



US SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, D.C. 20416

**AUDIT  
RELATED  
MEMORANDUM**

**Issue Date: February 18, 1997**

**Number: 7-4-E-001-009**

**To:** Jane P. Butler, Acting Associate Administrator  
for Financial Assistance

**From:** Peter L. McClintock, Assistant Inspector General  
for Auditing

**Subject:** Summary of Audits of the Early Default of Guaranteed Loans

Attached is a copy of the subject report. The report contains two findings and five recommendations directed to your office. The findings discuss the incidence of potential fraud that may have contributed to the high rate of early loan defaults. The Acting Deputy Administrator for Financial Assistance verbally agreed with the findings and recommendations on February 11, 1997.

The findings included in this report are the conclusions of the Office of Inspector General's Auditing Division based on testing of early defaulted 7(a) loans. The findings and recommendations are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide us your management decisions for the recommendations within 30 days. Record your management decision on the attached SBA Forms 1824, "Recommendation Action Sheet," and show your proposed corrective actions and target dates for completion.

We wish to extend our appreciation to you, your staff, district office staff, lenders' staff, and borrowers for their cooperation and courtesies during this audit.

If you have any questions, please contact Garry Duncan, Director, Field Operations, at (202) 205-7732.

Attachment

**SUMMARY REPORT ON  
THE EARLY DEFAULT OF GUARANTEED LOANS**

**REPORT NO. 7-4-E-001-009**

**February 18, 1997**

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.

## SUMMARY

We audited a selection of SBA guaranteed business loans that defaulted early. The purpose of these audits was to determine if early defaults were the consequence of fraud or abuse rather than natural economic factors. This report summarizes the results of the individual audits and provides our recommendations for improved controls.

Nine of 17 loans reviewed had indicators of potential fraud or abuse that may have contributed to loan failures. SBA paid \$9.9 million to honor the guarantees for the 17 loans but recovered only \$3.7 million through liquidation and legal actions. Only one loan with fraud indicators had been reported to a law enforcement agency. The Auditing Division referred an additional eight loans for investigation.

SBA's procedures were not adequate to reduce early defaults or to identify potential fraud. At the time of this audit, neither SBA nor lenders had a policy to review borrowers' records after defaults were declared. Effective July 25, 1996, SBA established a requirement for lenders to make a borrower visit when an event caused a loan to be placed in liquidation status. As part of the site visit, a review of borrower's books and records is required, when possible.

Also, lenders did not always ensure loan proceeds for working capital were used appropriately. Part of the working capital portion of loan proceeds for three loans was used for unauthorized purposes. Repayment ability for one loan to an eligible passive company was overstated because the lender and SBA had not considered all expenses in the cash flow analysis.

We recommend that the Associate Administrator for Financial Assistance take the following actions:

- Incorporate policy notice 5000-501, dated July 25, 1996, concerning site visits and review of borrower's books and records, into SOP 50 51.
- Refer borrowers to the Office of Inspector General for possible audit if they refuse to provide books and records.
- Refer all material discrepancies in lender or borrower loan records to the Office of Inspector General for investigation.
- Determine the feasibility of using joint payee checks or making partial disbursements based on receipts for loans designated as working capital.
- Ensure lenders include all expenses paid by an operating concern to its eligible passive company in repayment ability calculations.

In response to a draft report, the Acting Deputy Associate Administrator for Financial Assistance verbally agreed with the findings and recommendations.

The findings included 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 by your Office in accordance with existing Agency procedures for follow-up and resolution.**

**SUMMARY REPORT ON  
THE EARLY DEFAULT OF GUARANTEED LOANS**

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## **INTRODUCTION**

### **A. BACKGROUND**

Section 7(a) of The Small Business Act of 1958, as amended, gives SBA the authority to provide financial assistance to small businesses. SBA provides this financial assistance primarily through loan guarantees to lenders. To obtain the SBA guarantee, a lender must meet SBA's requirements and execute SBA Form 750, Loan Guaranty Agreement. The execution of this document binds the lender to abide by SBA's regulations and procedures for loan origination, servicing, and liquidation. It also gives SBA the authority to purchase the loan in case of default by the borrower.

As of April 30, 1996, SBA's portfolio included 153,307 guaranteed regular business loans valued at \$20.6 billion. SBA serviced 16,196 of these loans valued at \$2 billion with lenders servicing the remainder. There were 7,891 loans, valued at \$1.2 billion, in liquidation status.

Loan origination procedures require a review of the borrower's eligibility, repayment ability, management qualifications, and adequacy of collateral. These requirements are outlined in Title 13 of the Code of Federal Regulations (CFR), Section 120, and Standard Operating Procedure (SOP) 50 10 3. This guidance also provides credit evaluation criteria for repayment ability and identifies types of applicants and uses of loan proceeds that are ineligible for SBA financing.

Generally, a loan will be transferred to the "In Liquidation" classification when it is necessary to resort to the collateral for repayment or to otherwise enforce collection. Once in liquidation status, the loan may be liquidated by either the lender or SBA. Because SBA does not expect any serious loan performance problems during a loan's first 36 months, we concluded that loans transferred to liquidation within this time period were unusual. The 36 month period is considered the seasoning period and is based on 25 percent of the average term of the SBA loan portfolio. Based on this fact, we selected 24 months (two-thirds of the seasoning period) as the definition of early default for this audit.

### **B. OBJECTIVE AND SCOPE**

The Auditing Division conducted a series of audits to determine whether loans defaulted early because of potential fraud or abuse rather than because of natural causes, such as changes in economic conditions, unsound business plans, or poor management.

A computer generated listing was obtained showing that 4,335 loans were transferred to liquidation status between September 30, 1990 and September 30, 1993. Approximately 1,100 of these loans were transferred to liquidation within 24 months of their approval date.

From this population, we judgementally selected 17 loans for audit based on elapsed time from loan approval to default, loan amount, and lenders with several loan defaults. Audit reports have been issued on individual lenders and loans.

Documentation was reviewed and personnel interviewed at lenders and selected SBA district offices. Also, interviews were held with borrowers, their attorneys, and accountants.

Records were unavailable or limited for nine of the loans. As a result, canceled checks and supporting bank statements were subpoenaed from borrowers' banks. Although bank records were obtained, the lack of access to other business records made our analysis more difficult. We performed audit field work between October 1993 and March 1995. This report summarizes our observations on areas where SBA could improve controls to prevent or minimize losses relating to early defaulted loans.

## **OBSERVATIONS**

OIG audits of loans that defaulted early showed that borrower and bank records for 9 of 17 loans contained fraud indicators or documentation that loan proceeds were misused. SBA paid \$9.9 million to honor guarantees for the 17 loans but had recovered only \$3.7 million through liquidation and legal actions. The resulting high incidence of apparent fraud may have contributed to the early default of the nine loans. Neither SBA nor lenders had a policy to review borrowers' records after default was declared. As a result, only one loan with fraud indicators had been reported to a law enforcement agency. An additional eight loans were referred for investigation at the conclusion of the audit. Also, loan origination and disbursement practices contributed to the disclosed fraud by allowing the use of incomplete or false financial data and the misuse of loan proceeds.

### **FINDING 1 Review of Borrower Loan Records Could Identify Fraud**

SBA honored \$9.9 million of guarantees for defaulted loans without reviewing borrower records for indications of possible fraud or abuse. SBA loan officers stated it was not their practice nor was it feasible to review borrower records and that this was a lender responsibility. SBA was, therefore, unaware of the apparent fraud or abuse for nine loans with guarantees of \$5.4 million that defaulted early. For one of the nine loans reviewed, the lender and borrower agreed to a \$1.5 million settlement for OIG identified misrepresentations made during the loan approval process. SBA must ensure that borrower or bank records are reviewed for loans that default early. Such a review could identify possible fraud and misrepresentation for use as the basis of repair or guarantee denial and investigative referral.

#### **Availability of borrower loan records**

For those nine loans where we found possible fraud or abuse, borrower business records were available from only three borrowers. For the remaining six borrowers, records were subpoenaed from the borrowers' banks because documentation was claimed to have been misplaced.

#### **Borrower record reviews identified possible fraud**

Borrower records for three loans valued at \$2.8 million disclosed that, for two loans, borrowers apparently misrepresented their eligibility. For another loan, the records show that the borrower did not provide accurate financial data. SBA paid about \$2.1 million to honor the guarantees for these loans. The following is an example of the apparent fraud disclosed by our review of one borrower's records.



*[FOIA Deletion]*

As a result of SBA not reviewing borrower records, it was unaware that the borrower, with the lender's awareness, had misrepresented its eligibility and inappropriately obtained the SBA guaranty. Documents in the borrower and lender files show that ownership of the business was reduced at the time of application to meet eligibility standards and revised to the original positions after the loan closed.

*[FOIA Deletion]* received a \$1 million loan with a 75 percent guaranty to purchase equipment. Documents obtained from the firm show that, 2 days before the SBA loan agreement was signed, *[FOIA Deletion]* largest shareholder was elected chairman, secretary, and treasurer. The files also showed that before the loan approval, this shareholder was an active management team member. Lender file documentation showed that the lender was aware of this fact. Additionally, the lender required this shareholder to sign a statement representing that this shareholder would exercise actual control over the managerial decisions of the business enterprise. SBA was not informed of the shareholder's management position.

*[FOIA Deletion]* business records also showed that the lender was aware that this shareholder owned 46 percent of *[FOIA Deletion]* stock before the loan application. An officer of the lender observed that this ownership created a personal resource problem since the shareholder had \$6.5 million in liquid assets, thus making the loan ineligible for an SBA guaranty. Documents in *[FOIA Deletion]* and the lender's files show that to resolve this problem, the shareholder's ownership was reduced to less than 15 percent as of the loan application date and then returned to 46 percent two weeks after the loan closed.

When the business failed, SBA paid \$750,000 plus interest to honor the guarantee and recovered less than \$150,000 from the sale of the collateral. In March 1996, the lender and the borrower's principal shareholder agreed to reimburse SBA \$750,000 for the loan guarantee and to pay the Federal Government an additional \$750,000 for misrepresentations made during the loan approval process.

### **Bank record reviews also identified possible fraud**

Borrower records for six loans, valued at \$3.8 million, were not available. Copies of borrower bank statements and canceled checks were, therefore, subpoenaed from the borrower's bank. Bank records disclosed four loans were made based on apparently fraudulent financial data, or borrowers inappropriately used loan proceeds. SBA paid about \$1.9 million to honor the guarantees without knowing about the apparent misrepresentations and misuse of loan proceeds. A synopsis of these conditions is included in finding two. The following example demonstrates the usefulness of obtaining bank records when borrower records are unavailable.

*[FOIA Deletion]*

*[FOIA Deletion]*, an automotive repair shop, received an \$850,000 loan with an 80 percent guarantee on June 7, 1991, for the purpose of refinancing business real estate and acquiring *[FOIA Deletion]*, another automotive business. *[FOIA Deletion]* principals apparently misrepresented the use of the loan proceeds and financial data. Information submitted in support of the loan application showed that each brother operated a sole proprietor auto repair shop, at their respective residences, with a large amount of gross sales and net income. Five months prior to the loan application, the two formed the general partnership. SBA was asked to honor the guarantee 8 months after the loan was originated. The two brothers, who comprised the partnership, each declared bankruptcy.

When asked for the company's records, *[FOIA Deletion]* stated that the records had been left in the building. A review of bank records disclosed that the brothers had a checking account, titled *[FOIA Deletion]*, as early as March 1990. The March 1990 bank record also showed the same address as the building being purchased. Also, the deposits to the bank account were significantly less than the combined gross sales claimed by the brothers. These facts suggest that the use of loan proceeds and financial data may have been fraudulent.

SBA personnel stated that borrower records were not reviewed due to insufficient staffing and their expectation that lenders would review the records. Lenders included in the audit stated that they had no policy requiring reviews of defaulted borrowers' records.

Subsequently, SBA recognized the need for reviews of borrowers records. Effective July 25, 1996, SBA established a requirement for lenders to make a borrower site visit when an event caused a loan to be placed into liquidation status. As part of the site visit, a review of the borrower's books and records is required, when possible.

## **RECOMMENDATIONS**

We recommend that the Associate Administrator for Financial Assistance take the following actions:

- 1A. Incorporate policy notice 5000-501, dated July 25, 1996, concerning site visits and reviews of borrower's books and records into SOP 50 51.
- 1B. Refer borrowers to the Office of Inspector General for possible audit if they refuse to provide books and records.
- 1C. Refer all material discrepancies in lender or borrower loan records to the Office of Inspector General for investigation.

## **SBA Management's Response**

The Acting Deputy Associate Administrator for Financial Assistance verbally agreed with the finding and recommendations.

### **FINDING 2 Improved Controls were Needed for Loan Origination and Disbursement**

SBA loan guarantees were subject to a greater risk because of a lack of controls to detect indicators of fraud and abuse in loan origination and disbursement. A review of apparent fraud or abuse for nine loans disclosed that six had one or more of the following problems:

(1) poor controls over the use of working capital loan proceeds, (2) the submission of incomplete and false financial data, or (3) SBA and lenders inappropriately excluded lease/rent expense when computing repayment ability to an eligible passive company. The following chart provides a summary of processing deficiencies.

<b>BORROWER NAME AND LOAN NUMBER</b>	<b>LOAN AMOUNT</b>	<b>IMPROPER REPAYMENT CALCULATION</b>	<b>FINANCIAL DATA INCOMPLETE OR FALSE</b>	<b>MISUSE OF WORKING CAPITAL</b>
<i>[FOIA Deletion]</i>	\$150,000		X	X
<i>[FOIA Deletion]</i>	650,000		X	
<i>[FOIA Deletion]</i>	750,000		X	X
<i>[FOIA Deletion]</i>	700,000			X
<i>[FOIA Deletion]</i>	1,000,000	X	X	
<i>[FOIA Deletion]</i>	675,000		X	

### **Working capital loan proceeds were not adequately controlled**

Lenders did not always ensure that loan proceeds for working capital were used for authorized business purposes. Loan proceeds not properly controlled can be diverted to inappropriate purposes. For six of the loans reviewed, working capital comprised from 19 to 78 percent of loan proceeds. SOP 70 50 2, paragraph 3.F(1) requires that lenders exercise prudent control of loan proceeds through the use of joint payee checks (checks with the borrower and the vendor as payee). SBA Form 1050 (Settlement Sheet), however, states that

joint payee checks are not required for disbursement of operating capital (also known as working capital).

Three loans totaling \$1.6 million, processed by different lenders, had \$1.2 million of loan proceeds designated as working capital. Proceeds for these three loans were not disbursed using joint payee checks, and therefore, lenders could not monitor the use of the working capital portion, as these funds were disbursed directly to borrowers. Bank records were obtained to determine the use of proceeds because the borrowers' financial records were not provided for review.

One borrower did not respond to our subpoena for records, and two other borrowers stated records were lost. The bank records showed that the working capital proceeds were disbursed directly to the borrowers with about 24 percent (\$287,505) of the proceeds used for ineligible purposes, such as shareholders' debt and personal expenses. The use of the remaining 76 percent of working capital proceeds could not be determined due to the lack of borrowers' records. Following is a synopsis of each loan.

*[FOIA Deletion]*

*[FOIA Deletion]* received an 80 percent guaranteed loan for \$700,000 on October 31, 1991, of which \$585,985 was disbursed as working capital. *[FOIA Deletion]* used at least \$181,000 to repay shareholder debt.

*[FOIA Deletion]*

*[FOIA Deletion]* received a 76 percent guaranteed loan for \$750,000 on February 6, 1991, of which \$556,257 was for the purchase of inventory. *[FOIA Deletion]* used at least \$100,000 of the proceeds for personal expenditures.

*[FOIA Deletion]*

*[FOIA Deletion]* received an 82 percent guaranteed loan for \$150,000 on October 7, 1992, with \$62,879 for working capital. At least \$6,505 of the working capital loan proceeds were withdrawn from the business account by *[FOIA Deletion]* principals within 8 days of the loan closing.

The remaining three loans, totaling \$2.6 million, had \$705,055 disbursed for working capital. The lender who originated these loans used joint payee checks or direct disbursements to a third party to control working capital disbursements. Reviews of borrower records verified that the proceeds were used for designated business purposes.

An SBA official stated that working capital is excluded from the requirement for joint payee checks because there is frequently no second payee to designate. If no second payee is available, the lender could require the borrower to submit receipts to support the appropriate

use of loan proceeds. Borrowers were able to use loan proceeds for unauthorized purposes because SBA did not require lenders to control working capital loan proceeds.

### **Financial data was incomplete or false**

Financial data submitted for five loans, valued at \$3.3 million, was either incomplete or false. Three borrowers omitted relevant data from their financial statements, a fourth did not submit a balance sheet or a year-end profit and loss statement, and one submitted data that was inaccurate. As a result, lenders could not accurately determine repayment ability. Incomplete and false financial data was not detected because SBA's policies did not require financial statements to be verified with independent sources. In addition, SBA had allowed supporting tax returns to be obtained directly from the borrowers. Standard Operating Procedure (SOP) 50 10 3 states that ". . . the ability to repay the loan from the cash flow of the business is the most important consideration in the loan making process."

The five loans were transferred to liquidation status from 8 to 17 months after approval, with SBA paying \$2.5 million to honor the guarantees. As of October 30, 1996, recoveries from liquidation actions totaled about \$946,000.

Effective November 1994, SBA initiated a requirement that all loan applicants allow lenders to obtain Federal tax information directly from the U.S. Internal Revenue Service before disbursement of loan proceeds. This data is used to verify submitted financial data and should reduce the incidence of inaccurate financial data. Because this condition had been corrected, we are not making any recommendations. We mention this situation to demonstrate the value of the independent tax verification process and encourage its continued use as a fraud prevention procedure.

### **Repayment analysis for a loan to an eligible passive company was incomplete**

An eligible passive company is an otherwise ineligible holding company which owns and leases real or personal property to an operating small concern that has identical ownership interest. The guaranteed loan is generally made to the eligible passive company with the operating concern as guarantor or co-borrower. Eligible passive companies can be individuals.

The repayment analysis for a loan to an eligible passive company did not include all pertinent expenditures. The loan, totaling \$1.8 million, involved the refinancing of debt related to real estate owned by an eligible passive company and leased to an operating concern. The eligible passive company paid the SBA guaranteed loan from lease payments received from the operating concern. A portion of the lease payments, however, were not included in the repayment analysis. By not including the lease payments in the repayment analyses, the borrower's repayment ability was overstated.

*[FOIA Deletion]*

*[FOIA Deletion]*, as eligible passive company for the Agency, received a 75 percent guaranteed loan for \$1 million to purchase a building from which the Agency would operate. The Agency was guarantor on the loan and paid *[FOIA Deletion]* annual lease payments of \$138,984 plus 100 percent of all operating costs including taxes, insurance, utilities, and maintenance services.

The lease amount was \$33,660 more per year than required to be paid on the SBA guaranteed debt. In the cash flow analysis, the lender did not include the \$33,660 in the cash required to service debt. As a result, the analysis overstated the Agency's ability to repay the debt. Our review showed that this additional expense, with other problems identified with the loan, caused the Agency to have insufficient cash flow to service the debt.

SBA Standard Operating Procedure (SOP) 50 10 3, chapter 2 states that ". . . an analysis of repayment ability must include an adequate analysis of both the company's revenue and expenses, as well as owner withdrawals and officer compensation and their impact on cash flow." Because the Agency made payments to the eligible passive company *[FOIA Deletion]*, the payments should have been considered compensation to the *[FOIA Deletion]*. The repayment analysis conducted by the lender and SBA did not include this compensation. An SBA loan officer stated that the eligible passive company and the operating concern are considered one and the lease payments were merely a "pass-through." He assumed the eligible passive company would reduce its capital draw to offset the excess payments.

The loan defaulted 14 months after approval with SBA paying \$740,287 to honor the guarantee. As of September 1996, recovery through liquidation action totaled \$592,169.

## **RECOMMENDATIONS**

We recommend that the Associate Administrator for Financial Assistance take the following actions:

- 2A. Determine the feasibility of using joint payee checks or making partial disbursements based on receipts for loans designated as working capital.
- 2B. Ensure lenders include all expenses paid by an operating concern to its eligible passive company in repayment ability calculations.

### **SBA Management's Response**

The Acting Deputy Associate Administrator for Financial Assistance verbally agreed with the finding and recommendations.

