



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

AUDIT REPORT
ISSUE DATE: August 7, 2002
REPORT NUMBER: 2-23

To: Sandra V. Sutton, District Director
Santa Ana District Office

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

Subject: Audit of a SBA Guaranteed Loan to RSC Enterprises, Inc.

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 synopsisized 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

RSC ENTERPRISES, INC.

AUDIT REPORT NO. 2-23

LAKE FOREST, CA

August 7, 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 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.

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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 RSC Enterprises, Inc. and is the subject of this report.

In July 1996 the lender approved a SBA guaranteed loan (loan number [ex. 4]) for \$280,000 to RSC Enterprises, Inc. (borrower) under PLP procedures. The purpose of the loan was to acquire an existing tire store for \$160,000, purchase machinery and equipment of \$64,000, purchase inventory of \$40,000, and provide working capital of \$16,000. The last loan disbursement occurred in August 1996. The borrower defaulted

on the loan in February 1997 and abandoned the business in April 1997, approximately eight months after the last disbursement. In July 1998, the loan was placed in liquidation status and SBA purchased the guaranty for \$191,458.

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 and November 2000 in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding 1 - The Borrower Lacked Repayment Ability

Repayment ability was based on cash flow projections that did not include certain operating and loan servicing expenses. According to Standard Operating Procedure (SOP) 50 10 3, Chapter 2, Section 13, the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process and the absence of repayment ability dictates the decline of the loan application. An analysis of the repayment ability must include the company's revenues and expenses as well as the owner withdrawals and their impact on cash flow. If historical cash flow does not indicate repayment ability, a realistic projection of future earnings must be used. Any significant variations must be explained.

The seller provided income statements for the prior four years, 1992 through 1995, plus an income statement for the five-month period ending May 31, 1996. The historical income statements showed a steady decline in sales from 1992 to 1995 of 21 percent when sales went from \$876,459 to \$692,230. During the first five months of 1996, however, sales increased by 5 percent which, when annualized, resulted in \$727,654 in sales revenue. The lender's file did not include an explanation for the recent up swing in sales after three consecutive years of decline.

The SOP also provides that a realistic projection of future earnings may be used to determine repayment ability when historical cash flow does not support repayment ability. The projected earnings, however, must be tested against industry averages and historical operations to assess reasonableness. The lender used the projections submitted by the borrower to calculate repayment ability. Projected sales for the first year were \$1.35 million. This represented a 56 percent increase over 1996 sales (annualized) and a 64 percent increase over 1995 sales. The increase in sales, per the borrower, would be achieved through more involvement of the owner and better management.

In addition to unsupported projected earnings, the following expenses were not included in the cash flow analysis.

- **Lease and other Operating Expenses.** The cash flow analysis did not include the \$1,337 increase in building lease expense as well as other general operating expenses that were included in the seller's historical financial statements. These operating expenses, totaling \$42,893, include such items as worker's compensation insurance, credit card processing fees, laundry, tire disposal fees, and environmental fees. There was no explanation in the loan files why these business expenses would not carry over from the existing business.
- **Owner Salary or Withdrawals.** Although the lender's loan analysis noted that the principal would operate the store on a daily basis, the cash flow analysis did not recognize a salary for the principal (sole owner). The sole principal stated in the franchise application that he intended to devote full-time to developing the tire store. Based on the 1995 personal financial statement submitted with the loan application the principal reported an annual income of [ex. 6] therefore, we estimated that he would continue to receive the same amount from the tire store.
- **Loan from Stockholder.** The principal loaned the business [ex. 6, 4] which had a minimum monthly payment of \$1,200 (\$14,400 annually). The Authorization and Loan Agreement (A&LA) did not provide for a standby agreement and there was no standby agreement in the loan file.

The table on the next page demonstrates the impact these excluded expenses had on the borrower's repayment ability. The first column shows cash flow based on the last full year of operation (1995). The second column reflects cash flow for 1996 based on an interim income statement (annualized). The third column is the cash flow projection submitted by the borrower and the fourth column represents the projected cash flow adjusted for the excluded operating and loan servicing expenses.

FINA EX. 7, 6

Repayment Ability

Description	Historical Cash Flow		Projected Cash Flow	
	(1) Income Statement 1995	(2) 1996 Interim Income Statement	(3) Borrower Projections (unadjusted)	(4) Borrower Projections (adjusted)
Sales (Plus fees)	702,513	740,618	1,135,000	1,135,000
Less: Expenses	(710,310)	(702,725)	(976,801)	(97,6801)
Cash Available to Service Debt:	(7,797)	37,893	158,199	158,199
Less: Excluded Expenses:¹				
Increase in Lease Expense	(1,337)	(1,337)		(1,337)
Omitted Operating Expense				(42,893)
Owner's Salary				[ex. 4, 6]
Shareholder Loan	[ex. 4, 6]	[ex. 4, 6]		[ex. 4, 6]
Cash Avail. To Service SBA Loan	(23,514)	22,156	158,199	41,969
Less: SBA Loan Payment	(46,284)	(46,284)	(46,284)	(46,284)
Net Cash Flow	(69,818)	(24,128)	111,915	(4,315)

¹ Operating expenses and owner salary are included with the regular expenses in columns 1 and 2. These expenses are shown separately in column 4 to demonstrate their impact on the borrower's projected cash flow and repayment ability.

The table shows that cash flow based on historical and unsupported projected financial data were insufficient to support the SBA loan.

Finding 2 – The Lender did not Verify Equity Injection

The A&LA stated that "Prior to first disbursement, Lender was to be in receipt of evidence of injection of at least \$70,000 by the Borrower." According to CFR 120.150, the borrower must provide sufficient invested equity to operate on a sound financial basis. A solid equity position reduces the need for debt and provides an incentive for the borrower to remain committed.

The borrower provided detailed spreadsheets listing expenditures totaling \$95,912 as proof of equity injection. The spreadsheets included photocopies of receipts and checks as support for the majority of the equity amount claimed. Evidence contained in the lender's loan files, however, indicates that the lender did not review the equity injection documentation carefully before disbursing the loan. In December 1997, more than one year after the last loan disbursement, the lender noted that most of the expenses submitted

by the borrower might not qualify as equity into the business and that only about \$20,000 appeared to qualify. It was also noted that the amount that qualified as equity injection would depend on the interpretation of the District Office. Three months earlier, the lender noted that the biggest concern with the loan was the cash injection and that they would be hard pressed to convince the SBA that the documentation submitted by the principal represented bona fide cash injections into the business. During our review of the loan file, we were unable to find supporting documentation for \$48,267 of claimed equity injection.

On July 2, 1998, the District Office asked the lender to provide "...evidence of the borrower's \$70,000 injection, in the form of cancelled checks and receipts, as required by the A&LA Paragraph 4.F.23." The lender responded on August 17, 1998:

"The cash injection was submitted with the guaranty purchase request dated April 9, 1998, along with copies of all supporting documentation. The evidence of cash injection was substantial, consisting of voluminous copies of checks, invoices and receipts, including a very detailed spreadsheet prepared by the borrower itemizing all the checks, invoices and receipts."

The lender did not inform SBA that it conducted an earlier review of cash injections and could only support approximately \$20,000 of the required \$70,000.

Finding 3 The Lender did not Exercise Prudent Controls Over the use of Loan Proceeds

By signing the SBA Form 1050, "Settlement Sheet," the lender certified that, "...loan proceeds were used as set forth [in the settlement sheet] and in accordance with the Loan Authorization by issuance of joint payee checks as detailed [in the settlement sheet], except checks for cash operating capital, cash to reimburse borrower for evidenced expenditures made after loan approval for such authorized use of proceeds, or as otherwise directed by the Loan authorization...."

According to the settlement sheet, \$160,000 of the loan proceeds was disbursed to [Ex 4] \$104,000 to [Ex 4] and \$16,000 to the borrower as working capital. The closing documents prepared at settlement, however, show that \$98,664 of the loan proceeds was actually paid directly to the borrower instead of the third party vendors as stipulated in the SBA settlement sheet. There also was no evidence found in the loan file to support that any of these proceeds were used to purchase inventory, machinery or equipment in accordance with the settlement sheet and the A&LA.

Finding 4 The Lender did not Obtain Internal Revenue Service (IRS) Income Tax Verification

Although the principal provided the lender with a signed request for IRS tax transcripts dated four months before the first disbursement, there was no evidence that the

lender forwarded the request to the IRS. SBA Policy Notice 9000-941 requires IRS tax verification of financial information submitted with the application. The request for transcript, Form 4506, with an original signature, dated April 18, 1996, was found in the lender's loan file, but copies of the tax transcripts were not found. An internal note in the lender's file acknowledged the fact that Form 4506, Request for Tax Transcript, apparently had not been sent to IRS for verification.

RECOMMENDATION

We recommend that the Santa Ana District Office take the following action:

1. Seek recovery of \$197,751.97 from General Electric Capital Corporation on the guaranty paid, less any subsequent recoveries, for loan number [EX. 4]

District Office Response

The Santa Anna District Office indicated that the Lender agreed to repay the guaranty on this loan.

OIG Evaluation of the District Office Response

The Santa Anna District Office agreed to seek recovery on the guaranty.

Lender Response

The lender did not provide a response to the draft.

FBI EX. 4

From: [ex. 6]
Sent: Tuesday, August 06, 2002 11:32 AM
To:
Cc:
Subject: RE: Status of RSC Enterprises Draft Report

Larry,

[FOIA ex. 4]

[ex. 6]

FOIA EX. 4, 6

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AUDIT REPORT DISTRIBUTION**

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