AUDIT OF

AN EARLY DEFAULTED LOAN TO

Stickney & Poor Spice Company

Chelmsford, Massachusetts

AUDIT REPORT NUMBER 3-40

September 24, 2003

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding and recommendation are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

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

AUDIT REPORT
ISSUE DATE: September 24, 2003
REPORT NUMBER: 3-40

To: Elaine F. Guiney, District Director
Massachusetts District Office

From: Robert G Seabrooks, Assistant Inspector General
for Auditing Original Signed [FOIA Ex. 6]

Subject: Audit of an Early Defaulted Loan to Stickney and Poor Spice Company

Attached is a copy of the subject audit report. The report contains one finding and one recommendation addressed to your office. Your response is synopsized in the report and included in its entirety at Attachment A.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with the existing Agency procedures for audit follow-up. Please provide your management decision 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.

Any questions or discussion of the finding and recommendation contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachments

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Chelmsford, Massachusetts

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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 guidance. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations, loan authorization, or does not make, close, service, or liquidate the 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 Program (PLP). Under PLP, the lender processes, closes, services, and liquidates loans with reduced requirements of documentation and prior approval by SBA.

We selected a group of SBA guarantied PLP loans originated by the lender from October 1, 1999 to September 30, 2002 that had been charged off or were in liquidation status. Our audit identified that the loan to Stickney & Poor Spice Company (borrower) was originated in material non-compliance with SBA regulations. On November 30, 1999 the lender approved an SBA loan (number [FOIA Ex. 4]) for $1 million to the borrower under PLP procedures. The purpose of the loan was to refinance existing debt owed to Medford Bank. The borrower was composed of two partners [FOIA Ex. 6].

Loan proceeds were disbursed in May 2000 then in October the borrower ceased operations and the loan was placed in liquidation status. SBA then purchased the guaranty from the secondary market. After the business assets were sold, SBA sustained a loss of $316,165.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the early loan default was caused by lender or borrower noncompliance with SBA's requirements. SBA and lender loan files were reviewed and district office personnel were interviewed. 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 24 months of origination (early default). The audit was accomplished during December 2002 through Feburary 2003 in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

FINDING Prudent Lending Procedures were not used to Process a Loan

The lender did not use prudent lending procedures to process a Section 7(a) loan to the borrower. SOP 50 10 (4), Subpart "D" requires PLP lenders to conduct a credit analysis, complete a repayment ability and eligibility review, and evaluate the sufficiency and source of capital injection. In performing the credit analysis, the lender must consider management and repayment ability. The lender, however, did not adequately determine the borrower's repayment and management ability during this analysis. Also, the lender did not evaluate the eligibility of the debt being refinanced or the source of capital injection by the borrower. As a result, SBA made a $316,165 improper payment when the guaranty was purchased from the secondary market.

Repayment ability

The lender was not prudent in evaluating the repayment ability of the borrower. According to the lender's credit policy, a debt service ratio of at least 1.25:1 for the most recent fiscal year end (FYE) was required for loan approval. The debt service ratio for the borrower's most recent FYE was calculated as [FOIA Ex. 4]. Instead of relying on historical data, the lender used interim data that was inconsistent with prior operating results in making the loan approval decision. In the Credit Memorandum, the lender based the loan approval on interim financial data. According to SOP 50 10 (4), when interim results are inconsistent with prior operating results, interim financial data could be misleading for loan approval. The failure to follow established credit policy on debt service ratios could result in the inability of the borrower to repay the loan.

Management ability

The lender did not assess the borrower's management capacity in a prudent and diligent manner. SOP 50 10 (4) states that the credit analysis must assess the borrower's management ability by considering education, experience, motivation, and stability. The Credit Memorandum prepared by the lender in May 2000, prior to loan approval, included a profile of the company's president that indicated the president's lack of "focus on managing the company" was a cause for the "deterioration in the business". Additionally, during 1999, the company president withdrew [FOIA Ex. 6] from the business for personal use. The withdrawals included [FOIA Ex. 6]. These actions clearly demonstrated the president's lack of management skills and improper management of corporate finances. Prudent lending procedures would have identified the borrower as high risk, warranting denial of the loan.

Equity injection

The lender did not verify the borrower's equity injection. According to the loan authorization, the lender was to verify the equity injection of $197,000 prior to disbursing the loan. A review of the loan documentation indicated that the lender did not verify the equity injection until SBA requested such verification during the purchase review process. In addition, funds to be used as equity injection were borrowed via a second mortgage on the personal residence of the borrower. According to SOP 50 10 (4), borrowed funds are deemed equity injection when the lender of the borrowed funds agrees to a standby agreement of principal and interest until the SBA loan is paid in full, or the applicant can demonstrate repayment ability from a source other than cash flow of the business. The borrower was unable to meet either of these requirements (a standby agreement for the borrowed funds on the second mortgage was not found and the borrower was not receiving a salary). Therefore, there was no support for debt service of the second mortgage from salary. Inadequate equity injection can result in excessive debt, placing unreasonable demands on a firm's ability to develop sufficient cash flow to service the debt.

Actual SBA loss

A defaulted loan balance of $[FOIA Ex. 4] was transferred to liquidation in November 2000. The SBA then honored its guaranty by paying $767,815, which included expenses of $21,131. The assets of the corporation were sold for $602,200 with SBA receiving $451,650 thus suffering a loss of $316,165.

RECOMMENDATION

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

1A. Seek recovery of the SBA repair guaranty of $316,165 for loan number [FOIA Ex. 4].

District Office Comments

The Massachusetts District Office agreed with the recommendation to seek recovery of the SBA repair guaranty. Regarding the elements of the finding, the district office:

- Agreed that equity injection was not verified.
- Agreed that the lender was not prudent in approving the loan. However this determination should have been based on repayment ability because of a lack of analysis of business operations not the use of interim financial data as reported by the Office of Inspector General.

- Stated that since the company's President was being replaced, his ability to manage was not relevant to loan approval.

Evaluation of District Office Comments

The District Office comments are responsive to the recommendation.

- Regarding repayment ability, we agree with the district office statement that interim data can be relied on in some circumstances. However, our review of the repayment ability calculations for this loan showed that the use of interim data was inconsistent with prior operating results thus should not have been used in the calculation. A review of the prior operating results revealed a negative trend in net income and debt service ratio. Therefore, the interim data relied upon in the repayment ability calculation showed a positive net income figure not consistent with the prior three years. Accordingly, we have not made a change to our report.
- We disagree with the district office position that the borrower's management ability was not relevant. The president of the corporation admitted to having lost focus in the business and financial statements revealed numerous payments for expenses unrelated to the business. The district office claimed relinquishment of management duties to another employee of the corporation diminished any risks associated to the applicant's lack of management skills. We contend that the corporate president's lack of management ability was a direct cause for the loan failure. Accordingly, we have not modified our report.

U.S. Small Business Administration
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DATE: August 11, 2003

FROM: Robert H. Nelson

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

THRU: Robert F. Coen
Deputy Director

SUBJECT: 3734414003 - Stickney & Poor Spice Company, Inc.

CC: Reading File
Loan File
DD

Finding: 1) The draft audit report states that the lender did not use prudent lending procedures in performing its credit analysis during the processing of the 7a loan to the borrower. The District Office agrees with this finding, but disagrees with the IG's basis for the finding.

Finding: 2) The draft report states that the SBA made a $316,165 erroneous payment when it honored the lender's request for payment on the guaranty. The District Office payment was not made erroneously since it was made not to honor the guaranty request from the Bank but to pay the secondary market investors as SBA is required to do. Furthermore this office's review of the loan pre-dated HQ guidance issued in October of 2002 defining early default loans and setting guidelines for more stringent reviews of early defaulted loans.

Finding: 3) The draft audit report in the next to last sentence of the Finding section references the eligibility of the debt being refinanced. The District office believes that this reference is erroneous because this issue is not raised in the body of the report. The second part of this sentence refers to the bank's failure to verify the principal's required equity injection into the business. We agree with the IG's conclusion as to equity, but not with their reasoning.

There are three specific areas noted by the IG audit report leading to the above noted conclusions. The district office response to each item is as follows:

<u>Repayment Ability:</u> The IG audit finds that the lender was not prudent in evaluating the repayment ability of the borrower. The Lender based its repayment ability analysis on interim data.
While we agree that the SOP states that the best evidence of repayment ability is historical earnings, the SOP does state that projections can be relied upon if there is a change in the circumstances affecting the business......page 83. This business' historical debt service

coverage was positive in 1998 and 1997 but negative in 1999. Interim statement debt service coverage was 1.39x's. Given that there was historical debt service coverage for all but one year, we feel that the lender was not imprudent in looking to projections to evaluate the ability of the business to repay the loan from earnings. A bank's would be reasonable to rely on a turnaround in a business and to rely on the interim numbers and projections where there is demonstrated change in the management and significant cost reductions.

However once a bank elects to look at projections they have the responsibility to look carefully at the assumptions surrounding the projections before making the loan in reliance on them. The lender states on page four of their transaction overview that gross profit margin is projected to decline in the 2000 plan to 11.6% vs. 14.4% for 1999, based upon competitive pressures and efforts to be implemented to regain market share. **Reduced operating expenses are budgeted to offset the reduced margin.** They are forecast at $843,000 or 9.3% of sales compared to $1,523,000 or 17% for 1999. The bank never addressed in its analysis how this would be accomplished. In looking at the numbers closely, it is important to note that the company only had one month of profitability - March 2000. The PLP request was dated 5/9/00. There is no indication that they looked at how the business did in April 2000. One would think that this would have been a critical review item given the that company suffered losses in the past two fiscal years.

Again, our opinion is that a loan can be made on projections and interim numbers but after careful analysis it is our opinion that the bank was not prudent in this case. It did not fully analyze how this business would achieve the reduced expenses, and lacking such analysis the bank did not act in a prudent manner in making this loan.

Management Ability: Tthe audit report concludes that the lender did not assess the borrower's management capacity in a prudent and diligent manner. The district office does not concur with the IG findings on this item. Although the district office does agree with the factual statements made by the IG audit memo regarding the president and the withdrawal of funds etc., the credit memo does address management. Page Two of the bank credit memo states that Mr. Brown has removed himself from management and put Charles Lavery in charge. The credit memo discusses the experience of Mr. Lavery. The credit memo also addresses that the company has engaged a consultant, Joe Picano of Profit Management. The credit memo states that, due to the above, positive results were already being realized. The district office is of the opinion that the referenced argument does not support a denial of liability. Additionally, the guarantors bought the company in 1994 and operated it from that time till 2000 during which time the business realized a significant profit in 1997 and close to break even in 1998. The credit write up says that the loss in focus occurred only during the prior two year period. There is ample evidence that owner was able to successfully manage the business at periods since his acquisition, and that steps had been taken to overcome the management deficiencies.

Equity Injection: The finding by the audit team is that the lender did not verify the equity

injection of $197,000 and it stated that the lender did not verify same until requested to do so by the SBA as part of the post purchase review. It further states that the equity funds were borrowed via a second mortgage against the residence and that a standby agreement was not found. It states that according to SOP 50 10 (4), borrowed funds are only deemed equity injection when the lender of the borrowed funds agrees to a standby of P & I payments till the SBA is paid in full.

District response: Page 87 of SOP 50 10 (4) Subpart A – Paragraph (f) 6 states that funds borrowed through the use of personal credit for injection into the business should normally be treated as debt financing and not equity injection……however, it goes on to state that on a case by case basis you may be able to justify such funds as equity injection based upon the analysis. While it is acknowledged that there is no standby agreement, one is not appropriate in this circumstance nor could one be reasonably obtained from a conventional second mortgage lender. The SOP goes on to further state that "the other instance in which borrowed funds may be deemed equity is if the applicant can demonstrate repayment ability ……from reasonable withdrawals or salary and excessive withdrawals or salary are not required to service the side loan. "Reasonable" withdrawals or salary means an amount comparable to that paid to someone employed to perform the same functions and duties with the same level of responsibility and authority. A review of the bank credit write up does not find any analysis to support repayment of the second mortgage loan. The bank credit analysis further notes that Sandy Brown has removed himself and other family members from the payroll of the company along with other benefits. Mr. Brown took $[illegible] shareholder distributions in lieu of salary. There does not appear to be support for the principal's ability to pay the $174,000 first mortgage and $197,000 second mortgage debt service from the $77M shareholder distribution noted in the credit write up. The writer therefore concurs with the IG's finding that there was inadequate equity injection in the subject transaction. This finding buttresses the prior finding of an inadequate analysis of repayment ability since in order for the bank to conclude that there was repayment ability from operations, the bank needed to know how the principal was going to be able to live and pay his personal obligations since his only source of funds was from his withdrawals from the business. This also is significant in that the principal had no personal investment in the business having borrowed funds from the business to buy out the former owner.

OFFICE OF INSPECTOR GENERAL

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