**U.S. SMALL BUSINESS ADMINISTRATION**
**OFFICE OF INSPECTOR GENERAL**
**Washington, DC 20416**

| **AUDIT REPORT** |
|---|
| **ISSUE DATE: June 19, 2003** |
| **REPORT NUMBER: 3-30** |

**TO:** Richard Temkin, Acting District Director
Michigan District Office

**FROM:** Robert G. Seabrooks, Assistant Inspector General for Auditing
Office of the Inspector General \s\

**SUBJECT:** Audit of an Early Defaulted Loan to 2B Systems, Inc.

Attached is a copy of the subject audit report. The report contains one finding and one recommendation. A response received from your office indicating agreement with the finding and recommendation has been synopsized in the report and included as an appendix.

The finding in this report is the conclusion of the Office of Inspector General, Auditing Division. The finding and recommendation are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution. Please provide your management response for the recommendation to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation and Action Sheet.

Should you or your staff have further comments or questions, please contact Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 6].

Attachment

# AUDIT REPORT

# EARLY DEFAULTED LOAN TO

# 2B SYSTEMS, INC.

# STERLING HEIGHTS, MICHIGAN

# AUDIT REPORT NUMBER 3-30

**June 19, 2003**

**AUDIT REPORT**

**AUDIT OF
AN EARLY DEFAULTED LOAN TO
2B SYSTEMS, INC.**

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## BACKGROUND

The Small Business Administration (SBA) is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guarantied loans. SBA guarantied loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with SBA regulations, polices, and procedures. SBA is released from liability on a loan guaranty, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the Loan Agreement, or did not make, close, service, or liquidate a loan in a prudent manner.

First International Bank (lender), acquired by UPS Capital Company in August 2001, was authorized by SBA to make guarantied loans under the Preferred Lender's Program (PLP). Under the this program, the lender is allowed to process, close, service, and liquidate SBA guarantied loans with reduced requirements for documentation and prior approval.

2B Systems, Inc. (borrower) was located in Sterling Heights, Michigan. The company made plastic cards for public phones, physical security access, and credit cards. The current borrower acquired the business in 1991.

In June 2000, the lender approved a $1.1 million SBA guarantied loan (Number 3818304002) to the borrower using PLP processing procedures. The purpose of the loan was to refinance existing debt and purchase equipment. The single loan disbursement occurred on July 21, 2000. The borrower defaulted in November 2000 with the loan transferred to liquidation status in February 2001. SBA purchased the loan from the secondary market in March 2001. After liquidation of the collateral, SBA's projected loss was $630,224.

## AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the early loan default was caused by lender or borrower non-compliance with SBA requirements. We reviewed SBA and lender loan files and interviewed district office and lender personnel. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 36 months of origination (early default). The audit was performed during November 2002 through February 2003 in accordance with generally accepted Government Auditing Standards

To select this loan, we identified all PLP loans originated by the lender during the period October 1, 1999, and September 30, 2002. From this universe, we identified 32 loans with a gross value of $22.6 million that were transferred to liquidation status or charged off within 36 months after approval or disbursement. Of these 32 loans, we judgmentally selected the subject loan for review as a part of the Office of Inspector General's audits of early defaults.

## RESULTS OF THE AUDIT

### Finding 1 – The Lender Processed a Loan to an Ineligible Borrower

The lender approved a $1.1 million SBA guarantied loan to a borrower who was ineligible because of a lack of creditworthiness and repayment ability. Because of these deficiencies, the loan was inappropriately approved and disbursed. Consequently, SBA will likely suffer a loss of $630,224 plus interest.

### The business lacked creditworthiness

The lender's credit analysis failed to adequately address an obvious pattern of the borrower's inability or unwillingness to pay its debt. Our review disclosed the borrower and its affiliates had a history of lawsuits, judgments and liens, past-due Federal and state withholdings taxes**,** outstanding past-due sales and outstanding personal property taxes and a poor payment history with its creditors. These items indicated that the borrower and its affiliates lacked either the ability or willingness to pay debts in a timely manner.

*Borrower had a history of lawsuits and liens*

Dun and Bradstreet business information report**s** obtained by the OIG identified a history of lawsuits and tax liens filed against the borrower and its affiliates. The reports identified 14 lawsuits, judgments, and liens filed against the borrower between calendar years 1995 thru June 2000. As of the date of the loan approval, four of the lawsuits had been dismissed, and three of the lawsuits and liens were pending. There was no evidence in the loan file, with the exception of the lien, of the outstanding litigation or that the lender obtained a business credit report to identify these conditions. Also, there was no discussion of the litigation actions in the credit analysis. According to the lender, the bank's internal policies did not require the lender to obtain business credit reports. For this loan, the lender relied on the borrower and the borrower's counsel to disclose any outstanding litigation. Details of the data found in the business information report follow:

***Adverse Dunn & Bradstreet Information***

| Type of Legal Action | Date Filed | Amount of Claim | Filing Party | Defendant |
|---|---|---|---|---|
| **Lawsuit** | 05/11/98 | $25,080 | [FOIA Ex. 4] | [FOIA Ex. 4] |
| **Lawsuit** | 6/29/99 | $27,617 | [FOIA Ex. 4] | [FOIA Ex. 4] |
| **Lawsuit** | 4/12/00 | $75,000 | [FOIA Ex. 4] | [FOIA Ex. 4]<br>2B Systems, Inc.<br>[FOIA Ex. 4] |

Title 13 of the Code of Federal Regulations (CFR), Part 120.150(a), states that applicants must be creditworthy. Loans must be so sound as to reasonably assure repayment. In making this determination, the business' character, reputation, and credit history must be considered. SOP 50 10(4)(B), Chapter 4, Subpart A, paragraph 4. 1.a. states that in considering character**,** a determination should be made as to whether the principals have historically shown the willingness and ability to pay their debts.

*Past due/delinquent debts*

Comments received from creditors and the review of the Accounts Payable Aging Report disclosed that the business was not timely paying its debt. The primary creditor to whom the SBA loan was to provide repayment furnished payment transcripts which showed the borrower was consistently late on both its term loan and line of credit. Both loans were past due 60 or more days at the time the SBA loan was approved.

The lender's formal credit policies did not require that long-term creditors be contacted. It did, however, require three references each be obtained from the borrower's customers and suppliers-those accounts directly associated with receivables and trade payables. Only two of 55 creditors identified as accounts payables were contacted. The dollars owed to these two totaled $379 or less than one-tenth of one percent of the outstanding accounts payable on the aging listing. In addition, none of the 40 creditors with payments past due 60 or more days were contacted**.** As a result, the lender's actions did not provide a true picture of the borrower's credit worthiness.

*Delinquent taxes*

Further evidence of the borrower's lack of ability or unwillingness to pay its debts were Federal and state withholding and personal property taxes that were overdue when the SBA loan was approved. The lender discussed the overdue Federal and state taxes, which were the result of computer problems, in the credit analysis. The lender also acknowledged that proceeds from its commercial loan and line of credit were used to pay the delinquent taxes. According to the loan file documentation, the following delinquent taxes were paid from the proceeds of the lender's loans.

***Delinquent Taxes***

| Payee | Type of Taxes | Amount |
|---|---|---|
| Internal Revenue Services | Federal | [FOIA Ex. 4] |
| State of Michigan | Withholding/Sales | [FOIA Ex. 4] |
| Macomb County Treasurer | Property Taxes | [FOIA Ex. 4] |
| ***Total*** | | [FOIA Ex. 4] |

**The borrower lacked repayment ability**

Part 120.150 of 13 CFR states that in assessing a loan's soundness, there must be reasonable assurance that loan repayment can be made. In making this assessment, consideration must be given to: (i) the strength of the business; (ii) past earnings; (iii) ability to repay the loan with earnings from the business; and, (iv) the potential for long-term success. The borrower had history of financial losses prior to approval of the SBA loan. The business' financial statements disclosed insufficient working capital evidenced by weak financial ratios and negative cash flow from the business' operating activities for 1998 and 1999.

*Insufficient working capital and weak financial ratios*

Chapter 13 of SOP 50 11, states, that the comparison of company's ratios with industry averages reveals the company's relative strengths and weaknesses. Pertinent ratios help assess the firm's financial health, evaluate how a loan will aid the business, and help determine if there is a reasonable assurance that the loan can be repaid. Publications such as the Robert Morris Associates' (RMA) Annual Statement Studies provide industry averages of selected ratios.

During our review of the borrower's financial data, we noted some apparent accounting discrepancies. As we did not have sufficient data to fully analyze the discrepancies, we used the data as presented and as used by the lender. The lender appropriately computed ratios based upon the financial data but stated that due to the limited number of companies in this field, there was no RMA comparison information available.

We were able to readily locate the industry averages for the SIC code 2759-Commercial Printing assigned by the lender. Using RMA industry ratios, we concluded that the business had a weak financial condition, lacked sufficient liquidity, and was highly dependent on debt to finance its ongoing operations during 1998 and 1999.

***1999 Historical Ratios***

| Type of Ratio | Computed Ratio/Days | RMA Industry Averages* | Relationship to RMA Industry Averages |
|---|---|---|---|
| Current | 0.566 | 1.0 to 2.3 | Below Lowest Quartile |
| Quick | 0.456 | 0.7 to 1.9 | Below Lowest Quartile |
| **COGS to Inventory | 6.721 | 10.5 to 46.6 | Below Lowest Quartile |
| **COGS to Trade Payables | 5.800 | 6.8 to 19.6 | Below Lowest Quartile |
| Net Sales to Accounts Receivables | 2.66 | 7.5 to 11.7 | Below Lowest Quartile |
| Debt to Equity Ratios | 24.58 | 10.6 to 0.9 | Below Lowest Quartile |

***** *1999-2000 Annual Studies/1998-1999 averages were substantially the same.*
****** *COGS = Cost of Goods Sold*

To determine whether the business' financial condition would improve after the receipt of the SBA loan, we computed ratios using the projected balance sheet contained in the lender's application for loan guaranty. No marked improvement was found since the computed ratios still fell below the lowest quartile of performance. Our results are contained in the following table.

***Projected 2000 Ratios***

| Type of Ratio | Computed Ratio | RMA Industry Averages* | Relationship to RMA Industry Averages |
|---|---|---|---|
| Current | 0.787 | 1.0 to 2.3 | Below Lowest Quartile |
| Quick | 0.638 | 0.7 to 1.9 | Below Lowest Quartile |
| **COGS to Inventory | 7.890 | 10.5 to 46.6 | Below Lowest Quartile |
| **COGS to Trade Payables | 1.926 | 6.8 to 19.6 | Below Lowest Quartile |
| Net Sales to Accounts Receivables | 2.815 | 7.5 to 11.7 | Below Lowest Quartile |
| Debt to Equity Ratios | 24.813 | 10.6 to 0.9 | Below Lowest Quartile |

***** *1999-2000 Annual Studies/1998-1999 averages were substantially the same.*
****** *COGS = Cost of Goods Sold*

The lender took exception to our comparison of the ratios, stating that the type of business was unique and too small to be compared and offered no alternative comparisons. The lender asserted that the proposed SBA guarantied and commercial loans and the liquidation of an existing accounts receivable factoring line would have increased the current ratio to 1.04. Even after the influx of the new loans, the lender's revised ratio was still in the lowest quartile of performance for this industry code.

*Negative cash flow from operating activities*

The lender used both a rule of thumb and a detailed cash flow analysis to determine if the business had adequate cash flow to service the proposed debt. While the rule of thumb analysis showed that there was adequate debt coverage for the previous years, the detailed cash flow analysis demonstrated that the opposite was true. The lender's representative stated that the rule of thumb analysis was used by the bank to determine repayment ability. The following table provides detailed cash analyses for the two most recent historical years.

***Negative Cash Flow Computation***

| Cash Flow Analysis | 1998 (000) | 1999 (000) |
|---|---|---|
| Net Sales | $2,341 | $2,464 |
| Current Receivables | (132) | (546) |
| Cost of Goods Sold | (1,511) | (1,519) |
| Inventory | (18) | 22 |
| Accounts Payable | (252) | (35) |
| Selling & Admin. Expenses | (449) | (547) |
| Other Operating Expenses | (88) | (43) |
| Prepaids | 13 | 0 |
| Accrued Expenses | 128 | (135) |
| Other Current Assets/Liabilities | 14 | 0 |
| Other Income | 141 | 0 |
| Other Liabilities | (261) | (39) |
| Net Cash After Operations | (74) | (378) |
| Proposed Debt Service After New Loans | $228,000 | |

The business had a negative cash flow from its operating activities totaling $74,000 for 1998 and $378,000 for 1999. Therefore, the proposed debt could not be serviced historically.

SOP 50 10(4), Paragraph 4.1.e (1), states that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. Paragraph 4.1.d., states, that historical earnings and cash flow are the best bases upon which to gauge repayment ability. Additionally, Chapter 16 of SOP 50 11, states, a company's true cash flow is determined by the firm's sources and use of cash during the repayment period of the loan. If cash outflow exceeds cash inflows for an extended period of time, a business cannot continue to operate.

**Conclusion**

The lender made an SBA guarantied loan to a borrower that lacked creditworthiness and repayment ability. The borrower: (i) had outstanding lawsuits and unpaid judgments; (ii) was delinquent in its payments of Federal and state taxes; and, (iii) had a poor payment history. Additionally, the borrower had insufficient working capital as evidenced by its weak financial ratios and a negative cash flow from its business operations.

**Recommendation**

We recommend that the District Director, Michigan District Office, take the following action:

1.A Seek recovery of $630,224, plus accrued interest, from First International Bank on the guaranty paid, less any subsequent recoveries, for Loan Number 3818304002.

## Management Comments

The District Director stated that he agreed with the audit finding and recommendation.

## Evaluation of Management Comments

The District Director's comment is responsive to the recommendation.

## APPENDIX A

**Subject:** FW: Draft Report-Early Defaulted Loan to 2B Systems, Inc

**From:** Temkin, Richard
**Sent:** Wednesday, May 07, 2003 2:30 PM
**To:** Seabrooks, Robert G.
**Subject:** Draft Report-Early Defaulted Loan to 2B Systems, Inc.

This is in response to your memo of April 28, 2003 on this subject.

This office fully agrees with the audit finding and the recommendation. We will take the action recommended on page six to "Seek recovery of $630,224, plus accrued interest, from First International Bank on the guaranty paid to it, less any subsequent recoveries, for Loan No. 3818304002."

Richard Temkin
Acting District Director

**Appendix B**

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