



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

AUDIT REPORT
ISSUE DATE: December 19, 2002
REPORT NUMBER: 3-01

To: Terri L Denison, District Director
Georgia District Office

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

Subject: Audit of an SBA Guaranteed Loan to Webcot Farms and Gin Co., 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 in their entirety at Attachments 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 the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachments

AUDIT OF SBA GUARANTEED LOAN TO

WEBCOT FARMS AND GIN CO., INC.

GOUGH, GEORGIA

AUDIT REPORT NO. 3-01

DECEMBER 19, 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 guaranty, 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 (Heller) 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), Heller was allowed 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 processed loan applications and servicing actions submitted by Heller on a priority basis. Heller 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 Heller did not always materially comply with SBA rules and regulations. In a January 2000 response to one of the audits, Heller acknowledged that the loan, which closed in 1997, would not have been approved under its current underwriting and closing procedures. A few months later Heller admitted in response to an SBA PLP review that combined growth in volume and processing locations across the country was not in the best interest of Heller or SBA's lending program. Consequently, certain regions exercised more discretion in both credit analysis and compliance with procedures than Heller would have liked.

Based on Heller'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 Heller that were purchased by SBA between January 1996 and February 2000, to determine if the loans were processed correctly. The audit identified 25 loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of these loans was to Webcot Farms & Gin Company and is the subject of this report.

In [ex. 4] Heller approved an SBA guaranteed loan (loan number [ex. 4]) for \$1,100,000 to Webcot Farms & Gin Company (borrower) under the Preferred Lenders Program. The purpose of loan was to repay [ex. 4] of debt, to purchase [ex. 4] of equipment, to finance [ex. 4] for building improvements, to payoff [ex. 4] equipment leases and to provide [ex. 4] of working capital. The last disbursement occurred on August 5, 1997 and the borrower defaulted on the loan in [ex. 4] after making ten payments totaling \$129,666. SBA purchased the loan guaranty for \$609,203 on October 14, 1999.

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 November 2000 and January 2001 in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding 1 – The Lender Approved and Disbursed an SBA Guaranteed Loan to an Ineligible Borrower

The lender approved a \$1.1 million SBA guaranteed loan to a borrower whose principals owned an affiliated business that had several outstanding delinquent Federal loans. In addition, the borrower was in a weak financial condition at the time of loan approval and the lender did not verify the equity injection. As a result, SBA made a \$609,203 erroneous payment when it honored the lender's request for payment on the guaranty.

Borrower was ineligible to receive an SBA guaranteed loan

The principals of the borrowing business owned another business that had seven loans from the U. S. Department of Agriculture totaling \$279,379, all of which were delinquent when the lender disbursed the SBA loan.

Pursuant to 31 USC, § 285.13 and §3720 B individuals with outstanding delinquent Federal debts are ineligible to receive additional Federal financial assistance. According to SBA regulations at 13 CFR 120.110 (q), applicants are ineligible for an SBA business loan if the applicant or an affiliated business previously defaulted on a Federal loan which resulted in a loss. Although the borrower did not disclose the existence of the affiliated business and delinquent loans in the appropriate section of the loan application, the lender had sufficient information to readily identify both.

The Application for Business Loans (SBA Form 4) required the applicant to disclose all businesses in which the borrowing principals have a controlling interest (affiliates) and provide a list of any Federal debt ever requested by the business or its affiliates. The lender was also required to obtain current balance sheet, operating statements, and other information on any affiliated business. Although the borrower did not identify the affiliated business in the application form, the principals' 1995 Individual Income Tax Returns included with the loan application disclosed the name of the affiliated business, which was owned by the two majority principals of the borrowing business.

Prior to the SBA loan, the affiliated business had received seven seed cotton loans from the U.S. Department of Agriculture, totaling \$279,379. The loans were made during November and December 1996, and payments were to be made based on Department of Agriculture guidelines,

with final payments due no later than May 31, 1997. As the processor of the cotton produced by the affiliated business, the SBA borrower was required to notify the Department of Agriculture of the gin bale tag numbers as the cotton was produced. An official from the Department of Agriculture estimated that the cotton was ginned between December 1996 and April 1997, but there was no evidence that the SBA borrower provided the required production information to the Department of Agriculture or that the affiliated business made any of the required intermittent payments.

When the last SBA loan disbursement occurred in August 1997, the seven loans to the affiliated business were at a least 66 days delinquent. That actual number of days/months the loans were delinquent could not be determined due to the borrower's failure to report production information to the Department of Agriculture.

Consequently, because the lender did not identify the affiliated business and the outstanding delinquent Federal debt, the lender approved a SBA guaranty loan to an ineligible borrower.

The borrower's weak financial condition was not considered

The business had a negative net worth for almost four years prior to the loan application, sustaining losses in two of the four years. Further, current liabilities exceeded current assets for the three years prior to the loan. The business, therefore, was unable to pay current liabilities with current assets. According to 13 CFR 120.150, an applicant must be creditworthy and the strength of the business and its ability to repay the loan with the earnings of the business should be considered as part of the credit analysis. There was no evidence in the lender's files to support that the lender made an adequate assessment of the borrower's financial condition.

The table below shows the borrower's negative net worth prior to the SBA loan.

(Amounts shown in thousands of dollars)

As of Date	Assets	Liabilities	Net Worth (Deficit)
7-31-94			(\$146)
7-31-95			(\$19)
7-31-96			(\$102)
4-15-97			(\$44)*

* Figures adjusted for estimated depreciation.

The borrower's poor financial condition coupled with the little working capital provided by the SBA loan (\$50,000) created a situation where the borrower had little in reserve in the event of a low cotton production season. The borrower defaulted within a year of the last disbursement due to a severe drought.

The lender also did not adequately consider the continuing capital needs of the business based on past experience and reasonable expectation. SOP 50 10 3 provides that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. An absence of repayment ability dictates the decline of the loan.

In the years prior to the loan, the business had a history of purchasing equipment and making repairs. A continuation of this pattern, however, was not taken into consideration by the lender during the repayment analysis. According to a cotton gin manager that formerly worked for the borrower, cotton ginning is very hard on the equipment. Due to the dirt and debris in the cotton it would be expected that the equipment must be refurbished and/or replaced each year. A representative from a lender in Georgia agreed that the gin equipment requires annual refurbishing and repairs. He added that gin owners normally refurbish their gin equipment prior to the cotton ginning season to insure a smooth start and make repairs throughout the season.

The table below shows the impact of equipment purchase and repairs on the lender's analysis of the borrower's repayment ability.

Cash Flow
(Dollars shown in thousands)

Description	Repayment Analysis w/o Equipment Purchase and Repairs		Repayment Analysis Adjusted to Include Equipment Repair and Purchases	
	FYE 7-31-96	Partial Year 4-15-97	FYE 7-31-96	Partial Year 4-15-97
Net Income (Loss)				
Depreciation				
Interest Paid				
Cash from Operations				
Less: Gin Equipment Additions and Repairs				
Net Cash Available				
SBA Total Loan Debt Servicing				
Debt Coverage Ratio*				

FOIA EX. 4

- * Debt coverage ratio is defined as cash flow divided by debt.
- ** Debt ratio corrected by the auditor from 1.8 to 1.2 because the lender inappropriately recognized a positive cash flow from equipment funded with accounts payable.

As shown in the table, when the pattern of historical equipment purchases and repairs is extended to the borrower's repayment analysis, the borrower did not have sufficient cash flow to support repayment of the SBA guaranteed loan.

The lender did not verify equity injection

The loan agreement required the borrower to inject \$38,000 towards closing costs. Prior to the first disbursement, the lender was required to obtain satisfactory evidence of the borrower's equity injection.

The lender prepared an itemized list of the closing cost totaling \$39,106 as evidence of equity injection, which was submitted to SBA as part of the guaranty purchase request. The majority of these costs, however, were paid from loan proceeds with the exception of a \$500 escrow deposit and another \$1,000 paid to a loan packager. Consequently, there was no evidence that the borrower injected \$36,500, or 96 percent of the amount of equity required under the loan agreement.

RECOMMENDATION

We recommend that the Georgia District Director take the following action:

1. Seek recovery of \$609,203 from General Electric Capital Corporation on the guaranty paid to Heller First Capital Corporation, less any subsequent recoveries, for loan number [ex. 4]
[ex. 4]

District Office Comments

The Georgia District Office concurred with the finding and recommendation in the audit report and received a check from the lender in the amount of \$609,203.

Evaluation of District Office Comments

The District Office comment is responsive to the recommendation.

Lender Response

The lender concurred with the finding and recommendation in the report and sent a check to Georgia District Office for the full amount of the guaranty purchase.

Evaluation of Lender Response

The lender's actions comply with the recommendation.

FOIA Ex. 4



U. S. SMALL BUSINESS ADMINISTRATION
GEORGIA DISTRICT OFFICE
Peachtree Center-Harris Tower
233 Peachtree Street, N.E., Suite 1900
Atlanta, Georgia 30303

Date: December 13, 2002

To: Garry Duncan, Supervisory Auditor
Office of the Inspector General

From: Terri L. Denison, District Director *TLD*
Georgia District Office

Subject: Response to Audit of SBA Guaranteed Loan to Webcot Farms and Gin Co., Inc.

The Georgia District Office concurs with the finding and recommendation outlined in the audit report.

In a separate development, GE Capital sent to me a formal response to the draft stating that it concurred with the deficiencies cited and the recommendation to reimburse the agency for \$609,203. A check for that amount accompanied the letter.

Attachments



GE Capital

GE Capital Small Business Finance
 635 Maryville Centre Drive, Suite 120
 St. Louis, MO 63141

December 5, 2002

Terri L. Denison
 District Director
 U.S. Small Business Administration
 Atlanta District Office
 233 Peachtree St., NE
 STE 1900
 Atlanta, GA 30303

RE: **Webcot Farms & Gin Co.**
 PLP # [Ex. 4]
 Heller Loan # [Ex. 4]

Dear Terri:

GE Capital Small Business Finance (GE Capital) has reviewed the Inspector General's report on the above referenced Heller First Capital Corporation loan entered into with Webcot Farms & Gin Co. in May 1997. We concur with the deficiencies identified in this Heller First Capital loan and agree with your recommendation of reimbursement to the SBA in the amount of \$609,203.00

GE Capital appreciates the Atlanta SBA Office working with us in arriving at a mutual conclusion to this account. We value the relationship we have the Atlanta SBA Office and hope the actions in this Heller First Capital account does not diminish that relationship.

If you have any questions or need any additional information, please call me at 314-205-3602. Once again, than you for your cooperation in this matter.

Sincerely,

W.R. Duffek
 National Credit Manager

Enc.

cc. [Ex. 6] GE SBF Liquidation Manager

FIA Ex. 4-6

AUDIT REPORT DISTRIBUTION

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