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AUDIT OF
ATLANTA DISTRICT OFFICE 7(a) LOANS
ATLANTA, GEORGIA
AUDIT REPORT NO. 8-7-F-019-014
May 13, 1998

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

Date: May 13, 1998

To: Laura A. Brown, District Director
Atlanta District Office

Richard Taylor, Director
Preferred Lenders Program (PLP) Loan Processing Center

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

Subject: Audit of Atlanta District Office 7(a) Loans

Attached is a copy of the subject report. The report contains two findings with six recommendations for the District Director, Atlanta District Office, and two recommendations for the Director, Preferred Lender Processing Center.

The recommendations in this report are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up. Please provide your management response to the recommendations within 30 days from the date of this report, using the attached SBA Forms 1824, Recommendation Action Sheet.

Any questions or discussion of the issues contained in the report should be directed to Garry Duncan at (202) 205-7732.

Attachment

AUDIT OF 7 (a) LOAN PROCESSING
ATLANTA DISTRICT OFFICE
ATLANTA, GA

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SUMMARY

The audit was part of a nationwide review to determine whether 7(a) loans were processed, disbursed, and used in accordance with Small Business Administration (SBA) requirements. The Atlanta District Office was assigned 927 loans valued at \$402 million from March 1, 1996, to June 30, 1997. The loans, made to small business concerns within the state of Georgia, were processed by the District Office and the Preferred Lender Program Processing Center. We selected a random sample of 30 loans valued at \$12.5 million for review.

SBA has established procedures for lenders and SBA loan officers to follow to reduce risk associated with loan making and to assure that only eligible loans are guaranteed. Failure to follow these procedures increases the chance that ineligible or risky loans will be approved. We reviewed lenders' compliance with 22 such procedures. In the period audited, we determined that for 15 of the 30 loans, lenders did not follow at least one of the procedures reviewed.

For the 15 loans, the non-compliance with procedures consisted of the following:

- A conflict of interest was not reported to SBA (1 loan). The lender allowed the borrower to use \$218,306 of a \$378,000 loan to repay debt owed to the lender. The lender's refinancing of its own debt increased the risk that the loan was not objectively made.
- A portion of loan proceeds was not used for eligible purposes (2 loans). Proceeds totaling \$29,479 were used to pay personal debt and to fund an equity injection on a SBA 504 program loan. These are prohibited uses of loan proceeds.
- Cash injections were not verified prior to disbursement (4 loans). Without the required cash injections, borrowers may have insufficient working capital and commitment to the business. For the four loans, borrowers did not inject \$239,188 as required by the loan agreement.
- Business financial information was not verified with the IRS prior to disbursement of loan proceeds (7 loans). Without verified business financial data, loan decisions could be based on financial data that is not credible. For one loan totaling \$340,000, the lender did not verify business financial information with the IRS. The required verifications for the other six loans were made after disbursement.
- Business and personal credit reports were not obtained (4 loans). Credit reports are necessary to determine the borrowers' credit history and whether the borrowers have shown past willingness to pay debts. Our subsequent review disclosed satisfactory credit.
- A size determination was not made properly (1 loan). SBA loans can only be made to businesses that meet small business size standards. The affiliates of the borrower were not included in the size determination.
- Joint payee checks or other controls were not used in disbursing \$10,000 of loan proceeds for other than working capital (1 loan). Without the use of joint payee checks or other controls, the loan proceeds are at risk for improper use. A review of the use of the loan proceeds disclosed no problems.

We also identified four loans either lacking timely disbursements or with misrepresentations. Two loans with guarantees totaling \$1.4 million were not disbursed within the time specified in the loan authorization. For a third loan, a lender made a false representation to SBA regarding receipt of the IRS verification, and for the fourth loan a borrower made a false statement concerning his criminal history.

As of December 31, 1997, 21 of the 30 sample loans were current, 1 was past due, 1 was paid in full, 4 were canceled, and 3 were undisbursed. Lender responses regarding the loans indicated the deficiencies were due to both intentional and unintentional loan officer errors, as well as loan officer lack of knowledge of the SBA requirements.

We recommend the Atlanta District Office Director take the following actions to protect SBA's interests:

- Reduce the guarantee percentage to reflect the borrower's ineligible use of proceeds.
- Obtain a verification of the equity injection from the lender or reduce the guarantee percentage to reflect the lack of injections.
- Obtain a guarantee release or an indemnification agreement.
- Re-emphasize lender responsibilities for verification of equity injections and IRS financial data.
- Cancel guarantees for each loan not disbursed by the time specified in the loan authorization.
- Require lenders to either request an extension of the disbursement period or cancellation of the loan guarantee when disbursement is not made within the specified time limit.

We recommend that the Director, PLP Loan Processing Center, take the following actions to protect SBA's interests:

- Obtain a guarantee release from the lender or, in the event the lender fails to release SBA from the guarantee, recommend revocation of the guarantee to the Administrator.
- Obtain a verification of the equity injection from the lender or reduce the guarantee percentage to reflect the lack of injection.

In response to a draft report, the Atlanta District Director and the Director, PLP Center, disagreed with the recommendations relative to finding 1. The District Director agreed with the recommendations in finding 2. Management comments and our evaluation are included on pages 8, 9 and 11 of the report.

The findings in this report are the conclusions 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.

INTRODUCTION

A. BACKGROUND

Audits of the SBA LowDoc Loan Program (a subsection of the 7(a) Loan Program) in 1996 and 1997 showed that lenders and SBA district offices were not always processing loans in compliance with existing policies and procedures. At the request of SBA's Office of Financial Assistance, we initiated an audit of the 7(a) Loan Program to determine if a similar level of non-compliance exists. Our evaluation will be presented in a summary report combining the results of eight individual audits. This report presents the audit results for one site.

Section 7(a) of the Small Business Act of 1958, as amended, authorizes SBA to provide financial assistance to small businesses. SBA provides this financial assistance primarily by guaranteeing loans made by participating lenders to small businesses. To obtain the SBA guarantee, a lender must have continuing ability to evaluate, close, service, and liquidate loans in accordance with SBA requirements. A Loan Guaranty Agreement between SBA and the lender requires the lender to abide by SBA regulations and procedures and allows the lender to request SBA purchase of borrower defaulted loans.

Generally, SBA regulations and procedures require both the lender and SBA to review the borrower's eligibility, repayment ability, management qualifications, character, credit worthiness, and adequacy of collateral for loans submitted under regular procedures. The most active and expert lenders qualify for SBA's Certified Lender Program (CLP) and Preferred Lender Program (PLP), respectively. Under CLP procedures, SBA utilizes the credit presentation of the lender and makes a credit and eligibility determination. Under PLP procedures, the Sacramento PLP Loan Processing Center reviews the loan application solely for eligibility.

B. AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine whether 7(a) loans (excluding special programs such as LowDoc, FA\$TRAK) were processed and proceeds disbursed and used in accordance with SBA requirements. Special loan programs were excluded because the Office of Financial Assistance suggested a review of the regular 7(a) loan program. The audit was based on a statistical sample of 30 loans valued at \$12.5 million out of a population of 927 loans for \$402 million made to small businesses in the state of Georgia between March 1, 1996, and June 30, 1997.

The criteria used to evaluate loans consisted of 22 procedures selected from SBA's Standard Operating Procedures. These procedures were selected to facilitate a comparison to the results of the prior LowDoc audits.

The auditors reviewed lender and SBA file documentation for each loan in the sample; interviewed borrower, lender, and SBA district office personnel; and visited businesses to review records. Field work was performed during September and October 1997. The audit was conducted in accordance with Government Auditing Standards.

C. FOLLOW-UP ON PRIOR AUDITS

The Office of Inspector-General issued a report on July 7, 1997, (number 7-F-006-017) on the Low Documentation Loan Program (LowDoc), a subset of the 7(a) loan program. The report recommended that the District Director request the lender to release SBA from the guarantees on three loans because of false statements made by lenders and borrowers, failure to disclose material information about a borrower's creditworthiness, and lack of compliance with SBA's tax verification policy. We also recommended that the District Director review the financing of a loan to determine if the lender's objectivity was impaired by a conflict of interest and, if so, recommend withdrawal of the guarantee. In addition, we recommended that LowDoc lenders be notified of their responsibilities in processing and disbursing LowDoc loans and offer training to those lenders who need it. The District Director generally agreed with the recommendations but indicated that guarantees would be denied only if SBA were requested to honor them. The issue of the timing of a guarantee withdrawal has been referred to the Acting Associate Administrator for Financial Assistance. Her decision on an SBA policy is pending.

RESULTS OF AUDIT

FINDING 1 SBA 7(a) Guaranteed Loans were not Always Processed, Disbursed, and Used in Accordance with SBA Requirements

SBA has established procedures for lenders and SBA loan officers to follow in reducing risks associated with loan making and assuring that only eligible loans are approved. The chance that risky or ineligible loans will be approved is increased when these procedures are not followed. In our sample, at least one processing or disbursing deficiency was identified for 15 of 30 loans reviewed. Noncompliance with established procedure resulted in \$312,979 for three loans being inappropriately guaranteed. Corrective action is necessary to preclude guarantee adjustments applicable to \$432,000 on four loans. The remaining eight loans did not require guarantee adjustments because corrective action had been taken.

Loan Proceeds were not Used for Eligible Purposes

For three loans part or all of the guarantees were ineligible because the loan proceeds were used for prohibited purposes. For two of these loans, portions of the guarantees were ineligible because part of the loan proceeds were to be used to help obtain other SBA assistance or for non-business purposes. The guarantee for the other loan was ineligible because the lender did not disclose to SBA that the loan created a conflict of interest by reducing the lender's financial exposure. The Code of Federal Regulations (CFR) prohibits SBA from providing guarantees for loan proceeds used for the aforementioned purposes. The following details are provided about the three loans.

- A loan for [redacted] (sample number 29), processed under PLP procedures, was approved in [redacted] for the purchase of an existing business by the applicant. Our review of the disbursement of the loan proceeds showed that \$218,306 was repaid to the lender on behalf of the seller. Thus, the financing resulted in a conflict of interest because the loan reduced the lender's financial exposure. The lender stated he disclosed seller's debt to SBA, but there was no evidence the lender notified SBA of the conflict or used objective judgment to evaluate the loan.

Section 120.140 of the CFR states, in part, that a lender may not fail to disclose to SBA whether the loan will repay or refinance a debt due a lender, or engage in activity which taints the lender's objective judgment in evaluating the loan. The lender's loan officer stated he acted in the borrower's best interest by ensuring that the title to the business was clear and that it did not occur to him that the financing constituted a conflict of interest. As of December 31, 1997, the loan was current.

- A loan for [redacted] (sample number 25), processed under CLP procedures, was approved in [redacted] for the purpose of debt refinancing, purchase of assets,

working capital, and building improvements. The proceeds were required to be disbursed as follows:

\$	17,479	Property acquisition costs
		Refinance non-bank debt
		Refinance bank debt
		Refinance an automobile
		Purchase inventory
		Purchase a van
		Working capital
		Building improvements

Our review of the disbursement of loan proceeds showed that \$17,479 was used to refinance a loan for an automobile registered in the name of the borrower's spouse. The spouse was not shown as an owner of the business on the loan application. The borrower stated that the car was used in the business all the time and the lender's loan officer stated that she thought the car was used in the business. Neither could supply evidence to support their contentions.

Further, it was disclosed that the car was a personal asset since it was listed on the borrower's personal financial statement and could not be identified on the business financial statement. The use of this portion of the proceeds is not considered appropriate because Section 120.120 of the CFR states that an SBA business loan must be used for sound business purposes. As of December 31, 1997, the loan was current.

- A loan for [redacted] (sample number 14), processed under PLP procedures, was approved in [redacted] to finance [redacted] of working capital and \$12,000 for a portion of the equity injection required for a companion 504 loan made by another lender. Section 120.910 of the CFR prohibits the use of 7(a) loan proceeds to fund an SBA 504 Program loan equity injection.

The Chief, Finance Division, Atlanta District Office, stated that the documentation for the 504 Program loan did not disclose that a portion of the borrower's equity injection was to be obtained from 7(a) loan proceeds. Further, the SBA loan officer who approved the 7(a) loan stated that she was unaware of the intended use of the loan proceeds because the loan application was submitted under PLP processing procedures. The lender's loan officer stated that she was aware of the regulatory prohibition and that the use of the loan proceeds for equity injection for the 504 loan was an oversight.

Since neither loan had been disbursed, we issued an audit-related memorandum report on September 26, 1997 (Number 7-7-F-019-024), recommending that the Director, PLP Loan Processing Center, reduce the approved amount of the loan by \$12,000. As a result of our report, the entire loan was canceled.

Equity Injections were not Verified Prior to Disbursement

Guarantees for four current loans need to be adjusted due to unresolved risk caused by lender noncompliance. For these loans, lenders did not ensure that required equity injections were made. The Authorization and Loan Agreements (loan agreement) for the loans state, "Prior to first disbursement, Lender must be in receipt of satisfactory evidence (invoices, receipts, canceled checks, etc.) that Borrower and/or Guarantor(s) has/have made the requisite equity injection."

By not complying with the loan requirements, lenders increased the risk that borrowers may not remain committed to the business or that the business will have insufficient cash flow. Details of the four loans follow.

- A loan for [redacted] (sample number 5), processed under CLP procedures, was approved in [redacted] for the purchase of an existing business. The loan agreement called for the borrower to inject \$10,000 into the business prior to disbursement of the loan proceeds. At closing, the borrower stated he put \$5,000 in his business account and showed the lender a stock certificate worth \$5,000. The borrower subsequently stated that the \$5,000 placed in the business account was comprised of loan proceeds and funds received from the seller for vacation pay due employees.

When asked about the lack of an equity injection, the lender's loan officer stated that the fact that the borrower appeared to have the resources for the equity injection was sufficient. When capital injections are not made, however, the borrower may be less committed to the business with the SBA being put at greater financial risk. The loan was current as of December 31, 1997.

- A loan for [redacted] (sample number 11), processed under regular processing procedures, was approved in [redacted] for the purchase of a hardware store and working capital. The business purchase price of \$590,000 was based on an informal valuation of the business assets. The loan agreement called for an equity injection of \$100,000 consisting of \$50,000 credit for "foregone bonuses" due the buyer when he was an employee and \$50,000 in seller subordinated financing. The SBA financing would have provided the remainder of the sales price and [redacted] in working capital.

The "foregone bonuses" provided the appearance of equity in the business by the buyer. However, there was no liability in the seller's financial statements representing the "foregone bonuses" and no evidence that an actual payment had ever been made.

Based on a formal inventory of the business assets, the business was valued at \$445,410, with a resulting reduction of the business sales price to \$495,410. Thus the borrower purchased the business at a premium with no seller financing. The SBA guaranteed loan financed the entire purchase, allowed the buyer to forego the seller financing, and increased the working capital to [redacted]. The loan was current as of December 31, 1997.

- A loan for [redacted] (sample number 28), processed under regular procedures, was approved [redacted] to acquire a poultry farm. The loan agreement required an equity injection of \$65,000, of which \$60,000 was for the purchase of the business and \$5,000 for working capital. The equity injection was required to be from the personal funds of the buyer. The buyer indicated that retirement funds from his prior job would be sufficient to satisfy this requirement.

The borrower obtained a \$60,000 note from the seller in place of the required cash equity injection. The borrower did provide receipts supporting the expenditure of \$2,812 toward the required equity injection. When asked why the total required cash was not injected, the buyer stated that he could not obtain his retirement funds from his former employer. Therefore, the lender did not ensure that additional cash of \$62,188 (\$65,000 minus \$2,812) was injected into the business prior to loan closing. The loan was current as of December 31, 1997.

- A loan for [redacted] (sample number 22), processed under PLP procedures, was approved in [redacted] for purchase of an existing business. The loan agreement required an equity injection of \$107,000 comprised of a \$40,000 note to the seller and \$67,000 from personal funds. Documentation provided by the lender showed \$58,716 disbursed from the business accounts prior to loan closing. No support was provided that these funds had been injected from personal assets or that the remaining \$8,284 was injected into the business. The lender had no explanation why the documentation for the remaining equity injection was not available. The loan was current as of December 31, 1997.

Business Financial Information was not Verified with IRS Prior to Disbursement

On seven loans lenders did not verify business financial information with the IRS prior to disbursement. The guarantee for one loan may need to be adjusted due to unresolved risk resulting from the lender not performing IRS verification of information provided by the borrower. SBA Policy Notice 9000-941 requires lenders to obtain IRS verification of financial information of the small business concern or for a business being purchased prior to loan disbursement. The required verifications for the other six loans were made after disbursement or at our request.

For one loan (sample number 28, mentioned above), the lender did not attempt to obtain IRS verification of the seller's financial information. The lender's loan officer stated that he did not normally verify the returns of selling individuals. As the borrower's projected repayment ability was based on the seller's historical financial data, verification of this data was necessary to minimize the risk of this loan.

Lenders did not verify business financial information with the IRS prior to six other loans being disbursed (sample numbers 3, 5, 11, 17, 21, and 29). We determined that the verifications were made either after the loans were disbursed or at our request. As of December 31, 1997, five loans were current and one was paid in full.

Ex. 4

Business and Personal Credit Reports were not Obtained

Lenders did not obtain either personal or business credit reports for four loans (*sample numbers 1, 27, 28, and 30*). SBA requires that lenders evaluate a borrower's credit history as a part of the creditworthiness determination. In addition, Office of Management and Budget Circular A-129 requires that credit histories of applicants be verified through credit reports. Although our subsequent review of the borrower's credit reports disclosed no significant problems, the risk of approving a loan for an applicant who was not creditworthy was increased by the lender's noncompliance. As of December 31, 1997, three loans were current and one was not disbursed.

Appropriate Size Determination was not Made

For one loan (*sample number 7*) the lender did not evaluate a borrower's affiliates when making a size determination. There was no evidence in the file that the affiliates were considered when the borrower's size was determined. Section 121.302 of the CFR requires that a size determination including affiliates of the borrower be made as of the loan application date. Our analysis showed that the borrower and its affiliates met size standards. As of December 31, 1997, the loan was current.

Required Joint Payee Checks were not Made

For one loan (*sample number 16*) the lender did not use joint payee checks to disburse \$10,000 of loan proceeds designated as other than working capital. SOP 70 50 2, paragraph 3.F(1), and the Settlement Sheet (SBA Form 1050) require that the lender use joint payee checks to disburse loan proceeds not designated as working capital. A review of the use of loan proceeds disclosed no problem. As of December 31, 1997, the loan was current.

Relationship of Loan Deficiencies to SBA Oversight

The majority of loans with deficiencies were originated when SBA had limited or no oversight of the lender's loan processing and disbursing. For certain loan processing and disbursing actions, an SBA district office would normally be unaware of how and when the action was done because no documentation of the action was required to be submitted to SBA. These actions include, but are not limited to, equity injections, IRS verifications, and use of loan proceeds. In addition, district offices would be unaware of conflict of interest situations if lenders did not voluntarily request approval. District offices also are unaware of almost all actions for loans processed under PLP procedures.

Of the 20 deficiencies identified, 16 were processing or disbursing actions not normally reviewed by or reported to SBA under existing procedures. As a result, the deficiencies generally would not be identified by SBA under existing procedures, until after the loan defaulted and the lender requested the guarantee be honored. The remaining four deficiencies should have been identified during the SBA loan officer's review.

Reasons for lender deficiencies

Because lenders were responsible for most of the deficiencies identified, we asked them why the deficiencies occurred. The following reasons were provided:

Loan officer disagreed there was a deficiency	5 deficiencies
Loan officer intentional error	4 deficiencies
Loan officer unintentional error	4 deficiencies
Loan officer lack of knowledge	3 deficiencies

This issue will be further considered in a summary report because actions to minimize SBA's risk must be implemented agency-wide.

Recommendations

We recommend the Atlanta District Office Director take appropriate action to protect SBA's interests by:

- 1A. Reducing the guarantee percentage for sample number 25 to reflect the borrower's ineligible use of \$17,479.
- 1B. Obtaining a verification of the equity injection for sample numbers 5 and 11 from the lender or reducing the guarantee percentage to reflect the lack of injections of \$10,000 and \$100,000, respectively.
- 1C. Obtaining a guarantee release or an indemnification agreement from the lender due to the lender's failure to verify the equity injection and to obtain IRS verification of the seller's financial data for sample number 28.
- 1D. Re-emphasizing to lenders their responsibility for verifications of equity injections and IRS financial data.

We recommend that the Director, PLP Loan Processing Center take appropriate action to protect SBA's interests by:

- 1E. Obtaining a guarantee release from the lender for sample number 29, or if the lender fails to release SBA from the guarantee, recommend its revocation to the Administrator.
- 1F. Obtaining a verification of the equity injection from the lender or reducing the guarantee percentage to reflect the lack of injection of \$67,000 for sample number 22.

Atlanta District Director's Response

The District Director did not agree to reduce the guarantee percentages for sample numbers 5, 11, or 25 or obtain a guarantee release for number 28 because these loans were not considered at risk for the following reasons:

- For sample # 5 there were mitigating circumstances that are already reflected in the guarantee reduction of 75 to 50 percent. The reduction of the guarantee increased the risk to the applicant, the seller, and the lender. The opening of the business account with \$5,000 should be recognized as an equity injection regardless of the source. A further reduction of the guarantee percentage would not serve a meaningful purpose.
- For sample #11 the SBA guaranteed loan did not finance the entire purchase of the business. It financed \$445,410 of the purchase accompanied by the buyer /seller input of \$100,000. The [] was added to working capital based on the reduced inventory, and provided the applicant sufficient funds to purchase replacement inventory necessary for the attainment of the projected sales level. The net effect of the various changes was a reduction of the purchase price which preserved the business. Reduction of the guarantee percentage would not be deemed to be meaningful under the circumstances.
- For sample # 25 the loan proceeds were used to refinance a Jeep. However, it was not determinable that the refinanced vehicle was a personal asset, and the personal vehicle aspect has not been sufficiently analyzed to make an eligibility determination. Further study is needed.
- For sample # 28 the applicant and lender were not in compliance with the loan authorization. The applicant was given credit at closing for \$25,000 in earnest money and paid \$3,938.64. Therefore, the difference of \$36,061.36 is at issue, but should be allowed to be offset by the \$60,000 note due to the seller. This note reduced the risk to the Agency. The note has since been paid in full.

The District Director also did not agree to re-emphasize to lenders their responsibility for verification of equity injections and IRS financial data because, if the loans were to default, these issues would be addressed in the pre-purchase review process.

Evaluation of the Atlanta District Director's Response

As stated in the audit report, the lenders did not provide appropriate oversight to ensure compliance with the loan authorization as required by the Loan Guarantee Agreements, thereby increasing SBA's risk and decreasing the risk to the lender and borrower. We continue to support our recommendations based on the following:

- Sample # 5 - The borrower did not inject \$10,000 into the business from personal resources as was required in the loan authorization. As stated in the report, the \$5,000 the borrower put into the business was composed of SBA loan proceeds and the seller's payment of vacation pay due employees. These are business assets that do not meet the definition of personal resources of the borrower and do not satisfy the intent of the equity injection requirement. The mitigating factors cited by the District Director, the strong cash flow of the business, the borrower's good credit, and the decrease in the guarantee amount from 75 to 50 percent, were known at the time the

loan was originated, and still it was deemed prudent to require the equity injection. Therefore, these factors can not be used to offset the lack of the required injection.

- Sample # 11 - The loan authorization required a \$100,000 equity injection in the form of \$50,000 in forgone bonuses and subordinated seller debt of \$50,000. Neither the borrower nor the seller, however, could substantiate that any forgone bonuses existed and the seller financing was never made. Therefore there was no buyer/seller input of \$100,000 as the District Director asserts. As stated in the report, SBA made a 100 percent financing and the contractual agreement for equity injection was not met.
- Sample # 25 - There was sufficient evidence in the lender's file (which SBA did not review) to indicate that the jeep was not an asset of the business and therefore, refinancing of this debt was not an eligible use of SBA loan proceeds. The vehicle was in the name of [redacted] who was not listed as an owner of the business. Both the jeep and the related \$17,000 debt were listed in the borrower's personal financial statement, and the jeep was the only vehicle the borrower listed in those statements. Although the district director indicated that further study was needed, she did not indicate that further review would be done. ✓
- Sample # 28 - The borrower should not be given credit for an equity injection of \$28,938.64. The \$25,000 used by the borrower for the escrow payment was obtained from the lender as an interim loan and was repaid with SBA loan proceeds. As these were not personal funds, the transaction did not meet the definition or spirit of the equity injection requirement. The remaining \$3,938 was received by the borrower at closing, not paid by the borrower, and therefore, should not be considered an equity injection. The \$60,000 note due to the seller should not be used to offset the equity injection requirement. While this debt does allow SBA to maintain the same level of risk, and increases the risk to the seller, it reduces the risk to the borrower and does not commit the borrower to the project. The District Director does not state whether the seller's debt was repaid from personal funds or business proceeds.

There is no assurance that SBA would have identified these noncompliances during the pre-purchase review process. The totality of the deficiencies identified indicates the need for action to be taken to enforce lender compliance now. Seven of the 30 loans (23 percent of the sample) had a noncompliance with the IRS verification requirement. Four of the 30 loans (15 percent) had a noncompliance with the equity injection requirement. These noncompliance levels indicate the need for re-emphasizing the IRS verification and equity injection criteria to lenders.

PLP Center Director's Response

The PLP Center Director, while not disagreeing with the facts and conclusions presented, stated that the recommendations do not conform to current or past SBA policy. The policy consists of SBA asking lenders to correct deficiencies noted, and if the deficiencies cannot be corrected, the lenders are advised in writing that the deficiencies may affect SBA's decision regarding purchases of the guarantee if a request for purchase is initiated. The Center Director stated that there is no procedure to recommend denial of a guarantee on a current loan for which

there is no guarantee request pending, and that unless the Acting Assistant Administrator for Financial Assistance (AA/FA) changes the current policy, the PLP Center cannot consider complying with the recommendations.

Evaluation of the PLP Center Director's Response

We have researched the Code of Federal Regulations, SBA's Standard Operating Procedures, and various policy and procedural notices, but have not been able to identify the policy discussed by the PLP Center Director.

Because this may be informal SBA policy, we will postpone audit evaluation of management comments until audit follow-up on the Low Documentation Loan Program audit is completed. As a result of the LowDoc audit, the Acting AA/FA and the OIG are currently identifying deficiencies that are so material or serious that denial or repair of the guarantee prior to a request to purchase is warranted. This will provide the basis for a policy stating the circumstances when SBA will notify a lender, prior to loan default or a purchase request, that SBA will not honor or will request a repair of the guarantee.

FINDING 2 Loans were not Always Disbursed within Required Time Limits

Two loans, with guarantees totaling \$1,486,660, were not disbursed within the time limits specified in the loan authorization agreement. Neither the lenders nor the district office identified the expired loans and, therefore, action was not taken to cancel the guarantees. As a result, guarantees could have been provided based on information that is outdated.

Each loan applicant provides financial and background data to indicate their creditworthiness and repayment ability. Lenders supplement this information with credit reports and tax information from the IRS to further verify creditworthiness and repayment ability. Because this information is a basis for loan approval, it should be accurate and timely. Per SOP 50 10 3, personal financial information should be provided within 90 days of the application date. Also, an interim business financial statement for the current period should be prepared when the year-end business financial statement is not within 90 days of the application date.

Once the loan application is approved, SBA, the lender, and the borrower execute an Authorization and Loan Agreement (loan agreement) containing the conditions and requirements for the loan. Among the conditions and requirements are time limits for the first and final disbursements of loan proceeds. These time limits cannot be exceeded without the prior approval of SBA.

Of the 30 loans reviewed, we identified 2 where the proceeds had not been disbursed and the time periods for disbursement specified in the loan agreements had elapsed. Details are as follows.

- A loan (sample number 19), with a 54 percent guarantee, was approved for construction of a hotel. The loan agreement required the first disbursement to be made not later than 9 months from the approval date and no disbursement to be made later than 12 months from the approval date, unless such

time is extended based on prior written consent from SBA. As of 18 months after the approval date, no disbursement had been made. The lender's loan officer stated that he did not ask for an extension because he believed the loan would never be disbursed and that SBA would automatically cancel the loan after the expiration date.

- A loan for (sample number 30), with a 70 percent guarantee, was approved for acquisition of land and related improvements. The loan agreement required the first disbursement to be made not later than 6 months from the approval date and no disbursement to be made later than 9 months from the approval date, unless such time is extended based on prior written consent from SBA. The borrower requested the lender to cancel the loan application. As of December 31, 1997, SBA had not been notified of the cancellation and the guarantee authority was still obligated for this loan.

By not identifying and canceling these loans, SBA risked disbursement of loan proceeds based on outdated credit and financial information. For sample numbers 19 and 30, the credit and financial information was at least 20 and 18 months old, respectively, as of December 31, 1997. Significant changes could have occurred to both the creditworthiness and repayment ability of the borrowers during these periods. In addition, guarantee authority that could have been applied to other loans remained obligated unnecessarily.

Recommendations

We recommend the District Director, Atlanta District Office, take the following actions:

- 2A. Cancel the guarantees for each of these loans (sample numbers 19 and 30).
- 2B. Inform all lenders of the need to either request an extension of the disbursement period or to request cancellation of the loan whenever the disbursement time limit is exceeded.

Atlanta District Director's Response

The District Director agreed with the finding and recommendation. She stated that the lenders have submitted requests for loan cancellations and that all lenders would be notified of their responsibility to let SBA know in a timely manner when loan commitments are no longer valid.

Evaluation of the Atlanta District Director's Response

The district office response is acceptable.

Other Matters

Lender Misrepresentation

We identified one instance where a lender misrepresented facts concerning processing a

loan. This information is presented for action, as appropriate, by the Atlanta District Director.

A loan for [] (sample number 21) was approved in [] [] The lender was required to obtain an IRS verification of the borrower's 1995 tax return. A vice president of the lender signed a statement for the closing agent stating that the verification was obtained and that the verification conformed with the tax return submitted by the borrower. The loan closed [] [] When asked by the auditor, the vice president admitted that the verification had not been obtained prior to the loan closing.

Borrower Misrepresentation

The auditors requested criminal history reviews for the principals of each loan in the audit sample. The results of one of the criminal history checks showed that a borrower misrepresented his criminal history. The borrower's criminal history contained offenses serious enough to preclude financial assistance from SBA. This loan was forwarded to our investigative division for review and possible criminal prosecution.

A loan for [] (sample number 6) was made in [] [] for the construction of a convenience store. The borrower stated on SBA Form 912 that he had never been arrested. A criminal history check, however, showed that the borrower had five arrests and had been convicted of felonies. The lender had disbursed most of the proceeds by the time it was informed of the results of the criminal history check.

Ex. 4

Schedule of Loans Reviewed and Their Status as of December 31, 1997

SAMPLE NUMBER	LOAN NUMBER	BORROWER	LOAN AMOUNT	LOAN STATUS	TYPE
1				Current	PLP
2				Current	PLP
3				Current	PLP
4				Canceled	REG
5				Current	CLP
6				Current	PLP
7				Current	CLP
8				-----	---
9				Past Due	PLP
10				Canceled	PLP
11				Current	REG
12				Not Disbursed	PLP
13				Current	PLP
14				Canceled	PLP
15				Canceled	PLP
16				Current	PLP
17				Current	CLP
18				Current	CLP
19				Current	CLP
20				Not Disbursed	REG
21				Current	PLP
22				Paid-in-Full	CLP
23				Current	PLP
24				Current	PLP
25				Current	REG
26				Current	CLP
27				Current	CLP
28				Current	CLP
29				Current	REG
30				Current	PLP
31				Canceled	CLP
				Current	PLP



U. S. SMALL BUSINESS ADMINISTRATION
Peachtree-25th Complex
1720 Peachtree Road, N.W., 6th Floor
Atlanta, Georgia 30309

Date: March 30, 1998
To: Peter L. McClintock, Assistant Inspector General for Auditing
Thru: Laura A. Brown, District Director *L.A.B.*
From: Eugene Merriday, ADD/ED *EM*
Subject: IG Audit of \square

1.A. We do not concur with recommendation to reduce the guarantee percentage of Sample #'s 5 & 11. The reasons for each is spelled out as follows:

Sample #5:

Subject loan was submitted by \square \square whose specialty is financing Veterinary Medicine Practices. The issue of equity injection was posed by the loan officer upon the original submission. Historical cash flow of the practice was considered to be a strong contribution to repayment ability. The credit report of the purchaser was also deemed strong as to the character of the applicants to include prompt government student loan payments. The seller expressed strong confidence in the applicants by absorbing some of the purchase price. The applicant has a significant investment in the practice of Veterinary Medicine.

Opening of the business account with \$5,000 should be recognized as an equity contribution, regardless to source. The showing of a \$5,000 stock certificate would not constitute an equity injection for the purpose of compliance with the authorization paragraph 4.f.(12). However, the purpose of the additional \$5,000 was to fund working capital as distinguished from purchase of a capital asset. These funds should also have been immediately deposited on/before closing. The mitigating circumstances are already reflected in the reduced guarantee from 75% to 50%. This increased the risk to the applicant (Medical career at stake), the seller (subordinated debt), and the lender doubled their risk from \square .

\square Further reduction of the guarantee percentage would not serve a meaningful purpose at this juncture.

Sample 11:

Subject loan appears to have been disbursed in accordance with the authorization paragraph 4.f.(14). The stamp action dated \square \square approved the working capital

EX 4



U. S. SMALL BUSINESS ADMINISTRATION

Peachtree-25th Complex
1720 Peachtree Road, N.W., 6th Floor
Atlanta, Georgia 30309

increase by the lender from \$24,000 to \$69,400. Additionally, the seller reduced the price of the inventory by \$44,590 due to an actual count at closing. This change provided the applicant sufficient funds to purchase replacement inventory necessary for the attainment of the projected sales level. Paragraphs 4.f.(14)(b) & (c) of the authorization were documented by the seller note receivable from the purchaser for \$50,000, and the buyer acknowledgment of receipt of \$50,000 of foregone earnings and bonuses. The purchase price of the business was established by a willing buyer and seller at arms length for \$590,000. The SBA guaranteed loan did not finance the entire purchase of the business but \$445,410 of the purchase accompanied by the buyer/seller input of \$100,000 and [] added to working capital based on the reduced inventory. The net effect was reduction of the purchase price which benefited the applicant, reduced the potential exposure of the agency, and preserved a 75 year old business in []

1. Reduction of the guarantee percentage would not be deemed to be meaningful under the circumstances.

- 1.B. We do not concur with recommendation to reduce the guarantee percentage of Sample # 25 The reasons are spelled out as follows:

This trial CLP loan was submitted as a co-borrower application for []
1. The loan file does not indicate that the debt refinancing spelled out in the authorization paragraph 3.b.(8) was for a personal auto. Documentation of personal/business use was not provided by the applicant/lender. It appears that the refinancing was for a jeep, as disclosed on the Form 4, debt section. However, it should be noted that they also had personal ownership of a 1992 Ford. The corporate tax return for 1994 showed 2 additional vehicles owned which were 100% depreciated. This shows availability of 4 vehicles for purposes of business/personal for a minimum of 2 people. It was not determinable that the refinanced vehicle was personal. Additionally, the corporate balance sheet indicates that \$39,204 was owed to the principles and the \$17,000 debt may have been a part of the amount due for financing the vehicle personally but used for business. The personal vehicle aspect has not been sufficiently analyzed to make an eligibility determination. The vehicle would have to have been a luxury type vehicle to support an eligibility determination. It is not felt that the \$17,479 refinancing has been determined to be personal, at this time, without further study.

- 1.C. We do not concur with the recommendation to reduce the guarantee percentage of Sample # 28 The reasons are spelled out as follows:

EX. 4



U. S. SMALL BUSINESS ADMINISTRATION
Peachtree-25th Complex
1720 Peachtree Road, N.W., 6th Floor
Atlanta, Georgia 30309

Lender and applicant did not appear to be in compliance with paragraph 4.f.(10) of the authorization to the extent of \$62,188. It has been determined that at closing, the applicant received credit for \$25,000 in deposit or earnest money, and \$60,000 for the note due to the seller. The applicant additionally paid \$3,938.64 at closing. This would give him credit of \$28,938.64 towards the \$65,000 equity requirement. The difference of \$36,061.36 vs. \$62,188 is at issue but should be allowed to be offset by the \$60,000 note due to the seller which served to reduce the risk to the agency. The \$60,000 note has since been paid in full and further reduces the agency's risk.

- 1.D. We do concur with the recommendation to re-emphasize to lenders their responsibility for verification of equity injections and IRS financial data. However, equity injections and IRS financial data verification are issues which become a part of the Pre-Purchase Review process in the event of default on a loan. The lender referenced in 1.C. above, as a result of the audit is now very keenly aware of the need for verification of equity injection and IRS financial data. So much so, that the bank policy is not close a loan without verification of IRS financial data from the seller. This was a very positive result of the audit. However, given the one instance of IRS financial data non compliance, it is felt that compliance is generally being accomplished by SBA lender participants.

The IG staff is to be applauded for their comprehensive review and analysis of the referenced loan files. However, sample #'s 5, 11, 25, and 28 are not deemed to be at risk to the Agency.



U. S. SMALL BUSINESS ADMINISTRATION
Peachtree-25th Complex
1720 Peachtree Road, N.W., 6th Floor
Atlanta, Georgia 30309

Date: April 10, 1998

To: Peter L. McClintock, Assistant Inspector General for Auditing

Thru: Laura A. Brown, District Director *L.A.B.*

From: Eugene Merriday, ADD/ED *E.M.*

Subject: FINDING 2 Loans Not Disbursed Within Required Time Limits-Samples 19 & 30

2.A. Sample 19 has been researched and the findings determined to be correct. The loan was not disbursed timely in accordance with the authorization. We initiated communication with the lender and determined that it was an oversight on their part as a result of poor communication with the applicant. The lender has submitted a request dated 4/8/98 to cancel the loan and it has since been canceled.

2.B. Sample 30 has also been researched and the findings determined to be correct. This loan was also not disbursed timely in accordance with the authorization. We initiated communication with the lender and determined that it was also an oversight on their part. The lender has submitted a request dated 4/10/98 to cancel the loan. We will move forward to cancel the loan in its entirety upon receipt thereof.

*It should be noted that after approval of a loan, the authorization is issued to the lender along with closing instructions. The burden then rests with the lender to make the 1st and final disbursements in accordance with the authorization. Technically, the conditional commitment to guarantee by SBA expires when final disbursement is not made. The purpose of the 1st and final disbursement in the authorization is to eliminate outstanding guarantees which are not fulfilled/do not have to be honored unless the agency approves an extension..



U.S. Small Business Administration
Sacramento Loan Processing Center
660 J Street, Suite 233
Sacramento, CA 95814-2413
(916) 498-6446 Fax (916) 498-6434

Date: April 15, 1998

From: Richard Taylor, Center Director *Richard Taylor*

RE: IG Audit Report re Atlanta Loans

To: Peter L. McClintock, Assistant Inspector General

Attached you will find a memorandum written by [redacted], the Center's Counsel. [redacted] memorandum, [redacted] explains why your recommended actions are inconsistent with our policy. I agree with [redacted]. Unless the Acting Assistant Administrator for Financial Assistance makes that a policy decision that SBA staff should deny liability prior to receiving a request to pay on the guarantee, we cannot consider doing your recommendations.

Ex. 536



U.S. Small Business Administration
Sacramento Loan Processing Center
660 J Street, Suite 233
Sacramento, CA 95814-2413
Phone (916) 498-6433 Fax (916) 498-6434

Appendix B
Page 6 of 6

DATE: April 15, 1998

FROM: [Handwritten marks]

RE: IG Audit Report re Atlanta Loans

TO: Richard Taylor
Center Director

You asked me to review the above draft report, dated February 24, 1998, as to the recommendations it made for action by the Center. IG reviewed processing and disbursement of a sample of loans and recommended as to two PLP loans, that we reduce the guarantee percentage on one loan and attempt to obtain a guarantee release on the other loan because of processing and closing deficiencies.

The draft report notes on page 2 regarding "Follow-Up on Prior Audits" that this issue was raised following the last IG report on July 7, 1997, in which it made similar recommendations. The District Director in that case also stated that denial of an SBA guarantee is appropriate only after SBA is requested to honor it. The report states:

The issue of the timing of a guarantee withdrawal has been referred to the Acting Associate Administrator for Financial Assistance. Her decision on an SBA policy is pending.

EX. 5 & 6

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