



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

AUDIT REPORT
ISSUE DATE: AUGUST 5, 2002
REPORT NUMBER: 2-21

To: Judith A. Roussel, District Director
Illinois District Office

From: *Robert Seabrooks*
Robert Seabrooks, Assistant Inspector General
For Auditing

Subject: Audit of a SBA Guaranteed Loan to [FOIA EX. 4]

Attached is a copy of the subject audit report. The report contains two findings and one recommendation addressed to your office. Your comments have been synopsized 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 SBA GUARANTEED LOAN TO

[FOIA EX. 4]

CHICAGO, ILLINOIS

AUDIT REPORT NO. 2-21

AUGUST 5, 2002

The findings in this report are the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The findings 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.

FOIA EX. 4

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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) was 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), 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), SBA processes loan guarantee applications and servicing actions on a priority basis. The lender also made loans under SBA's Low Documentation Loan Program (LowDoc). Although this program streamlined the guarantee application process, participating lenders are expected to perform a loan analysis in a manner consistent with prudent lending practices. The analysis is included with the lender's request for a SBA guaranteed loan. The lender stopped making SBA guaranteed loans in February 2001 and was acquired 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 the best interest of the lender 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 140 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 several loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of these loans was to [FOIA Ex. 4] (the borrower) and is the subject of this report.

On [Ex. 4] was sold for \$225,000. The sale was for cash and the assumption of an SBA guaranteed loan with a balance of \$140,128. The individual that purchased the business and assumed the loan was the original owner of the restaurant, who had sold it, and was now purchasing it back. Following the purchase and assumption, the assumptor made payments for only 3 months, defaulting on the loan in

FOIA Ex 4

⌈ Ex + ⌋ After the assumptor abandoned the business, the franchiser took over operations. SBA purchased the loan guarantee for \$93,689 on ⌈ Ex. 4 ⌋

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 January 2001 in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding 1 – The Borrower Submitted False and Misleading Financial Information

The financial documentation submitted by the borrower contained several obvious modifications that apparently were not noticed and/or questioned by the lender. Under 13 CFR 120.150, the character of the applicant and the ability to repay the loan from the earnings of the business must be considered during the credit analysis of the applicant. According to SOP 50 10 4, subpart A, Chapter 4, consideration of character includes, among other things, whether the applicant has historically shown a willingness to repay debts and abide by the law. SOP 50 10 4, Chapter 5, 10 c, provides that loan assumptions must be evaluated in the same manner as a new SBA loan application. As part of the review of the loan assumption, the lender obtained financial information on the existing business and the applicant. A review of these documents revealed that several key figures were modified or altered, none of which were identified or considered by the lender during the credit analysis. Discussed below are the documents reviewed and the modifications and alterations identified.

- **Wage and Tax Statement (W-2).** The applicant's 1997 W-2 form submitted to the lender was altered to agree with wages reported on the tax return submitted which also was altered. The amount shown for wages, tips, and other compensation (Box 1) was changed from "\$23,909.20" to "84,093." The original amount (\$23,909.20) is clearly visible on the W-2 form, even though it was printed over the title of the box. Also, the modified amount is printed in a different, larger font than the rest of the figures shown on the W-2 form and is the only amount without a dollar sign and whole dollars only. Finally, the dollar amounts withheld for social security and Medicare are incorrect when the withholding rates are applied to the modified amount. Applying the rates to the correct figure of \$23,909.20 results in amounts equal to the withholdings shown on the W-2 form.
- **Tax Return.** The applicant's 1997 Federal Income Tax Return was modified to show an increase in salaries and wages that matched the altered amount shown in the W-2 form. Gross wages was reported at \$84,903 on line 7 of the tax return

and adjusted gross income was reported at \$79,553 on line 32. On line 33 of the next page, however, gross income was reported as \$39,553 even though the amounts on lines 32 and 33 should be the same. Also, as was the case with the W-2 form, the altered figures shown on the first page were printed in a different font that were not as bold as the figures printed on the top half of the page and the remaining pages of the tax return.

- **Income Statement.** The 1997 business income statement was an exact copy of the 1996 income statement, with the exceptions of the dates. The Profit and Loss Statement for the month of May 1998 showed a net income that was 2.5 times higher than net income for the entire year of 1996 and 1.5 times higher than income projected for 1997 and 1998. Losses of \$9,451 and \$11,996 were reported for the following two months.

The above conditions reflect a lack of due care by the lender during the review and evaluation of the loan application. Otherwise, the loan would have been denied based on the applicant's questionable character and repayment ability.

Finding 2 – The Lender did not Obtain IRS Tax Verification.

SBA Policy Notice 9000-941 requires lenders to obtain IRS transcripts in order to validate financial data relied upon to make a loan approval decision and to detect any false or potentially fraudulent financial data that might impact the applicant's character and the viability of the business. The lender did not obtain IRS transcripts for the business, the seller, or the assumptor. IRS transcripts would have revealed that the applicant submitted false financial information in order to obtain a SBA guaranteed loan.

RECOMMENDATION

We recommend that the Illinois District Office take the following action:

1. Seek recovery of \$93,689 from General Electric Capital Corporation on the guaranty paid Heller, less any subsequent recoveries, for loan number

[Ex. 4]

District Office Comments

The Illinois District Office concurred with the finding and recommendation.

OIG Evaluation of District Office Comments


The Illinois District Office agreed to seek recovery from the lender as recommended.

Lender Comments

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



U. S. SMALL BUSINESS ADMINISTRATION
ILLINOIS DISTRICT OFFICE
500 WEST MADISON STREET, SUITE 1250
CHICAGO, IL 60661-2511
312-353-4528 • 312-896-5688 (FAX) • 312-894-5108 (TDD)
<http://www.sba.gov>

DATE: July 31, 2002
FROM: Judith A. Rousseau 
District Director, Illinois District Office
TO: Robert Seabrooks, Assistant Inspector General for Auditing
SUBJECT: Audit of SBA Guaranteed Loan to [Ex. 4]

We have reviewed the subject draft audit report. The report recommends that the Illinois District Office seek recovery of the \$93,689 loan guaranty paid to the lender. The audit results were based on findings that the income tax returns submitted in connection with an assumption of the SBA loan were fraudulently altered and that the Lender failed to notice these obvious alterations or obtain IRS verification of these returns. Based on the information provided in the report, this office intends to make demand on Lender for a full refund of the purchase monies.

FOIA Ex 4

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