

**AUDIT OF**  
**AN EARLY DEFAULTED LOAN TO**  
**[FOIA Ex. 4]**  
**Roseland, NJ**  
**AUDI REPORT NUMBER 4-13**  
**MARCH 2, 2004**

**The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding 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.**



**US Small Business Administration  
Office of Inspector General  
Washington, DC 20416**

<b>AUDIT REPORT</b>
<b>ISSUE DATE: March 2, 2004</b>
<b>REPORT NUMBER: 4-13</b>

**To:** James A. Kocsi, District Director  
New Jersey District Office

**From:** Robert G. Seabrooks, \s\ Original signed  
Assistant Inspector General for Auditing

**Subject:** Audit of an Early Defaulted Loan to [FOIA Ex. 4]

Attached is a copy of the subject audit report. The report contains one finding and one recommendation addressed to your office. Your response is synopsised in the report and included in its entirety at Attachment 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.

Attachments

**AUDIT OF AN  
EARLY DEFAULTED LOAN TO**

**{FOIA Ex. 4}  
Roseland, NJ**

**TABLE OF CONTENTS**

	<b><u>Page</u></b>
<b>Background .....</b>	<b>1</b>
<b>Audit Objective and Scope .....</b>	<b>1</b>
<b>Results of Audit.....</b>	<b>2</b>
<b>Finding and Recommendation</b>	
Prudent Lending Procedures were not used to Process a Loan.....	2

**APPENDICES**

A - Management Response

B - Audit Report Distribution

## **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 loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with Administration rules and regulations. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations, the loan authorization, or does not make, close, service, or liquidate the loan in a prudent manner.

In June 2000, First International Bank (lender) processed a \$1.4 million SBA guaranteed loan (number [FOIA Ex. 4]) to [FOIA Ex. 4] (borrower) under the Preferred Lenders Program (PLP) to refinance existing debt owed to [FOIA Ex. 4]. The borrower was composed of two owners whose ownership percentages were 50 percent each.

The loan proceeds were disbursed in August 2000. The borrower defaulted on the loan in June 2001. The loan was placed in liquidation status and a purchase request was received in August 2001. SBA honored the guaranty on January 31, 2002. The borrower and lender reached a settlement agreement in which the borrower agreed to bring the loan current by November 2003. The loan, however, was not brought current.

## **AUDIT OBJECTIVE AND SCOPE**

The audit objective was to determine if the early loan default was caused by lender or borrower noncompliance with SBA's requirements. We reviewed the SBA and lender's loan file and interviewed district office and lender personnel. Audit fieldwork was conducted in Dallas, Texas, during December 2002 through July 2003. The audit was performed in accordance with generally accepted Government Auditing Standards.

The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 24 months of origination (early default).

## RESULTS OF AUDIT

### FINDING Prudent Lending Procedures were not used to Process a Loan

The lender did not use prudent lending procedures to process a Section 7(a) loan to [FOIA Ex. 4]. Standard Operating Procedure (SOP) 50 10 (4), Subpart “D”, lists the loan processing responsibilities of PLP lenders. These responsibilities include assessing credit history and completing a repayment ability review when performing the credit analysis. The lender, however, did not adequately evaluate the borrower’s credit history and repayment ability during this analysis. As a result, the SBA made an improper payment of \$767,049.

#### Credit History

Subpart “D” of SOP 50 10 (4) required PLP lenders to review credit reports for both consumer and business debt to determine if the borrower had a history of responsible use of debt. Although the lender reviewed business and personal credit reports, it did not adequately evaluate the borrower’s credit history. The lender’s loan file showed the following credit history problems:

- The borrower was delinquent in repaying a prior loan that was refinanced by the current SBA loan. There was also a history of slow payments, unsatisfied judgments, and pending lawsuits. One of the principals had two judgments, a profit and loss write-off and a civil suit. The other principal filed bankruptcy, had two pending civil suits totaling \$279,000, two judgments totaling \$585,000, a state tax lien for \$46,600, a federal tax lien for \$205,000, one credit card placed for collection, two lines of credit shown as profit & loss write-offs, and a credit card that was in Chapter 13.
- The company’s credit report showed a history of slow payments, judgments, and lawsuits. Dunn and Bradstreet reported the borrower had an unacceptable Paydex score<sup>1</sup> of 49 based on the company’s payment history. Payments to suppliers averaged 33 days beyond extended terms. Additionally, the report showed open judgments of over \$7,000 and an open lawsuit for \$2,044. Further, the business loan application showed that the debt being refinanced was past due and in foreclosure.

The lender was aware of the negative credit information and the bankruptcy but stated in its credit analysis that the first principal’s negatives were in error. The lender provided no support for that position. Additionally, the lender stated that the credit issues of both principals did not reflect character flaws or an inability to manage the company. The business and consumer credit history problems should have caused the lender to deny the loan application.

---

<sup>1</sup> Paydex scores range from 0 – 100 with 75 and above considered acceptable.

## Repayment Ability

The lender used the rule-of-thumb cash flow method to identify the borrower's cash flow and the resulting repayment ability. The rule-of-thumb analysis showed sufficient cash flow in the most recent year to service the proposed debt.

According to SOP 50 11, however, the rule of thumb is only an approximation while a cash flow analysis is needed to determine the sources and uses of cash available during the repayment period of the loan. Part 120.150 of Title 13 of the Code of Federal Regulations states that in assessing a loan's soundness, there must be reasonable assurance that loan repayment can be made. In making this assessment, consideration must be given to: (i) the strength of the business; (ii) past earnings; (iii) ability to repay the loan with earnings from the business; and (iv) the potential for long-term success.

A cash flow analyses prepared by the OIG demonstrates that the borrower did not have adequate cash available to service the proposed debt. See the following table.

### Detailed Cash Flow Analysis

	Historical 1999 Cash Flow from Operations
Net Income/(Loss)	\$ (436,580)
Increase in Depreciation	\$ 1,027,200
Increase in Inventories	\$ (510,769)
Increase Deferred tax asset	\$ (187,100)
Interest Expense	\$ 306,212
Decrease in other current assets	\$ 290,081
Accrued royalty expense	\$ 51,768
Increase in accounts payable	\$ 52,029
Increase in accounts receivable	\$ (226,413)
Cash from operations	\$ 366,427
Proposed Debt Service	\$ 628,000
Debt Coverage	.58

The cash flow computation shows a debt service ratio of only .58 which shows that cash flow was insufficient to service borrower debt.

SOP 50 10(4), Paragraph 4.1.e (1), states that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. Paragraph 4.1.d states that historical earnings and cash flow are the best bases upon which to gauge repayment ability. Paragraph 4.1.d (2) states that if historical cash flow does not demonstrate repayment ability, a realistic projection of future earnings must be used. The projections must be tested against industry averages and historical operations

to assess feasibility and any significant variations should be explained. The lender failed to make the required projection.

### **Potential SBA Loss**

A defaulted loan balance of \$1,369,367 was transferred to liquidation. The SBA honored its guarantee on January 31, 2002, paying \$767,049. The collateral was reappraised at a liquidation value of \$181,000 less recovery costs of \$67,000. To date, the SBA has lost \$767,049, less potential recovery and liquidation of collateral.

### **RECOMMENDATION**

We recommend that the District Director, New Jersey, take the following action:

- 1A.** Seek recovery from the lender of principal, interest, and expenses totaling \$767,049, paid to honor the guaranty for loan number [FOIA Ex. 4].

### **District Office Comments**

The New Jersey District Office agreed with the recommendation to seek recovery of the SBA guaranty. The District Office stated that it had made demand on the lender for the return of the guaranty amount of \$767,049 paid by SBA, plus interest.

### **Evaluation of District Office Comments**

The District Office comments are responsive to the recommendation.



U.S. SMALL BUSINESS ADMINISTRATION  
New Jersey District Office  
Two Gateway Center, 15th Floor  
Newark, New Jersey 07102-5003

OFFICE OF THE DISTRICT DIRECTOR

DATE: February 24, 2004  
FROM: James A. ~~Kocs~~ District Director [ FOIA Ex. 6 ]  
TO: Robert G. Scabrooks  
Assistant Inspector General for Auditing  
Office of Inspector General  
SUBJECT: Audit of an Early Defaulted Loan to [ FOIA Ex. 4 ]

We are in agreement with your finding presented in your revised draft audit of January 23, 2004.

Demand has been made on the participating lender for the return of the Guaranty amount of \$767,049.21 paid by the SBA on January 31, 2002, plus interest, in accordance with Part 120.524(a) (1-3) of Title 13 of the Code of Federal Regulations, namely:

- (1) The Lender has failed to comply materially with any of the provisions of these regulations, the Loan Guaranty Agreement, or the Authorization;
- (2) The Lender has failed to make, close, service, or liquidate a loan in a prudent manner;
- (3) The Lender's improper action or inaction has placed SBA at risk.

Should you have any questions on this matter, please contact William C. Boone of our office at (973) 645-2179.

cc: William C. Boone, Assistant District Director

SBA - Your Community Development Partner



AUDIT REPORT DISTRIBUTION

<u>Recipient</u>	<u>Number of Copies</u>
District Director New Jersey District Office-----	2
Deputy Associate Administrator Capital Access-----	1
General Counsel-----	3
Associate Administrator for Financial Assistance-----	1
Associate Administrator for Field Operations-----	1
Office of Chief Financial Officers Attn: Jeff Brown-----	1
General Accounting Office-----	1