



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

Date: September 24, 2002

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

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

Subject: Audit of a SBA Guaranteed Loan to Earth Treasures, Inc.

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your response and the Lender's comments are synopsisized in the report and included at Appendices A and B, respectively.

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 this report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732

Attachment

AUDIT OF A SBA GUARANTEED LOAN TO

EARTH TREASURES, INC.

DALLAS, TX

AUDIT REPORT NO. 2-30

SEPTEMBER 24, 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.

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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 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 Earth Treasures, Incorporated (borrower) and is the subject of this report.

In [REDACTED] the lender approved a loan (loan number [REDACTED]) for \$100,000 to the borrower under the LowDoc Program. The purpose of the loan was to purchase [REDACTED] of inventory, [REDACTED] of machinery and equipment, and provide [REDACTED] for working capital. The borrower made 17 payments of which 10 were interest only. Only five payments between November 1994 and March 1995 were applied to principal and interest. The borrower defaulted in [REDACTED] and the loan guarantee was purchased on [REDACTED]

AUDIT SCOPE AND OBJECTIVE

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 it resulted in a material loss to SBA. A material loss was defined as exceeding \$25,000. The audit was conducted during September 2000 in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding 1. The Lender did not Follow Prudent Lending Practices in Assessing Borrower Repayment Ability and Securing Collateral

Borrower Repayment Ability

The lender based repayment ability on projected revenue from two pending contracts that were never executed. According to 13 Code of Federal Regulations (CFR) 120.103-2 (a), all SBA guaranteed loans shall be of such sound value or so secured as to reasonably assure repayment. No financial assistance shall be extended unless there is reasonable assurance that the loan can be paid from the earnings of the business. Standard Operating Procedure (SOP) 50 10 3, Chapter 2, para.13, provides that the best evidence of repayment ability is sufficient cash flow from prior operations. If historical cash flow does not indicate repayment ability, a realistic projection must be used.

The lender's loan file contained an analysis of the borrower's historical cash flow which appeared to support repayment ability, but the analysis did not include an annual rent increase of \$20,400 that took effect three months prior to loan approval. When this additional expense is considered, as shown in the table below, the borrower did not have repayment ability based on prior operations.

Historical Cash Flow

	Lender	Per Audit
Sales	\$97,600	\$97,600
Less: Expenses	\$79,100	\$79,100
Rent Increase		\$20,400
Net Income	\$18,500	(\$1,900)
Less: Owner's Draw*		
Cash Available to Service Debt	\$18,500	(\$1,900)
Less: SBA Guaranteed Loan	\$17,600	\$17,600
Net Cash Flow	\$900	(\$19,500)

* An owner's draw was not shown in Lender's historical cash flow.

The lender, however, did not rely on the historical cash flow and instead based repayment ability on projected revenues from two pending contracts. The loan officer's report stated that the borrower had negotiated agreements with two companies for product distribution in major department stores and promotion via television advertising. As shown in the table below, sales were projected to increase over 900 percent which would have resulted in \$319,200 being available to service the annual SBA guaranteed loan payment of \$17,600.

**Projected Cash Flow
Based on Cash Flow from Pending Contracts**

	Lender's Projection	Historical Cash Flow	Percent Increase over Historical
Sales	\$999,600	\$97,600	924%
Less: Expenses	(\$638,800)*	\$79,100	
Net Income	\$360,800	\$18,500	1,740%
Less: Owner's Draw	(24,000)		
Cash Available to Service Debt	\$336,800	\$18,500	
Less: SBA Guaranteed Loan	(\$17,600)	\$17,600	
Net Cash Flow	\$319,200	\$900	35,366%

* Expenses do not include the \$20,400 annual increase in rent expense.

The projected cash flow never materialized because the two contracts were never executed. Consequently, the borrower defaulted on the loan after making 17 payments, 10 of which were interest only.

Because the lender did not take prudent measures to ensure that the two contracts were in effect before disbursing the loan, SBA was placed at unnecessary risk and suffered a loss of \$84,911 when it erroneously paid the guaranty on this loan.

Securing Borrower's Collateral

The loan file contained no evidence that the lender performed mandatory site visits or notified SBA after learning that the borrower was experiencing financial problems. SOP 50 51 1, Chapter 4, Paragraph 44.c. provides that the lender must notify SBA when a loan becomes 90 days delinquent or earlier, if it appears likely that a loan will go into liquidation. The SOP further provides that the borrower's premises will be visited by the lender and/or SBA representative within 10 working days following knowledge of any condition(s) which creates an "in liquidation" situation.

Documents found in the lender's loan files show that the borrower had trouble paying the loan for 2 ½ years before finally defaulting. The borrower began experiencing problems soon after the loan was approved in [EX. 4] and was 60 days in arrears within the first three months of the loan. One year later, the borrower began making interest only payments and was continuously in arrears. During April and May of 1996, the lender received four checks from the

borrower that could not be processed due to insufficient funds and the borrower was again in arrears. There was no evidence found in the loan files to support that the lender made any site visits during this period to assess the financial condition of the borrower and secure the collateral, if necessary.

After the borrower defaulted on the loan in [Ex. 4] the lender attempted to contact the borrower at the business but found that the phone had been disconnected. The lender then contacted the borrower's landlord in December 1996, and was told that the borrower had been evicted and moved to a new location. This prompted the lender to drive by the new location but the borrower and the collateral could not be located. The collateral had an estimated liquidation value of \$31,590 at loan approval. If the collateral had been available for liquidation, the loss to SBA could have been reduced by \$23,692 (75 percent of the lost collateral's liquidation value).

RECOMMENDATION

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

1. Seek recovery of \$84,911 from General Electric Capital Corporation on the guaranty paid to Heller First Capital, less any subsequent recoveries, for loan number [Ex. 4]

Management Response

The Dallas District Director stated that liability on the loan, which was processed in the San Antonio District Office, should not be denied based on credit that was approved by SBA.

OIG Evaluation of the Management Response

Under the streamlined procedures for the Low Doc program, the lender was responsible for performing the credit analysis and maintaining the supporting documents. We found no evidence that SBA received and reviewed any of the supporting documents for the lender's credit analysis. Accordingly, SBA's approval of the Low Doc loan application was primarily based on the lender's representation of the credit rather than an actual analysis of the supporting documents.

Lender Comments

A complete application package was submitted to the SBA which stated that "Earth Treasures needs to increase its production of the aromatherapy products in order to meet the requirement for the contracts with [Ex. 4] its distributors. The loan will allow [the borrower] to take the next step in the growth of his business."

FBI/EX. 4

OIG Evaluation of Lender Comments

As noted in the lender's response, the language used in the application appears to indicate that the two distribution contracts were in effect when the application was submitted to SBA. Thus, absent evidence to the contrary, SBA had no way of knowing from the application alone that the distribution channels had not been finalized. Further, we found no evidence in the lender's loan file, such as a copy of a signed agreement/contract or letter of intent, that the borrower had binding agreements with either [EX. 4] on the date of disbursement.

The loan file did contain a February 23, 1994 letter to the lender in which the borrower stated that the principle owner of [EX. 4] had:

... "made connections to put earth treasures in nine major department stores in Mexico as well as high end salons across the USA...with [EX. 4] as a distributor, all we do is ship a contractual amount of product monthly and we are paid upon delivery. They [EX. 4] handle the rest."

While this may suggest that some form of an agreement with [EX. 4] existed or was contemplated, we found no evidence that a distribution/promotion agreement between the borrower and [EX. 4] was ever executed or reduced to writing.

With respect to the other distributor, [EX. 4] the borrower stated in the February 23, 1994 letter that:

"We have been approached by [EX. 4] to distribute our products into major department stores across the USA."

Again, there was no evidence in the loan file to support that an agreement with [EX. 4] was ever finalized.

Lender Comments

The application package communicated sufficient information for SBA to determine the nature of the "hobby" turning into a start-up business venture.

OIG Evaluation of Lender Comments

Characterizing the business as a "hobby" is somewhat misleading. In 1993, the year prior to the loan, Earth Treasures reported sales of \$97,000 and net income of \$18,500 in its income tax return. Classifying the business as a hobby, however, highlights the importance of the lender's obligation to have ensured that the applicant had the ability to distribute its products before disbursing loan proceeds.

FOIA EX. 4

Lender Comments

The lack of the ability to increase production prior to disbursement of the loan proceeds would have made delivery and execution of the contracts impossible. It was necessary for the loan proceeds to be disbursed and utilized prior to execution of the contract to set up the production capacity.

OIG Evaluation of Lender Comments

Considering that repayment was based on a projected increase in sales of 924 percent, which was based solely on the distribution channels provided by the two distributors, we believe it was highly irresponsible of the lender to place SBA at risk by disbursing the loan proceeds without adequate assurance that the distribution channels were in place. Prudent lending practices dictate that the lender obtain evidence, either in the form of binding contracts or, at a minimum, binding contingent agreements, to evidence the existence of the distribution channels prior to loan disbursement. Without such assurance, there was no rationale for the overly optimistic projected increase in sales, which was the sole basis for loan repayment.

Lender Comments

A file review performed by GE does show indications of a contract with [EX. 4] which does not support the OIG report statement that the two pending contracts were never executed.

OIG Evaluation of Lender Comments

As stated above, we found no evidence that the borrower ever executed distribution and/or promotion contracts with the two distributors. However, in a letter dated May 18, 1995 from the borrower to the lender in which the borrower requested a deferment of SBA loan payments, the borrower stated that "*In December of 1994 Earth Treasures terminated its only exclusive distributor, [EX. 4]*" The borrower further stated that "*[EX. 4] had misrepresented its performance and was unable to keep its' performance commitments.*" This occurred just eight months after the loan was disbursed.

Although the letter indicates that a relationship may have existed with one of the distributors, the letter alone does not serve as evidence that a contract was ever executed. Furthermore, the letter strongly suggests that the borrower had only one distributor instead of two as represented in the Low Doc application submitted to SBA. Finally, the letter was dated well after the loan was disbursed; therefore, it does not serve as evidence of a condition that existed prior to disbursement.

Lender Comments

Heller performed an analysis of the borrower's historical cash flow, which did support cash flow. GE's review of the file indicates the appropriate rent expense was included in the analysis and the SBA application package.

OIG Evaluation of Lender Comments

The loan officer's analysis for the year ended 12/31/93 showed general and administration (G&A) expenses of \$32,000. Since the analysis did not include a break out of these expenses, it can only be assumed that it included all appropriate expenses, including annual rent. The borrower's 1993 income tax return included \$32,000 of expenses which was broken down by category and showed rent expense \$6,600 for the year. On January 14, 1994, three months prior to loan approval, the borrower executed a three-year lease. The rent for the first six months was \$2,000 per month and \$2,500 each month thereafter. Thus, lease payments for the 1994 totaled \$27,000, not the historical amount of \$6,600 shown in the 1993 tax return. This equates to a rent increase in 1994 of \$20,400. Consequently, the borrower lacked repayment ability based on historical financial statements when adjusted for the rent increase.

Lender Comments

The OIG report goes on to state the SOP provides that the borrower's premises will be visited by the lender and/or SBA representative within 10 working days following knowledge of any condition(s) which "created" and in liquidation situation. Policy Notice 5000-501, effective July 25, 1966, under paragraph entitled Requirements, paragraph A. states, lenders are to "make site visits within 60 days following knowledge of an unremedied default in payment, or as soon as possible after default if there are assets of significant value that could be removed or depleted."

OIG Evaluation of Lender Comments

Policy Notice 5000-501 also states "Whether or not a payment default exists, a site visit must be conducted within 15 days of an event which would cause a loan to be placed into liquidation...." As noted in the report, there were several occasions when the lender had knowledge of the borrower's troubles which we believe should have been considered conditions that created "an in liquidation situation." Not only did the borrower have trouble making full payments most of the time during the loan, but he also submitted four NSF checks to the lender during January and February 1995, and requested a deferment of payments in May 1995. We believe these conditions combined or alone, created a potential "in liquidation situation" and that it was poor judgment by the lender not to visit the business site in order to assess the magnitude of the problems and protect the collateral.

Lender Comments

The loan appears to have been processed under CLP LowDoc guidelines, which does not require field visits on LowDoc loan by SBA liquidation officers.

OIG Evaluation of Lender Comments

According to SBA program personnel, there is no such thing as a CLP LowDoc loan.

Lender Comments

The contention that had the collateral been available for liquidation, the loss to SBA could have been reduced is unfounded. The liquidation plan shows that the cost of recovering and remarketing for resale the collateral would have most likely far exceeded any amount that may have been recovered. SBA subsequently agreed to abandon the collateral.

OIG Evaluation of Lender Comments

The \$23,692 liquidation value of collateral shown in the draft audit report was developed by taking 75 percent (SBA guaranty percentage) of the \$31,590 liquidation value established by the lender on collateral with a fair market value of \$197,000. The figure shown in the draft report is slightly understated because SBA's guaranty percentage was 90 percent.

Although the lender contends that it was too costly to recover and liquidate the collateral, it should be noted that the liquidation report was dated long after the borrower abandoned the business and the collateral had disappeared. Thus, it is not surprising that the lender found liquidation too costly. This further demonstrates the importance of taking prudent actions at the first sign of trouble to assess the problem and protect the collateral; actions that were not taken by the lender until after the borrower had vacated the business along with the collateral.



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Appendix A

August 15, 2002

To: Mr. Robert Seabrooks
Assistant Inspector General for Auditing

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

NA 8/15/02

Subject: Audit of Earth Treasures, Inc.

[Ex. 4]

In response to your memo of August 1, 2002, we have reviewed the subject loan file.

This loan was processed by the San Antonio District Office under SBA's Pilot LOWDOC Program in 1994. In our opinion we should not deny liability based on credit when SBA approved the credit at origination.

If we can be of further assistance, please advise.

FOIA EX. 4



GE Capital Small Business Finance
www.GEbusinessfinancing.com

August 19, 2002

U.S. Small Business Administration
Office of Inspector General
Washington, D.C. 20416

To: Robert Seabrooks, Assistant Inspector General for Auditing

From: [FOIA Ex. 6]
General Electric Small Business Finance, Inc.

RE: Audit of SBA Guaranteed Loan to Earth Treasures
GE Response

In March 1994, Heller submitted to SBA an application for the above mentioned borrower under the pilot LowDoc Program. SBA approved the application as evidenced by the Small Loan Pilot Program Authorization and Loan Agreement, signed on April 5, 1994 by Jim E. Clement, ADD for Finance & Investment at SBA.

A complete application package was submitted to the SBA office, including the U. S. Small Business Administration Application for Business Loan (Up to \$100,000). Paragraph titled "Loan Request: How Much, What For, Why its Needed", stated **Earth Treasures needs to increase its production of the aromatherapy products in order to meet the requirement for the contracts with [Ex. 4] its distributors. This loan will allow [Ex. 6] to take the next step in the growth of his business"**. The application package communicated sufficient information for SBA to determine the nature of the "hobby" turning into a start-up business venture.

In response to the OIG finding which states "Because the lender did not take prudent measures to ensure that the two contract were in effect before disbursing the loan, SBA was placed at unnecessary risk and suffered a loss of \$84,911 when it erroneously paid the guaranty on this loan", GE would like the following to be considered:

GE questions whether it would have been prudent, even if possible, for Heller to require the borrower to enter into a contract prior to the expansion of the operation, nor would a reasonable businessperson, including a potential distributor, agree to do so. The lack of ability to increase production prior to disbursement of the loan proceeds would have made delivery and execution of contract terms impossible. It was necessary for the loan

EX. 4-6

proceeds to be disbursed and utilized prior to execution of the contract to set up the production capacity.

Guidelines from the LowDoc Appendix and Pilot Program Guide indicate "...if repayment cannot be ensured from historic cash flow, or from reasonable projection, as could be the case for start up businesses, the lender should document its knowledge and judgment of the principals management ability, character, capacity and credit in determining whether future cash flow will be adequate to service the needs of the applicant". Heller did document and share with SBA the start-up nature of this business, and its analysis of the principals. Heller performed an analysis of the borrower's historical cash flow, which did support repayment ability. File documents indicate Heller communicated with representatives of [4] regarding the potential contract. Accordingly, GE feels Heller was prudent in also performing an analysis based on projected revenue from the pending contracts. Additionally, a file review performed by GE does show indications of a contract with [Ex 4] which does not support the OIG report statement that the two pending contracts were never executed.

The OIG draft report, Finding 1, paragraph 2, under "Borrowers Repayment Ability" indicates, "The lenders loan file contained an analysis of the borrowers historical cash flow which appeared to support repayment ability, but the analysis did not include an annual rent increase of \$20,400 that took effect three months prior to loan approval. When this additional expense is considered... the borrower did not have repayment ability based on prior operation".

GE's review of the file indicates the appropriate rent expense was included in the analysis and the SBA application package. Page 7 of the write-up attached to the application details the operating expenses included in the financial statement spread. GE is unable to find any reference to the OIG's contention of an annual rent increase of \$20,400 three months prior to loan approval.

Regarding the statements contained in the OIG draft report under the heading "Securing Borrowers Collateral", which states "The loan file contained no evidence that the lender performed mandatory site visits or notified SBA after learning that the borrower was experiencing financial problems", GE would like to have the following considered:

There is in file a letter dated November 19, 1996 to [Ex 6] Loan Liquidation Officer in Dallas Fort Worth District office indicating the loan "is now 89 days delinquent... and has the potential to fall into liquidation status in the near future.

The OIG report goes on to state "The SOP further provides that the borrower's premises will be visited by the lender and/or SBA representative within 10 working days following knowledge of any condition(s) which created an "In Liquidation" situation". GE would like to have the following considered:

Policy Notice 5000-501, effective July 25, 1996, under paragraph entitled "Requirements", paragraph A, states Lenders are to "make site visits within 60 days of an unremedied default in payment, or as soon as possible after default **if there are assets of significant value that could be removed or depleted**". Further, this loan appears to

have been processed under CLP LowDoc guidelines, which indicate "SBA Liquidation officers are **not** expected to make field visits on LowDoc loans..but are not restricted from doing so".

Finally, the contention of the OIG report that had the collateral been available for liquidation, the loss to the SBA could have been reduced by \$23, 692 is unfounded. As detailed in Hellers Liquidation plan, the cost of recovering and remarketing for resale the few kilns, drums and dispersers, along with the herbs, salts, minerals, and oils securing this loan would have most likely far exceeded any amount that may have been recovered. SBA agreed with viewpoint and subsequently agreed to abandon the collateral.

GE appreciates the opportunity to respond to this report, and looks forward to the final recommendation.

AUDIT REPORT DISTRIBUTION

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