AUDIT OF A SBA GUARANTIED LOAN TO

[FOIA Ex. 4] AND [FOIA Ex. 4]

[FOIA Ex. 4], MASSACHUSSETS

AUDIT REPORT NO. 4-40

September 13, 2004

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

AUDIT REPORT
ISSUE DATE: September 13, 2004
REPORT NUMBER 4-40

To: James Rivera
Associate Administrator, Office of Financial Assistance

/S/ Original signed
From: Robert Seabrooks [FOIA Ex. 6]
Assistant Inspector General for Auditing

Subject: Audit of a SBA Guarantied Loan to [FOIA Ex. 4]

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your response is synopsized in the report and included in its 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].

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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-guarantied loans. SBA guarantied loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with SBA regulations, polices, and procedures. In accordance with 13 CFR§120.524, SBA is released from liability on a loan guaranty, in whole or in part, within SBA's exclusive discretion, if a lender fails to comply materially with SBA regulations, the Loan Agreement, or does not make, close, service, or liquidate the loan in a prudent manner.

First International Bank (lender) is authorized by SBA to make loans under the Preferred Lender's Program (PLP). Preferred lenders are allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior SBA approval.

On June 25, 1999, the lender approved a $650,000 SBA loan (number [FOIA Ex. 4]) to [FOIA Ex. 4] (borrowers) using PLP procedures. The loan proceeds were for refinancing two commercial loans--an equipment loan for $225,000 and a working capital loan for $395,000. The borrowers defaulted on January 29, 2001 and SBA purchased the loan on April 2, 2001, for $246,460. The borrower filed for Chapter 11 bankruptcy on July 7, 2003. SBA transferred the loan to liquidation status on May 30, 2001.

Prior to default, the borrowers made 17 payments during July 1999, to December 2000. There were at least two other sources of funds other than the operations of the business that enabled the borrowing businesses to remain solvent. Nine months after approval of the SBA loan, the lender approved a second SBA loan for $480,000. The purpose of the second loan was to reimburse the borrowers for leasehold improvements financed with working capital. In addition, the borrowers received disbursements from a commercial line of credit. Finally, according to a consulting firm hired to assess the financial condition of the borrowers and their affiliated companies, the borrowers were exchanging inventory and equipment to settle past due trade accounts. It appears likely that repayment of the SBA loan included funds from sources other than the operations of the borrowing businesses which may have artificially extended the borrowers' ability to repay the loan.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the lender and borrowers materially complied with SBA's requirements in originating, closing, and liquidating the loan. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 24 months of origination (early default). We reviewed SBA's loan files for compliance with requirements found in SBA's rules and regulations and the loan authorization. The lender's loan file was not reviewed because the lender was unable to locate the file. We also interviewed SBA and lender personnel. The audit was performed in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

Finding 1 The Lender Approved a Loan to a Borrower that Lacked Repayment Ability

The lender made material errors in calculating the borrowers' cash flow and repayment ability. According to SBA procedures, repayment from the cash flow of the business is the most important consideration in the loan making process. Because material expenses were excluded from the cash flow analysis, the lender made a SBA guarantied loan that should have been declined due to a lack of repayment ability. Consequently, SBA made a $246,460 erroneous payment when it honored the guaranty.

Pursuant to SOP 50 10 (4), Chapter 4, Section 1(3) (1), historical earnings and cash flow are considered to be the most reliable bases for gauging repayment ability. The repayment analysis must include the company's revenues and expenses, as well as owner withdrawals, and their impact on cash flow. Any significant variations must be explained. The SOP further provides that the loan application must be denied if the borrower cannot repay the loan from the cash flow of its operations.

The lender based repayment ability on the borrowers' historical financial information adjusted to reflect the impact of the SBA loan. The cash flow analysis indicated that the borrower had repayment ability. The lender, however, omitted several expenses and made questionable adjustments to others without adequate explanation or support. Details on the lender errors are discussed below.

(i) ***Owner's Salary***. The owner's historical salary of $116,000 was reduced by $16,000 to achieve repayment ability. In the cash flow analysis, the $16,000 was added to the historical net income to reflect the lower salary. The lender did not have documentary evidence that the owner agreed to and would honor the lower salary, such as a written agreement or a binding provision in the loan authorization. A personal financial statement as of February 29, 2000, indicated that owner's salary remained unchanged. Since there was no evidence of an agreement requiring the owner to reduce his salary and it remained unchanged, there was no justification for the $16,000 increase to the cash flow analysis.

(ii) ***Extraordinary Loss.*** The borrowing businesses were involved in exporting which meant that a portion of revenue was subject to currency exchange rate fluctuations. The borrowers' historical financial information showed foreign currency exchange losses of $12,000. The lender added back the $12,000 loss to historical net income which effectively negated the impact of the exchange rate on cash flow. The lender did not document the basis for the adjustment to net income. Since the borrower planned to continue exporting products, projected losses or gains from exchange rate fluctuation should have been included in the analysis. Consequently, cash flow was overstated as a result of the omission.

(iii) ***Depreciation Adjustment***. The cash flow analysis did not properly reflect depreciation expense on machinery and equipment. Since depreciation is a non-cash expense, 100 percent of the expense should have been added back to historical net income in the analysis. The lender added back 100 percent of the depreciation expense to cash flow but also subtracted approximately 25 percent of depreciation expense further down in the cash flow analysis to arrive at the adjusted earnings before debt service. The net effect was to recapture only 75 percent of the depreciation expense in the cash flow analysis. Consequently, cash flow was understated by 25 percent of depreciation expense, or $22,000.

(iv) ***Real Estate Taxes***. Pursuant to the terms of the leases between the borrowers and the building owner, the borrowers were required to pay the real estate taxes. A June 18, 1999, appraisal obtained during loan processing showed that real estate taxes were estimated to be approximately $20,000. The lender did not include the real estate expense in its analysis or provide a basis for its exclusion. The omission of the taxes resulted in cash flow overstatement of $20,000.

(v) ***Debt Service***. Although a portion of the loan proceeds was used to refinance borrower debt, the borrower retained $19,000 in annual debt service payments. The lender did not include the debt service in the cash flow analysis causing an overstatement of $19,000.

The table below compares the lender's cash flow with cash flow adjusted for the lender errors and omissions. The adjustments are numbered to correspond with the preceding paragraphs.

TABLE
Cash Flow Analysis

Para. No.	**Description**	**Column A Lender's Analysis**	**Column B Adjusted Analysis**
	Net Income (Historical)	**$71,000**	**$71,000**
	Add:		
	Interest (refinanced debt)	94,000	94,000
	Depreciation	86,000	86,000
	Amortization	20,000	20,000
(i)	Owner's Salary	16,000	0
	Rent	62,000	62,000
(ii)	Foreign Exchange Loss	12,000	0
	Less:		
(iii)	Depreciation (25 %)	22,000	0
(iv)	Real Estate Taxes	0	20,000
	Cash Avail. before Debt Servicing	**$339,000**	**$313,000**
	Less:		

	Debt Service (refinanced.)	333,000	333,000
(v)	Debt Service (not refinanced)	0	19,000
	Cash Excess (Shortage)	**$6,000**	**$(39,000)**

As the table shows, the cumulative effect of the lender's errors resulted in cash flow overstated by $45,000 ($39,000 + $6,000). As a result, the borrower was ineligible for an SBA guarantied loan due to a lack of repayment ability and the lender should have declined the loan application as required by SBA procedures.

Therefore, in accordance with SBA Policy Notice 500-831, "7(a) Loan Guaranty Purchase Policy," SBA should seek recovery of the guaranty based on the lender's negligence for failing to account for obvious facts that could likely impact the borrower's repayment ability.

Recommendation

We recommend that the Associate Administrator, Office of Financial Assistance take the following action:

1. Recover $246,460 paid to purchase the guaranty from the secondary market for loan number [FOIA Ex. 4].

Management Comments

The Associate Administrator for Portfolio Management (AA/PM) provided an interim response to the draft report. The response expressed concern regarding the issues involving the reduction in the owner's salary and exclusion of historical foreign exchange losses. The AA/PM indicated that including a salary reduction in the cash flow analysis is not considered faulty just because there was no evidence that the reduction took place. The lender's mistake may have been failure to include the reduction in the loan authorization. The AA/PM further believed that the lender was correct to omit the loss from foreign exchange from the cash flow analysis since this is not a factor that can be predicted with a high degree of accuracy. The AA/PM agreed that the adjustment to the depreciation expense was an error, but noted that it resulted in a positive effect on cash flow. Finally, the AA/PM stated that that since the lender did not adequately address the issues noted in the report, the lender will be given an opportunity to address the inconsistencies and provide any additional information to address the issues.

OIG Comments

We disagree that it was prudent lending to adjust the cash flow based on a planned salary reduction without assuring that (1) the salary reduction was enforceable by making it a provision of the loan agreement and (2) the borrower was aware of the requirement. Apparently the borrower was not aware of salary reduction or simply disregarded the requirement. Records show that the borrower did not reduce his salary after the loan was made. As a consequence, the borrower lacked sufficient cash flow to support the SBA guarantied loan.

We also do not agree that excluding foreign exchange losses from the cash analysis was prudent because; (1) the exchange losses were based on historical data from the prior two years,

(2) the firm was planning to continue foreign sales, and (3) the borrower offered no basis as to why the losses would not continue to occur. Therefore, we continue to recommend full recovery and will evaluate the actions taken by SBA to address the recommendation during the audit follow up process.

Redacted for FOIA

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

DATE: July 15, 2004

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

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: Audit of SBA Guaranteed Loan
Loan: FOIA Ex. 4
PLP FOIA Ex. 4
Lender: First International Bank
(loan now held by UPS Capital Business Credit)

We have received the Office of Inspector General (OIG) May 6, 2004, memorandum and accompanying draft audit report for this loan that recommends full recovery of the guaranty payment of $246,460, less any subsequent recoveries.

According to the audit report, the lender made material errors in calculating the borrower's cash flow and repayment ability. The lender based repayment ability on the borrower's historical financial information adjusted to reflect the impact of the SBA loan. The lender's cash flow analysis indicated that the borrower had repayment ability. The audit contends, however, that the lender omitted certain expenses and made questionable adjustments to other expenses without adequate explanation or support.

We have made a brief review of the report and have some concerns regarding the issues raised. For example, the report suggests that including the $16,000 reduction in the borrower's salary in the cash flow analysis was faulty because there is no evidence that the reduction took place. We disagree that including it is in the analysis was a mistake. It appears from your report that the bank did not follow up to insure compliance with this requirement. While that is a matter of concern, we do not see it as having an impact on the repayment analysis. The mistake may have been failure to put this requirement in the loan authorization.

We agree with the depreciation adjustment in the audit but note that this would positively affect cash flow. We do not agree that the foreign exchange loss/gain should have been included in the analysis as suggested in the audit since this is not a factor that can be predicted with a great deal of accuracy. Consequently, it is speculative to conclude that the lender's treatment of this item was erroneous.

Since the lender did not adequately address the items noted by the OIG Report, we believe it is appropriate to allow the lender the opportunity to review and address the inconsistencies and provide any additional information or documentation that may address the matters in issue. Therefore, we have requested that the lender respond to the audit findings within 30 days. When we receive the lender's response. we will provide a further reply with regard to the audit findings.

Appendix B

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