



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

AUDIT REPORT
ISSUE DATE: AUGUST 24, 2004
REPORT NUMBER 4-38

To: James Rivera
Associate Administrator, Office of Financial Assistance

From: Robert Seabrooks [FOIA Ex. 6]
Assistant Inspector General for Auditing

Subject: Audit of a SBA Guarantied Loan to Lenzell, Inc. d/b/a New Vision

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your responses are synopsized in the report and included in their entirety at Attachment A.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with the existing Agency procedures for audit follow-up. Please provide your management decision for the recommendation to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation and Action Sheet.

Any questions or discussion of the finding and recommendation contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 2].

Attachments

AUDIT OF AN SBA GUARANTIED LOAN TO

LENZELL, INC. D/B/A

NEW VISION

ALBANY, NEW YORK

AUDIT REPORT NO. 4-38

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendation is 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 OF AN SBA GUARANTIED LOAN TO
LENZELL, INC. d/b/a NEW VISION**

ALBANY, NEW YORK

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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 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.

Valley National Bank (the lender) is authorized by SBA to make guaranteed loans under the Preferred Lenders Programs (PLP). Preferred lenders are allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior SBA approval.

On September 11, 1998, the lender approved a \$210,000 SBA loan (number 2318634006) to Lenzell, Inc. (borrower) and [FOIA Ex. 4] (co-borrower), using PLP procedures. The proceeds were to be used as follows: \$107,100 to purchase real estate (land and building); \$33,800 for equipment; and \$69,100 for working capital. In October 1998, the Authorization was amended to show the borrower as Lenzell, Inc. d/b/a New Vision. In November 1998, the borrower decided not to purchase the building so the loan amount was reduced to \$110,000. The purpose of the reduced loan was to provide working capital and purchase equipment. The loan was disbursed on December 31, 1998. The borrower defaulted on the loan in June 1999, and SBA purchased the guaranty in November 1999, for \$83,576.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the lender originated, disbursed, and liquidated the loan in accordance with SBA rules and regulations. The loan was reviewed for compliance with requirements found in SBA rules and regulations and the SBA lender guaranty agreement. During the audit we examined the loan files maintained by SBA and the lender and interviewed SBA and lender officials. The audit was conducted during July 2003, in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding 1 The Borrower lacked Repayment Ability and Loan Proceeds were Disbursed for an Unauthorized Purpose

The lender did not recalculate the borrower's repayment ability after the loan was restructured in a fashion that adversely affected the borrower's cash flow. Consequently, the lender was not aware of the adverse impact that the restructured loan had on the borrower's repayment ability. The lender also disbursed loan proceeds to pay a debt that did not qualify for refinancing. As a result, SBA made an erroneous payment of \$83,576 when it honored the loan guaranty.

Borrower Lacked Repayment Ability

The loan was originally structured to use approximately 50 percent of the proceeds to purchase the building that was currently occupied by the borrower. According to the lender, this would increase the borrower's retail space by 88 percent and allow the borrower to add new inventory and display merchandise in a logical and attractive manner. Also, the borrower would no longer incur a rental expense and would receive additional income from two building tenants.

Pursuant to Standard Operating Procedure (SOP) 50 10(4):

*“The ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. **Lack of repayment ability from the cash flow of the business dictates decline of the application...** the best evidence of repayment ability is cash flow from prior operations, but projections may be relied on when there is a change in the circumstances affecting the business.” (Emphasis added)*

According to the loan officer's report the borrower's repayment ability was based solely on the historical performance of the business adjusted to reflect the increased cash flow from the purchase of the building. Table 1 shows the lender's cash flow analysis based on the borrower's historical financial information.

TABLE 1
Cash Flow Analysis w/ Purchase of Building

	1997 Historical Data
Net Profit	\$14,850
Add Back:	
Depreciation (equipment) *	1,534
Rent Expense	14,139
Interest (Chamber of Commerce Loan)**	0
Rental Income from Tenants	13,200
Cash Available to Service Debt	43,723
Less: Debt Service (P&I)	
SBA Loan	(25,860)
Chamber of Commerce Loan	(6,192)
Cash Excess	\$11,671

* Depreciation is a non-cash expense which is added back to the cash flow analysis.

** Interest expense shown on the borrower's financial statement was not added back to the lender's cash flow analysis. The omission was not explained in the lender's files.

As shown in the table, the borrower had sufficient cash flow to repay the SBA loan under the original plan to purchase the building. After the loan was approved, however, the borrower decided not to purchase the building because the appraised value was \$40,000 less than the agreed upon purchase price of \$119,000 and the seller was not willing to lower the price. As a result, the loan was reduced from \$210,000 to \$110,000 and the annual payments were reduced from \$25,860 to \$20,208. Under the new loan structure without purchase of the building, the borrower continued to incur a rental expense and did not receive rental income from the building tenants.

The lender, however, did not reassess the borrower's repayment ability after the loan was restructured and continued to base repayment on the cash flow analysis that included the building purchase. Table 2 shows the impact of the restructured loan on the borrower's cash flow and repayment ability.

TABLE 2
Cash Flow Analysis w/o Purchase of Building

	1997 Historical Data	1998 Annualized Data (based on 7 month financial data)
Net Profit	\$14,850	\$13,935
Add Back:		
Depreciation (equipment)	1,534	1,534
Rent Expense	0	0
Interest (Chamber of Commerce loan)	1,676	1,676
Rental Income from Tenants	0	0
Cash Available to Service Debt	18,060	17,145
Less: Debt Service (P&I)		
SBA Loan	(20,208)	(20,208)
Chamber of Commerce Loan	(6,192)	(6,192)
Cash Shortage	(\$8,340)	(\$9,255)

As shown above, the borrower lacked the ability to repay the loan from the cash flow of the business after the loan was modified. The positive cash flow from the building purchase, as shown in Table 1, was not achieved under the restructured loan. The most current financial information (1998) available prior to closing did not support loan repayment, as shown above. Accordingly, the loan as restructured should have been declined due to a lack of repayment ability.

The Lender Refinanced an Ineligible Debt

Loan proceeds were used to pay off a debt that did not qualify for refinancing. SOP 50 10(4), Chapter 2, paragraph 11, provides that loan proceeds may only be used to refinance debt when the terms of the existing debt are unreasonable and the refinancing will provide a substantial benefit to the small business in the form of increased cash flow.

In the loan application, the borrower requested that part of the loan proceeds be used to repay a non-SBA loan from the Chamber of Commerce. After evaluating the request, the lender determined that the loan did not qualify for refinancing. According to the loan officer's report:

"... [The] loan is not on "unreasonable" terms and we have removed it from the request."

This decision is reflected in the lender's cash flow analysis, which included a debt service item entitled "Chamber of Commerce loan." If the lender intended to refinance the debt, servicing of the debt would not have been included in the cash flow analysis.

Contrary to the lender's statement, loan proceeds were used to refinance the Chamber of Commerce loan. An attachment to the SBA Form 1050, Settlement Sheet, showed that the lender disbursed \$19,040 directly to the third party lender (Albany-Colonie Regional Chamber of Commerce) to pay off the ineligible debt. As a result of the improper disbursement, SBA was not obligated to honor the guaranty on the portion of the loan proceeds used to finance the ineligible debt.

Conclusion

The lender's failure to identify that the borrower lacked repayment ability and the improper disbursement to pay off an ineligible debt placed SBA at unnecessary and unacceptable risk. Consequently, SBA made a \$83,576 erroneous guaranty payment to the lender.

RECOMMENDATION

We recommend that the Associate Administrator for Financial Assistance take the following action:

1. Seek recovery of \$83,576, less any prior recoveries, from the lender for loan number 2318634006.

Management Response

The Associate Administrator for Portfolio Management (AA/PM) provided two responses to the draft report. In the initial response, the AA/PM agreed to take appropriate action to recover the \$19,040 disbursed to repay an ineligible debt. The AA/PM did not agree that the borrower lacked repayment ability because the lender claimed it revised its repayment analysis to include projected sales, which showed that the borrower had repayment ability after the loan was restructured.

In a second response, the AA/PM stated that while there may have been additional steps that the lender could have taken while reviewing the loan application, SBA cannot conclude that the loan origination was clearly negligent. Therefore, full recovery of the guaranty is not warranted. On March 29, 2004, SBA agreed to refer the matter to Office of General Counsel (OGC) for a legal opinion.

OIG Evaluation of Management Comments

The decision to recover the portion of the guaranty paid for the ineligible debt is responsive to part of the recommendation. We do not, however, find the additional information provided regarding projected revenue and repayment ability convincing.

Although the loan officer's report included a schedule of projected revenue from the manufacturing business, there was nothing to support or justify the projected figures. Moreover, the loan officer made it clear in his report that the projections were "very

aggressive” and that repayment was “...*not based on the cash flow [from] the projections but rather solely on historical performance of the retail outlet.*” There was no evidence that the lender reexamined the borrower’s repayment ability after the loan was restructured. There also was no evidence that the borrower established or operated a manufacturing business which was the basis for the projections. Consequently, we believe the lender is attempting to rely on unsupported projected revenue after learning from our audit that historical information did not support repayment after the loan was restructured.

On March 29, 2004, we met with SBA officials to discuss the issues raised in the two responses. SBA agreed to ask OGC to review the loan file. As of the date of this report, OGC had not completed its review. Therefore, we will evaluate actions taken by SBA to address the recommendation during the audit follow up process.

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

Redacted for FOIA



DATE: December 3, 2003

TO: Robert G. Scabrooks, Assistant Inspector General for Auditing
FOIA Ex. 6

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: June 2000 Guaranty Purchase Review (GPR1)
Revised Recommendation
Loan: New Vision
PLP 23186340-06
Lender: Valley National Bank
Wayne, NJ

We have received the Office of Inspector General (OIG) September 15, 2003, memorandum and accompanying draft audit report for this loan that recommends full recovery of the guaranty payment of \$86,576, less any prior recoveries. The basis for the OIG recommendation is 1) the lender's improper disbursement of loan proceeds for an ineligible purpose and 2) failure to identify that the borrower lacked repayment ability in the credit analysis.

Initially, this loan was submitted for our review through a Guaranty Purchase Review audit conducted in June of 2000. We obtained a legal opinion from the Office of General Counsel that [

FOIA Ex. B - Attorney Client Privilege
]

After reviewing the OIG draft audit, we contacted the lender for a response to the two issues. The lender agreed with us that loan proceeds were disbursed to repay a Chamber of Commerce loan that was not on unreasonable terms, and therefore this loan was ineligible for refinancing. Accordingly, the lender will repay SBA \$19,140 disbursed for this purpose.

The lender did not agree that the credit analysis did not demonstrate repayment ability. We have reviewed the file and analyzed the course of events. The lender stated that loan repayment was based upon the borrower's profit and loss projections as opposed to the historical information in the file because the business would be expanding with the SBA loan, and would have the ability to manufacture its own products with the equipment purchased with loan proceeds. The historical cash flow of the business was based solely on retail sales.

The lender stated in its letter dated October 30, 2003, that loan approval was based upon projected sales of \$775,000, which consisted of \$100,000 for retail sales and \$675,000 for manufacturing. This compared with historical annualized retail sales of \$90,221 (based upon the interim period ending 7/31/98). There were no historical data for manufacturing since this was to be a new endeavor for the business. Projected income that would be generated by both retail sales and manufacturing sales was adequate to pay the borrower's debt. Per the lender in its October 30 letter, the income projections did not take into account rental income from the anticipated purchase of a building.

Our review of the credit analysis and supporting documentation contained in the loan file indicates that the lender took a conservative approach and based repayment ability on the borrower's historical, not projected, financial information. Although projections that included income from manufacturing sales were contained in the lender's credit memorandum, the loan officer stated that he did not initially base the cash flow on the projections but rather solely on the historical performance of the retail outlet because with the rental income included, the historical cash flow was adequate to service the debt.

The loan proceeds were later modified due to a change in business plans and the historical cash flow was no longer sufficient to service the debt. Standard lender procedures include a review of the cash flow after a change in the use of proceeds. The lender would then have faced a decision – either decline the loan, or base the approval on other factors, including profit and loss projections that took into account the manufacturing income. The projections that included income from manufacturing were in the credit memo and did, in fact, support repayment. It appears that the lender's error was not documenting this analysis in the loan file.

To allay our concerns, we reanalyzed the credit based on the information available to the lender at the time the use of proceeds was changed. It is our conclusion that there was a reasonable assurance of repayment based on the cash flow available from the sale of manufactured items. Projected sales of \$775,000 provided significantly more than sufficient cash flow to service the debt. Sales could be reduced by more than \$250,000 and the borrower would still have been able to generate sufficient income to meet its expenses (see attached projection analysis).

SBA has delegated credit decisions of this nature to PLP lenders. In this case, we have replicated the lender's credit analysis and reached the same decision as the lender. We reviewed the SBA loan purchase and charge-off rates for this lender and found them to be far better than the average rates for SBA lenders. We therefore recommend that the OIG adjust the draft audit to require repayment of \$19,040, the amount of ineligible use of proceeds. We will proceed to recover this amount from the lender.

Thank you for your assistance.

Division Analysis
 Retail and Manufacturing

	12/31/1997		Projections		Breakeven	
	88,479		775,000		524,080	
of Goods Sold	40,780	46.09%	621,858	80.24%	420,522	80.24%
is Profit	47,699	53.91%	153,142	19.76%	103,558	19.76%
Expenses	32,849	37.13%	105,665	13.63%	89,677	17.11%
er's Salary	-		-		-	
Γ	14,850	16.78%	47,477	6.13%	13,881	2.65%
ie Taxes	-	0.00%	-		-	
Γ	14,850	16.78%	47,477	6.13%	13,881	2.65%
Expenses						
ecitation	1,534					
ist	1,676		28,465	3.67%	12,519	2.39%
er's Draw						
to Service Debt	18,060		75,942		26,400	
Debt Service (P&I)						
Loan	-		20,208		20,208	
umber of Commerce Loan	6,192		6,192		6,192	
Surplus (Deficit)	11,868		49,542		0	

Expenses adjusted to account for lower interest expense due to decrease in loan amount from \$210,000 to \$110,000
 Interest expense for the first 12 months of the \$110,000, 8-year term loan with initial interest rate of 10.25%



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

DATE: January 23, 2004

TO: Robert G. Seabrook, Assistant Inspector General for Auditing
FOIA Ex. 6

FROM: James W. Hammettsky, Acting AA/PM

SUBJECT: June 2000 Guaranty Purchase Review (GPR1)
Revised Recommendation
Loan: New Vision
PLP 23186340-06
Lender: Valley National Bank, Wayne NJ

We are responding to the additional issues your office brought to our attention in connection with the draft audit report for this loan. OIG raised new concerns not mentioned in the report, regarding the loan revenue projections of \$675,000 relied upon by the lender for the clothing manufacturing operation of the borrower. We requested additional information and documentation from the lender in an attempt to satisfy these new concerns and have reviewed the responses. Unfortunately there is little new information available in the response. A copy of the lender's response is attached.

While our analysis indicates that there may have been additional steps that this PLP lender could have taken while reviewing the loan application, we cannot conclude that its loan origination was clearly negligent and therefore a basis for full recovery. We note that the lender has agreed to repay \$19,000 which is an amount that we consider to be a reasonable resolution of this matter. The maximum additional recovery would be \$60,000.

If you are not in agreement with this settlement offer, we will refer this matter to the Office of General Counsel (OGC) for a legal opinion and litigative analysis. We will ask them what they believe the odds of recovering more than \$19,000 would be if we went to trial for full recovery. We will also ask them how much such a trial would be expected to cost. Thank you for your assistance.

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