



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

**AUDIT-RELATED
MEMORANDUM REPORT**

Issue Date: July 13, 1998

Number: 8-7-F-018-021

TO: Jane P. Butler, Acting Associate Administrator
for Financial Assistance
Peter J. McClintock
FROM: Peter L. McClintock, Assistant Inspector General
for Auditing
SUBJECT: Internal Revenue Service (IRS) Verification Requirements
for Purchased Businesses

As a part of our nationwide audit of 7(a) Loan Processing, we reviewed the SBA's requirement to obtain seller income tax verification. This memorandum addresses the IRS verification criteria in SOP 50-10(4), the conflicts within the criteria, and significant changes of the criteria from prior policy. We believe the changes result in a greater potential for fraud and increase the risk of losses to SBA.

Finding - SOP 50-10(4) waives requirement for obtaining IRS tax verification as a means of analyzing historical performance of a business being sold

The SBA has altered its IRS verification policy in SOP 50-10(4), effective December 1, 1997. The new policy allows lenders to waive IRS verification of tax returns as a means of verifying the accuracy of financial information of an existing business being acquired. Tax verification is an adopted control procedure to decrease the risk of relying on false information and thus reduce the exposure to loss.

In October 1994, SBA issued Policy Notice 9000-941 that required lenders to obtain IRS verification of financial information of the applicant business, prior to loan disbursement. When a loan was for the purchase of an existing business, the verification was obtained for the business being sold. The purpose of the policy was to deter and detect fraudulent financial data submitted to SBA. The notice stated that the approval of

unqualified businesses inevitably results in an increase in defaulted loans and denies needed funding to legitimately eligible businesses.

SOP 50-10(4), Chapter 6, Paragraph 4.f., provides conflicting guidance and significantly changes prior policy regarding tax verification of financial information. Paragraph 4.f. A1. states that loan processors are required to use the tax verification process to verify the accuracy of the financial information submitted with each loan application because such information will be relied on for the credit analysis of the application. Paragraph 4.f. A2. states that the IRS verification policy is mandatory for all existing businesses and for any business being acquired with loan proceeds. Paragraph 4.f. A3. states, in part, that "Care must always be taken to ensure the veracity of submitted data."

Paragraph 4.f. A3., however, states that while the historical performance of a going concern needs to be analyzed, verification of the seller's tax return is not required if the analyst is confident the financial information is adequate and reliable. This paragraph conflicts with the requirement in paragraph 4.f. A2. and changes prior policy.

This "waiver" of the IRS verification requirement reduces SBA's assurance that the financial information submitted concerning the business being sold is valid. It also contradicts the intent of the previous policy notice as well as the stated purpose of the tax return verification policy of SOP 50-10(4).

The Office of Inspector General has investigated incidents where sellers provided false financial information. The fact that loans have been approved based on false historical financial information shows that IRS verification is a necessary and beneficial requirement. Following are two examples where false historical financial information was submitted with loan applications:

- An application for two loans totaling \$538,000 for the purchase of two convenience stores contained false historical financial information including the tax returns submitted by the sellers. The loans were declined when SBA could not verify the profits shown on the false tax returns.
- An application for a \$350,000 loan for the purchase of a gas station included false tax returns submitted by the seller. The IRS verification showed no record of returns filed by the seller. As a result of this disclosure, the loan was not disbursed.

In both of the aforementioned instances, loan approval and disbursement based on false information was avoided by IRS verification of seller financial data, and SBA was saved from possible significant losses. Without required verification of seller financial information, SBA will not be aware of such fraudulent actions.

Recommendation:

We recommend that the Office of Financial Assistance revise the language of SOP 50-10(4) to require IRS verification of seller financial information for all loan applications except when the seller provides audited financial statements.

Management Response and OIG Evaluation:

The Acting Associate Administrator for Financial Assistance agreed with the report and stated that SOP 10-50(4) is in the process of being modified to clarify when seller financial information and tax returns must be verified. See Attachment 1 for management's response.

The actions being taken per the Acting Associate Administrator for Financial Assistance should satisfy the recommendation.



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF LOAN PROGRAMS
409 3RD STREET, SW, 8TH FLOOR
WASHINGTON, DC 20416**

Attachment 1

DATE: June 12, 1998

TO: Peter L. McClintock;
Assistant Inspector General

FROM: *Jane Paisgrave Butler*
Jane Paisgrave Butler;
Acting Associate Administrator for Financial Assistance

SUBJECT: I.G. Audit Memo Report Response

The Office of Financial Assistance (OFA) has reviewed Audit-Related Memorandum Report number 8-7-F-018, as issued by the Office of Inspector General (OIG) in April, 1998, and makes the following comments.

We find that the requirements specified in SOP 50-10(4) for the submission of financial statements from businesses selling their assets to our applicants and getting these statements verified through the IRS tax verification process needed further clarification. The existing SOP requires that the same procedures be followed for all types of "asset purchases", regardless of whether or not repayment is dependent on how the assets performed for the seller.

One type of asset purchase involves the selling of all, or a significant portion, of a business's existing assets, where the operation of these assets transfers to the buyer. In these cases, the repayment of any loan made to buy these assets would be either fully or partially dependent on how well these assets historically performed for the seller. Under such circumstances, the financial statements of the seller would need to be included as part of the application package and these statements would have to be verified.

A second type of asset purchase involves the selling of assets by one business to another without the transfer of any of the seller's business operation that was connected with these assets to the buyer. In these cases, the repayment of any loan made to buy these assets would be dependent on how the applicant will use the assets in the future, rather than on their historical performance. Therefore, how the seller has performed with these assets is not relevant, so the seller's financial statements are not needed, and their tax returns are not required.

OFA is modifying the SOP sections on financial statement requirements and on tax verification to reflect these clarifications

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