:

- 1.A Seek recovery of \$282,447 from the lender, less any subsequent recoveries, for loan number 3437674004.

Management's Comments

The Acting District Director stated that the New York District Office agreed with our finding and recommendation and that SBA should recover 50 percent of the outstanding balance, \$564,893.82, from the lender.

Evaluation of Management's Comments

Management's comments are responsive to the recommendation. This was a loan with a 50 percent SBA guaranty and the district is agreeing to recover the outstanding balance of all guaranteed funds.



U.S. Small Business Administration
Melville Branch Office
35 Pinelawn Road – Suite 207W
Melville, NY 11747

Tel: 631-454-0750
Fax: 631-454-0769
www.sba.gov

August 8, 2003

Robert G. Seabrooks
Assistant Inspector General for Auditing
U.S. Small Business Administration
409 3rd Street, SW
Washington, DC 20416

RE: P.O'Reilly Enterprises, Inc.
PLP 3437674004

Dear Mr. Seabrooks:

We have reviewed the draft report and agree with the Office of the Inspector General's finding and recommendation. This loan was handled in our Melville Branch Office during the lender liquidation period. A post purchase review was completed December 18, 2000 with a recommendation to honor the guaranty. This post purchase was done prior to the Policy Notice on early defaulted loans so the underwriting was not solicited for SBA's review. Throughout the liquidation period the lender indicated that the loan would be paid in full from the sale of the real property. Since the liquidation of collateral has been completed by the lender and the loan has a principal balance of \$564,893.82, the SBA should recover 50% of that balance from the lender.

If you have any questions please contact John Marino, Team Leader, Melville Branch at 631-[FOIA ex. 6].

Sincerely,

Herbert Austin
Deputy District Director

APPENDIX B

AUDIT REPORT DISTRIBUTION

<u>Recipient</u>	<u>Number of Copies</u>
Deputy Associate Administrator for Capital Access	1
General Counsel	3
Associate Administrator for Financial Assistance	1
Associate Administrator for Lender Oversight	1
Associate Administrator for Field Operations.....	1
Office of Chief Financial Officers Attn: Jeff Brown.....	1
General Accounting Office	1