



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

AUDIT REPORT
ISSUE DATE: MARCH 21, 2002
REPORT NUMBER: 2-13

To: Lavan D. Alexander, District Director
Dallas/Fort Worth District Office

Robert G. Seabrooks

From: Robert Seabrooks, Assistant Inspector General
For Auditing

Subject: Audit of a SBA Guaranteed Loan to CFM Bracket Company Incorporated

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your comments have been synopsised in the report and included in their entirety at Appendix 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) 205-7732.

Attachment

AUDIT OF A SBA GUARANTEED LOAN TO

CFM BRACKET COMPANY, INC.

SCURRY, TEXAS

AUDIT REPORT NO. 2-13

MARCH 21, 2002

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.

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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 guarantee, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the Loan Agreement, or failed to make, close, service, or liquidate a loan in a prudent manner.

Heller First Capital Corporation (the lender) is a Small Business Lending Company authorized by SBA to make guaranteed loans under the Preferred and Certified Lenders Programs. Under the Preferred Lenders Program (PLP), participating lenders are permitted to process, close, service, and liquidate SBA guaranteed loans with reduced requirements for documentation to and prior approval by SBA. Under the Certified Lenders Program (CLP), loan guarantee applications and servicing actions are processed by SBA on a priority basis. Heller First Capital Corporation stopped making SBA guaranteed loans in February 2001 and was purchased by General Electric Capital Corporation on October 25, 2001.

Prior audits of early default loans found that the lender did not always materially comply with SBA rules and regulations. In a January 2000 response to one of the audits, the lender acknowledged that the loan, which closed in 1997, would not have been approved under its current underwriting and closing procedures. A few months later, in response to a SBA PLP review, the lender admitted that combined growth in volume and processing locations across the country was not in its best interest or SBA's lending program. Consequently, certain regions exercised more discretion in both credit analysis and compliance with procedures than the lender would have liked.

Based on the lender's acknowledgement of the lack of controls over the SBA guaranteed loan process, the Office of Inspector General initiated an audit of all loans originated by the lender that were purchased by SBA between January 1996 and February 2000, to determine if the loans were processed correctly. The audit identified multiple loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of those loans went to CFM Bracket Company Incorporated and is the subject of this report.

In December 1997, the lender approved a SBA guaranteed loan [FOIA EX. 4] for \$150,796 to CFM Bracket Company, Incorporated under PLP procedures. CFM Bracket Company, Incorporated (the borrower) was a start-up business that planned to manufacture a bracket for photo-sensing equipment for use on airport luggage conveyer systems. The primary purpose of the loan was to refinance seven other loans totaling \$70,761 that were obtained by the borrower from two other banks and a private source. Additionally, the proceeds were to be used for making real estate improvements of \$37,754, purchase machinery and equipment of \$34,937, and provide working capital of \$7,345. The last loan disbursement occurred in December 1997. The borrower defaulted on the loan in June 1998, after making only 1½ payments totaling \$2,375. The loan was placed into liquidation in August 1998, with the SBA purchasing the loan guaranty for \$116,722 in September 1998.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, disbursed, and liquidated the loan purchased by SBA in accordance with SBA rules and regulations.

The subject loan was reviewed for compliance with 11 requirements found in SBA rules and regulations and the SBA-lender guarantee agreements. All identified lender deficiencies were evaluated to determine if a material loss to SBA resulted. A material loss was defined as exceeding \$25,000.

The audit was conducted during October 2000 in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding 1 The Lender Lacked Support for the Borrower's Repayment Ability

The lender did not exercise reasonable care in protecting SBA's financial interest by using unsupported information to evaluate the borrower's repayment ability. According to 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.

The lender used a breakeven sales figure of \$600,000 to calculate repayment ability. The loan analysis in the loan file provided the following information in support of repayment ability:

- The business had purchase orders in place representing \$600,000 in annual breakeven sales.
- Initial purchase orders had been executed to meet the breakeven sales levels.
- Breakeven sales are based on purchase orders in the file and verbal commitments from customers.
- The borrower had an U.S. Patent that protected the design of the product (bracket) to be manufactured.

The lender's loan file did not support the above statements. The file contained evidence of only one purchase order for \$25,760 and a "Letter of Intent" to purchase brackets. The Letter of Intent, however, did not specify the quantities and dollar amounts and subjected the purchase to various contingencies. There was no other evidence found that showed the borrower had sufficient purchase orders to achieve the breakeven level of sales or that the applicant had a patent on the bracket, which was the primary product of the business. Further, the only documentation supporting the borrower's patent protection was an Assignment of Patent Application from the original patent applicant.

Finding 2 The Lender did not obtain Adequate Support for the Equity Injection

The lender did not take prudent measures to ensure that the borrower injected equity of \$43,329 into the business as required. Evidence of the equity injection consisted of copies of 74 cancelled checks totaling \$35,191 and 22 receipts for construction and various other expenses for \$7,484. The checks, however, were drawn on the same bank accounts used by the borrower for the deposit of several commercial loans, all of which were refinanced with the SBA loan. Since borrowed funds generally do not qualify as equity, the checks alone were not sufficient evidence of the principal’s equity injection.

Furthermore, as shown in the table below, the timing of the commercial loan disbursements and the equity injection checks support the likelihood that the checks were drawn against the commercial loans rather than borrower equity.

Prior Loans and Amounts Claimed as “Equity” Injection		
Month Loan Disbursed (1997)	Loan Amount	Amount of Checks Claimed As Equity Injection
March	\$ 10,000	\$ 744
April	0	0
May	0	0
June	6,000	5,970
July (3 loans)	27,000	25,066
August	0	6,749
September	0	635
October	4,060	17
November	0	0
December	8,000	3,394
Total	\$ 55,060	\$ 42,575

Although the loan file documentation was insufficient to link most of the checks to specific commercial loans, we were able to associate one check to a commercial loan. On March 7, 1997, the borrower received a \$10,000 loan to pour a cement slab for a garage, install a septic tank, and build a road. On June 2, 1997, the borrower issued a \$3,850 check drawn against the loan for materials and construction of the septic system. The same check was submitted to the lender as evidence of equity injection.

The lender’s file contained no evidence that the principal had other sources of equity outside of the start up business. [FOIA EX. 4 & 6]. In addition, monthly debt exceeded income, and overdrafts were repaid with borrowed funds. Following are details of the borrower’s and principal’s financial conditions.

[FOIA EX. 4 & 6]

Monthly debts far exceeded income. [FOIA EX. 4 & 6]

Loan to pay overdrafts. One loan for \$4,060 dated October 1997, was for the sole purpose of paying overdrafts which indicates the borrower's weak financial condition, just two months prior to approval of the SBA loan.

In summary, these adverse conditions indicate that the lender did not exercise due care in obtaining evidence that repayment ability existed and the appropriate amount of equity was injected into the business before the loan was disbursed, as required by SBA.

RECOMMENDATION

We recommend that the Dallas/Fort Worth District Office take the following action:

1. Seek recovery of \$116,772 from General Electric Capital Corporation on the guaranty paid Heller, less any subsequent recoveries, for loan number [FOIA EX. 4].

District Office Comments

The District Office concurred with the recommendation to seek recovery of \$116,772 from the lender.

Evaluation of District Office Comments

The District Office comment is responsive to the recommendation.

Lender Comments

The lender did not provide comments to the draft report in time for inclusion in this report.



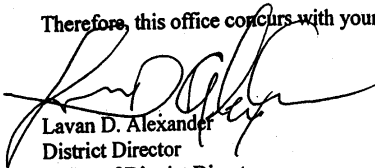
U. S. SMALL BUSINESS ADMINISTRATION
DALLAS/FORT WORTH DISTRICT OFFICE
4300 AMON CARTER BLVD. SUITE 114
FORT WORTH, TEXAS 76155
(817) 684-5500 • (817) 684-5516 (FAX)

Appendix A

DATE: February 28, 2002
FROM: Lavan D. Alexander
District Director
Office of District Director
TO: Robert Seabrooks, Assistant Inspector General
For Auditing
SUBJECT: Audit of SBA Guaranteed Loan to CFM Bracket Company Incorporated
SBA Loan No. XGP 173,953-4004

The documentation reviewed by the Office of Inspector General Audit Team was not made available to the Dallas/Ft. Worth District Office during the guaranty purchase documents review. Had the information been provided, this office would most definitely have entertained the plausibility of guaranty repair.

Therefore, this office concurs with your recommendation to seek recovery from the Lender.



Lavan D. Alexander
District Director
Office of District Director
(817) 684-5502

Enclosures

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