

AUDIT OF AN SBA GUARANTEED LOAN TO

[EXEMPTION 6]

[EXEMPTION 6]

Audit Report Number: 7-02

October 23, 2006

The finding in this report is the conclusion of the Office of Inspector General'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.



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

AUDIT REPORT
Issue Date: October 23, 2006
Report Number: 7-02

To: Janet A. Tasker
Acting Associate Administrator for Financial Assistance

/S/ original signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of an SBA Guaranteed Loan to [EXEMPTION 6].

The purpose of this memorandum is to notify you of a \$256,933 improper payment that should be recovered. During our ongoing audit of the guarantee purchase process at the National Guaranty Purchase Center, we identified a problematic loan [EXEMPTION 6] made by [EXEMPTION 6] (borrower). The audit was conducted during February 2006 in Dallas, Texas, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

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 SBA regulations, policies and procedures. If a lender fails to comply materially with SBA regulations, the loan agreement, or does not make, close, service, or liquidate a loan in a prudent manner, SBA has exclusive discretion to release itself from liability, in whole, or in part, on the loan guarantee.

[EXEMPTION 6] is authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, [EXEMPTION 6] was permitted to process, close, service and liquidate SBA loans with limited documentation and review by SBA.

On August 22, 2003, the lender approved an SBA guaranteed loan to the borrower for \$367,000 using PLP procedures. The purpose of the loan was to purchase inventory for \$300,000, furniture and fixtures totaling \$30,000, two box trucks for \$27,000, and equipment in the amount of \$10,000. The lender made seven loan disbursements between September 3, 2003 and March 8, 2004. The borrower defaulted on November

26, 2004, less than 9 months after the last loan disbursement. SBA purchased the guarantee for \$256,933 on January 6, 2005. The post purchase review decision was approved by the National Guaranty Purchase Center on April 14, 2005, and no material deficiencies were identified.

The Lender Did Not Disburse the Loan in Accordance with SBA Policies

The lender disbursed the loan proceeds directly to the borrower, and when the loan defaulted, the lender was not able to provide adequate documentation to substantiate the use of \$358,071 in loan proceeds. The deficiency was not detected during the guarantee purchase process. As a result, SBA made a \$256,933 improper payment when it honored the guarantee.

The loan authorization required the lender to document that the borrower used the loan proceeds for the purposes provided in the authorization. It also required the lender to complete SBA Form 1050, *Settlement Sheet*, for each disbursement and retain documentation supporting the disbursement of proceeds as authorized, such as joint payee checks or evidence of deposit into controlled accounts. Upon signing the Form 1050, the lender certified that the loan proceeds were used in accordance with the loan authorization and disbursements were made by issuance of joint payee checks, checks to reimburse the borrower for evidenced expenditures made after loan approval, checks for operating capital, or as otherwise directed by the loan authorization.

According to the loan settlement sheets and the borrower's written requests, six of the seven loan disbursements totaling \$358,071 were used to purchase inventory, which was pledged as collateral to secure the loan. The lender, however, did not use joint payee checks or provide copies of paid receipts, vendor invoices, or other documentation to substantiate that proceeds were used to purchase inventory. Instead, the lender disbursed the loan proceeds directly to the borrower.

In November 2004, 9 months after the last disbursement, the borrower informed the lender that a prospective buyer had agreed to assume the loan, who later reneged on the deal and kept the inventory that the borrower allowed him to control. The lender's December 10, 2004, site visit report confirmed that inventory was missing as it noted that substantially all inventory was removed by a third party. When all available collateral was sold at auction, the lender recovered only \$37,005 for a truck, a forklift, equipment, fixtures, and some inventory, according to the liquidation report. Available documentation did not identify how much, if any, of the liquidated collateral comprised inventory purchased with loan proceeds. Thus, based on the lender's lack of documentation supporting the loan disbursements and the nominal recovery from collateral, we were unable to determine from our review of the loan files if the inventory allegedly purchased with SBA loan proceeds ever existed.

Because the lender did not exercise prudent controls and obtain adequate support to ensure that \$358,071 of the SBA loan proceeds was used in accordance with the loan

authorization, as required, we believe full recovery of the \$256,933 guarantee paid to the lender is warranted.

Recommendation

We recommend that the Acting Associate Administrator for Financial Assistance:

1. Seek recovery of \$256,933, less any subsequent recoveries, from the lender on the guarantee paid for loan number 662-141-[EXEMPTION 2]

Lender Response

The lender agreed with the audit findings given the information presently contained in its files. The lender is attempting to collect additional information to support a reconsideration of the denial of the guarantee and will notify SBA if such documentation is located. The lender's response is included in its entirety as Attachment 1.

OIG Evaluation of Lender Response

The lender's comments are responsive to our finding and recommendation.

SBA Management Response

SBA Management agreed with the recommendation, but has provided the lender the opportunity to secure additional documentation to substantiate the purchase of inventory. By letter dated October 19, 2006, SBA requested that the lender submit additional supporting documentation to mitigate our finding or repay the guarantee purchase amount of \$256,933. SBA's target date for final action is December 31, 2006.

OIG Evaluation of SBA Management Response

SBA Management's actions are responsive to our finding and recommendation.

Exemption 6

[Exemption 6]

October 6, 2006

[Exemption 6]

Ms. Terry Settle
SBA Office of Inspector General
1145 Herndon Parkway
Suite 900
Herndon, Virginia 20170

RE: [Exemption 6]

Dear Ms. Settle,

We have received and reviewed the draft audit report on the above referenced account. Given the findings from the audit and the information presently contained in our files, we agree with your findings.

As we mentioned in our phone conversation with [Exp 6] on October 6, 2006 we are attempting to collect additional information from various sources, including the borrower. In the event we are able to secure additional documentation to support a reconsideration of this guaranty denial we will notify you and submit our request.

Sincerely,

[Exemption 6]

Senior Vice President
Special Assets Group - Texas

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