

AUDIT OF
NORTH CAROLINA DISTRICT OFFICE 7(a) LOANS
CHARLOTTE, NORTH CAROLINA
AUDIT REPORT NO. 9-04
February 10, 1999

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US SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
ISSUE DATE: FEBRUARY 10, 1999
NUMBER: 9-04

To: Bynum G. Rudisill, Acting District Director
North Carolina District Office

Peter L. McClintock

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

Subject: Audit of North Carolina District Office 7(a) Loans

Attached is a copy of the subject audit report. The report contains two findings with six recommendations for the North Carolina District Office.

The recommendations in the 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
NORTH CAROLINA DISTRICT OFFICE
CHARLOTTE, NORTH CAROLINA**

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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 North Carolina District Office was assigned 343 loans valued at \$111.2 million from March 1, 1996, to June 30, 1997. We selected a random sample of 30 loans valued at \$6.6 million for review. The District Office and the Preferred Lender Program Loan Processing Center processed the sample loans made to small business concerns within the State of North Carolina.

SBA procedures for lenders and SBA loan officers are intended to reduce risks 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. We determined that lenders did not follow at least 1 of the 22 SBA procedures for 14 of the 30 loans reviewed.

The noncompliance with procedures consisted of the following:

- A loan for ~~an~~ ~~an~~ was approved for an ineligible applicant and an ineligible purpose.
- Internal Revenue Service tax verifications were not obtained prior to disbursing two loans valued at \$80,700.
- Uses of loan proceeds were not verified for seven loans totaling \$1.6 million.
- Equity injections of \$150,000 were not verified for two loans totaling \$289,000.
- A Statement of Personal History (SBA Form 912) was not obtained from some required parties for two loans totaling \$876,000.
- Settlement Sheets (SBA Form 1050) for disbursements totaling \$144,872 were not available for two loans valued at \$169,000.
- Professional fees totaling \$4,375 were not itemized and attached to the Compensation Agreement (SBA Form 159) for two loans valued at \$437,500.

In addition, a lender did not notify SBA that a ~~an~~ ~~an~~ loan had been canceled 17 months prior to our review.

The report contains recommendations to the Acting District Director to not honor requests for purchase in the event of loan defaults, when appropriate, and to take corrective actions to prevent recurrence of the problems found. The Acting District Director agreed with our recommendations.

As of October 31, 1998, 22 of the 30 loans were current, 7 were canceled and 1 was in liquidation. Lenders stated that the deficiencies were generally due to loan officers' lack of knowledge of SBA requirements and unintentional loan officer errors.

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 defaulted loans.

Generally, SBA regulations and procedures require both the lender and SBA to review the borrower's eligibility, repayment ability, management qualifications, character, creditworthiness, 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). Under CLP procedures, SBA utilizes the credit presentation of the lender and makes a credit and eligibility determination. Under PLP procedures, the PLP Loan Processing Center reviews loan applications solely for eligibility.

B. AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine whether 7(a) loans (excluding special programs with modified requirements such as LowDoc) were processed and proceeds disbursed and used in accordance with SBA requirements. The audit was based on a statistical sample of 30 loans (see Appendix A) valued at \$6.6 million out of a population of 343 loans totaling \$111.2 million. These loans were made to small businesses in the State of North Carolina and assigned to the North Carolina District Office between March 1, 1996, and June 30, 1997.

The auditors reviewed compliance with 22 procedures established by SBA to reduce risks associated with loan making and to assure that only eligible loans are guaranteed (see Appendix B). To make these determinations, 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. Fieldwork was performed from July through November 1998. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

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

SBA procedures for lenders and SBA loan officers are intended to reduce risks and assure that only eligible loans are approved. The chance that ineligible or risky 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 14 of the 30 loans reviewed. Noncompliance with established procedures resulted in SBA inappropriately providing guarantees for three loans (sample numbers 2, 8, and 31) totaling \$196,026. No action is required to protect the guarantees for the remaining 12 loans because deficiencies were corrected as a result of our audit.

An ineligible applicant received an SBA loan for an ineligible purpose

In April 1996, SBA approved a ~~2~~ * 3 loan (sample number 8) to a corporation for repayment of two outstanding LowDoc loans. The applicant was ineligible because he was not a legal resident and the purpose of the loan was ineligible.

Applicant's eligibility was not established

The applicant was foreign born, entered the US in 1990 as a visitor, and subsequently filed for political asylum. Neither the lender nor the district had evidence that the applicant had obtained resident alien or other status allowing legal residency in this country and eligibility for 7(a) assistance. During the audit, district personnel were told by the Immigration and Naturalization Service that the applicant's application for political asylum was still pending.

At the time this loan was processed, it was subject to the requirements of both draft SOP 50 10 4 and SOP 50 10 3. SOP 50 10 4 prohibits providing business loan assistance to individuals not lawfully in the US and requires verification of resident alien status. SOP 50 10 3 also required resident alien status, but as an alternative, allowed SBA to consider whether capable and consistent management would be assured or the loan collateral would be sufficient to repay the loan balance upon liquidation. Without resident alien status, the applicant's management could not be considered "consistent" because his right to be in this country could be revoked. Also, the lender's credit analysis indicated that the collateral was insufficient to assure repayment of the loan in the event of liquidation.

Debt refinancing criteria was not met

The proceeds of the loan were not used for a purpose authorized by SBA. To refinance debt, SBA's Refinancing of Debt Policy Notice, dated March 22, 1996, requires that the existing loan terms must be unreasonable and that substantial benefit to the small business will result. The policy defines substantial benefits as a significant improvement to the company's cash flow; i.e., at least 20 percent less than the scheduled payment of the existing debt. The two LowDoc loans refinanced by the debt required annual principal and interest payments of \$25,911. The new debt, however, required principal and interest payments of \$27,692, a 6.9 percent increase.

SBA should have been aware of both deficiencies since the loan was processed under CLP procedures. As of October 31, 1998, the loan was in liquidation status.

Financial information was not verified prior to disbursement

For two loans, lenders did not verify borrowers' financial information prior to disbursements as required by the loan agreements. SBA Policy Notice 9000-941 requires lenders to obtain Internal Revenue Service (IRS) verification of the financial information of the small business concern prior to disbursing the loan. This requirement ensures the financial information, submitted by small businesses and used by lenders and SBA to make loan decisions, is credible.

SBA approved a * loan (*sample number 31*) for the purchase of business equipment in * . There was no evidence in the lender's file that the IRS verification had been requested nor could the lender explain why the IRS verification was not requested. At our request, the lender applied for the IRS verification, but as of January 20, 1999, it had not been received.

Another loan (*sample number 17*) for * was approved on * . The loan proceeds were disbursed before the tax verification was received. There was, however, no difference between the financial information submitted by the borrower and the IRS verification.

The use of loan proceeds was not verified

Lenders for seven loans (*sample numbers 2, 12, 13, 14, 28, 29, and 32*) did not verify the use of proceeds, as required. Loan files did not contain copies of joint payee checks or paid invoices supporting the borrowers' use of the proceeds. For six of the seven loans, we obtained sufficient evidence from borrowers and vendors to show that the proceeds were used as authorized.

Lender documentation for sample number 2 did not support the use of loan proceeds totaling \$104,326. On * , SBA approved a * loan for the acquisition of equipment, inventory, and working capital. Documentation provided by the lender did not contain support for the use of the loan proceeds, and showed that almost 30 percent of the proceeds may have been used for unauthorized purposes. A comparison of the authorized and actual use follows:

Approved/Actual use of Loan Proceeds	Authorized	Actual	Difference
Equipment	\$ 60,000	\$ 20,731	\$ (39,269)
Inventory	275,000	227,443	(47,557)
Working Capital	17,500	-0-	(17,500)
Repayment of Interim Loan to Lender	-0-	104,326	104,326

The lender did not have documentation explaining how the \$104,326 was used.

SBA Form 1050 (settlement Sheet) requires the lender to certify that the loan proceeds are disbursed and used in accordance with the loan authorization. Verification of the use of loan proceeds prevents a borrower from using loan proceeds for unauthorized purposes.

As of October 31, 1998, all the loans were current.

Personal history statements were not always obtained

For two loans (*sample numbers 14 and 23*) valued at \$876,000, lenders did not obtain all required Statements of Personal History (SBA Form 912). SBA SOP 50 10 (4) requires a statement of personal history from each principal, officer, director, key employee, and guarantor associated with a loan application to confirm the applicant's honesty and responsibility. At our request, the missing statements were subsequently obtained for two of the loans. For the third, a statement was not requested because the loan had been cancelled. Background checks made for the parties involved did not disclose any problems. As of October 31, 1998, two loans were current and one had been cancelled.

Equity injections were not verified prior to loan disbursement

Lenders did not ensure that required equity injections of \$150,000 for two loans totaling * (*sample numbers 25 and 30*) were made prior to the first loan proceeds disbursement as required by the loan agreement. We determined, however, that the required cash injections were made after initial or final loan disbursements. By not ensuring that equity injections were made in full prior to loan disbursement, the risk that borrowers will not remain committed to the business increases and the business will not have sufficient cash flow to sustain operations. As of October 31, 1998, both loans were current.

Settlement sheets were not in the files

Lenders for two loans totaling \$169,000 were missing some Settlement Sheets (SBA Form 1050). For one loan of * (*sample number 30*), the lender did not have settlement sheets for loan proceeds totaling \$12,900. For a * (*sample number 32*), the lender had only one settlement sheet for \$7,028. The loan agreements required the lenders to prepare and execute

settlement sheets certifying that all disbursements were used in accordance with the loan agreements and that there were no substantial adverse change or encumbrances against the business assets except those disclosed in the loan application. At our request, the lender furnished documentation that showed no adverse effect as a result of not having the settlement sheets. As October 31, 1998, both loans were current.

Fees were not itemized

Fees charged to borrowers for professional services in excess of \$1,000 were not itemized to show date and type of service rendered. The compensation agreements (SBA Form 159) for two loans (sample numbers 12 and 28) disclosed that borrowers were charged loan processing and legal fees totaling \$1,875 and \$2,500, respectively. Neither fee was itemized to provide details of how the amount was developed. Without such itemization, SBA can not determine if the fees were reasonable and allowable.

According to the authorization and loan agreement, if the fee charged to the borrower exceeds \$1,000, the lender should provide an itemized schedule showing daily services, location, time spent, and a description of services rendered. As of October 31, 1998, both loans were current.

Relationship of loan deficiencies to SBA oversight

Fifteen of the 20 deficiencies we identified occurred during processing and disbursing actions that were not reviewed by SBA. Under the CLP and PLP programs, certain loan origination and disbursement actions taken by the lenders are not subject to review by SBA. These actions include, but are not limited to, equity injections, IRS verifications, and use of loan proceeds. Generally, adverse conditions under these actions would not be detected by SBA until a request for a guarantee purchase is received, at which time SBA reviews lender submitted documentation to ensure compliance with SBA regulations.

Reasons for lender deficiencies

Lenders provided the following reasons for the deficiencies:

Loan officers made unintentional errors	8 deficiencies
Loan officers lacked knowledge of SBA policy	4 deficiencies
Loan officer disagreed with deficiency	1 deficiencies
Loan officer could not provide reason	2 deficiencies

These issues will be further addressed in a summary audit report on the 7 (a) Loan Program because actions to minimize SBA's risk must be implemented Agency-wide.

Recommendations

We recommend that the Acting District Director, North Carolina District Office, take the following actions:

- 1.A. Notify the lender for sample number 31 that unless the IRS verification is obtained and the data agrees with the financial information submitted by the borrower, SBA may not honor the request for purchase in the event of a loan default.
- 1.B. Notify the lender that unless sufficient evidence is provided that the loan proceeds for sample number 2 were used in accordance with the loan agreement, SBA may not honor the request for purchase in the event of loan default.
- 1.C. Re-emphasize to lenders their responsibility to comply with SBA loan requirements, including ensuring
 - loans are for eligible purposes,
 - loan proceeds are used for authorized purposes,
 - required equity injections are made and properly documented,
 - financial data are verified with the IRS prior to disbursement of loan proceeds,
 - borrowers are creditworthy and eligible for loans, and
 - personal histories are obtained on key employees and guarantors.
- 1.D. Require the lenders for sample numbers 12 and 28 to obtain itemization of the fees charged. District personnel should review the itemization to ensure that charges are reasonable and allowable.

Management Response

The Acting District Director agreed with our recommendations and stated that notifications will be sent to lenders addressing procedures for IRS verification and disbursement of loan proceeds. He stated that areas found deficient by the audit will be given renewed emphasis in training sessions and other communications with both SBA personnel and lenders. He agreed to ask the lenders for samples 12 and 128 to submit properly completed and itemized SBA Forms 159.

Evaluation of Management Response

Based on the Acting District Director's response to our draft report, we removed one deficiency concerning SBA Form 912 for sample number 27. The Acting District Director's remaining comments are responsive to our recommendations.

FINDING 2 A Canceled Loan was not Reported to SBA

A ~~19~~ * ~~19~~ loan (*sample number 19*) was canceled by the lender but SBA was not notified. The loan was approved in ~~1997~~ * ~~1997~~ for repayment of existing debts and working capital. The loan was cancelled in May 1997 at the borrower's request. As of October 1998, SBA had not been notified of the cancellation. According to the lender's representative, responsibility for informing SBA of the cancellation was lost as a result of a bank merger. The lender's failure to report the cancellation resulted in SBA's guarantee authority remaining obligated unnecessarily.

Recommendations

We recommend that the Acting District Director, North Carolina District Office, take the following action:

- 2.A. Require the lender to submit a cancellation request for loan sample number 19.
- 2.B. Re-emphasize to lenders their responsibility to comply with the requirement to notify SBA promptly whenever a change in the loan status warrants withholding or not making a disbursement.

Management Response

The Acting District Director agreed with our recommendation and stated that the loan, as well as a companion loan, was canceled after a request was received. He also stated that the district would reemphasize to participating lenders the importance of promptly notifying SBA when a guarantee commitment will not be used.

Evaluation of Management Response

The Acting District Director's comments are responsive to our recommendations.

* Ex. 4

OTHER MATTERS

Borrower Misrepresentations

We requested criminal history checks for the principals of each loan. The results of the criminal history checks showed that four borrowers (*sample numbers 3, 12, 15 and 17*) incorrectly stated they had not been charged or convicted of criminal offenses. A background check showed prior criminal offenses; however, these offenses either were not serious enough or occurred so long ago that they would not preclude financial assistance from SBA.

Schedule of Loans Reviewed and Their Status as of May 31, 1998

Appendix A

SAMPLE NUMBER	LOAN NUMBER	BEFORE REVIEW	STATUS	STATUS
2			CURRENT	CLP
3			CURRENT	REGULAR
4			CANCELED	PLP
5			CANCELED	REGULAR
6			CURRENT	CLP
7			CURRENT	REGULAR
8			LIQUIDATION	CLP
9			CURRENT	PLP
10			CANCELED	REGULAR
11			CURRENT	REGULAR
12			CURRENT	REGULAR
13		*	CURRENT	REGULAR
14			CURRENT	CLP
15			CURRENT	CLP
16			CURRENT	CLP
17			CURRENT	REGULAR
18			CURRENT	PI.P
19			CANCELED	REGULAR
20			CURRENT	PLP
21			CANCELED	REGULAR
22			CURRENT	REGULAR
23			CANCELED	REGULAR
25			CURRENT	REGULAR
26			CANCELED	REGULAR
27			CURRENT	REGULAR
28			CURRENT	PLP
29			CURRENT	CLP
30			CURRENT	CLP
31			CURRENT	REGULAR
32			CURRENT	CLP

* EX. 4

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