AUDIT OF

A SBA GUARANTIED LOAN TO

WYNNE TELECOM, INC.

El Dorado Springs, MO

AUDIT REPORT NO. 4-28

JULY 9, 2004

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

AUDIT REPORT
ISSUE DATE: July 9, 2004
REPORT NUMBER 4-28

To: James Rivera
Associate Administrator, Office of Financial Assistance

From: Robert Seabrooks [FOIA Ex. 6]
Assistant Inspector General for Auditing

Subject: Audit of a SBA Guarantied Loan to Wynne Telecom, Inc.

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. The response from you office is summarized 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 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-[FOIA Ex. 2].

Attachments

AUDIT OF A SBA GUARANTIED TO
WYNNE TELECOM, INC.
El Dorado Springs, MO

Table of Contents

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 loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with SBA regulations, policies, 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.

Heller First Capital Corporation (lender) was a Small Business Lending Company authorized by SBA to make guarantied loans under the Preferred Lenders Program (PLP). The lender was allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation to and prior approval by SBA. The lender stopped making SBA loans in February 2001, and was acquired by General Electric Capital Corporation in October 2001.

Prior audits of early defaulted loans found that this lender did not always materially comply with SBA rules and regulations. In a January 2000, response to one of the audits, the lender acknowledged that the loan, which closed in 1997, would not have been approved under its current underwriting and closing procedures. A few months later they admitted in response to a PLP review that combined growth in volume and processing locations across the country was not in their or SBA's best interest. Consequently, certain regions exercised more discretion in both credit analysis and compliance with procedures than the lender would have liked.

Based on the lender's acknowledgement of the lack of controls over the SBA loan process, the Office of Inspector General initiated an audit of all loans originated by the lender and purchased by SBA. The loans included those purchased by SBA from January 1996, through February 2000. The audit identified 25 loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of these loans was to Wynne Telecom, Inc. (borrower) and is the subject of this report.

In February 1998, the lender approved a loan (number 1848264005) for $523,700 to the borrower using PLP procedures. The purpose of the loan was to refinance $363,222 of debt; purchase machinery, equipment, and furniture for $146,848; and provide working capital of $13,630. The last loan disbursement was made to the borrower on March 18, 1998, with the loan defaulting on January 1, 1999. Of the 14 payments made by the borrower, 13 were for interest only.

[FOIA Ex. 6]. The loan was placed in liquidation in May 1999, with SBA purchasing the loan guaranty for $142,549 in January 2000.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, disbursed, and liquidated the loan purchased by SBA in accordance with established guidance. The subject loan was reviewed for compliance with 11 requirements found in SBA rules and regulations and SBA lender guaranty agreements. We obtained and reviewed documentation in the lender's loan file. All identified lender deficiencies were evaluated to determine if a [FOIA Ex. 2] loss of $25,000 or more to SBA resulted. The audit was conducted in Washington, DC in accordance with generally accepted Government Auditing Standards.

AUDIT RESULTS

FINDING Prudent Lending Procedures were not used to Process a Loan

The lender did not materially comply with SBA rules and regulations in its approval of a SBA guarantied loan to the borrower. Prudent lending practices were not exercised in obtaining evidence that repayment ability existed, resolving questionable credit worthiness issues, or disbursing loan proceeds. A lack of due diligence by the lender in originating a loan resulted in SBA making an improper payment of $142,549.

Critical data was excluded from the credit analysis

According to CFR 120.150,*"Loans must be so sound as to reasonably assure repayment"*. Furthermore, SOP 50 10 (4) states, *"The ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process"*. Information in the loan file showed that the lender did not consider all of the borrower's debts in calculating repayment ability.

The cash flow analysis incorrectly showed the borrower had repayment ability. The analysis excluded repayment for a working capital loan obtained from a third party lender. The lender loan file contained a facsimile from the second lender dated February 19, 1998, —one day before the SBA loan was approved. This document stated that the borrower was applying for a working capital loan of $327,375. It further stated that the debt service on this working capital loan would be $100,713 annually. A Universal Commercial Code financing form (UCC-1) found in the borrower's bankruptcy documents showed that the loan was, in fact, disbursed to the borrower. In addition, the lender excluded five leases that the borrower initiated between May and October 1997 requiring annual payments of $148,752.

The following table shows that the borrower would not have repayment ability had the total working capital loan and lease payments been included in the lender's analysis.

Repayment Ability Calculation

DESCRIPTION	LENDER PROJECTIONS	OIG PROJECTIONS
Cash Available to Service Debt	272,333	$272,333
Less: SBA Guaranteed Loan Payment	($87,468)	($87,468)
Other Installment Debt	($19,476)	($19,476)
Lease Payments (5 Leases)	-0-	($148,752)
Cash Available without Working Capital Loan	**$165,389**	**$16,637**
Less: Repayment of Pending Working Capital Loan	($11,976)	($100,713)
Lender Repayment Ability Calculation	**$153,413**	
OIG Repayment Ability Calculation Considering the Working Capital Loan and Lease Payments		**($84,076)**

By the lender excluding the two expenses, the borrower appeared to have repayment ability. Based on the information in the lender's file, however, payments for the loan and leases should have been considered in calculating repayment ability.

The "Lender's Transcript of Account" showed that the borrower had difficulty in making payments since loan origination. Only one full payment had been received during the life of the loan. SOP 50 10 (4) states that if a borrower does not have reasonable assurance of repayment from the earnings of the business, the loan must be declined. The lender should have declined the loan based on the borrower's inability to service the SBA debt.

Borrower's creditworthiness was questionable

At the time of loan approval, [FOIA Ex. 6].

According to 13 CFR 120.150, the applicant's, principals, and guarantor's credit history must be considered when reviewing the loan application. There was no indication in the file showing that the lender had analyzed the potential risk to SBA from the borrower's [FOIA Ex. 6]. Furthermore, the loan officer's report stated, [FOIA Ex. 6].

[FOIA Ex. 6].

Loan proceeds were used for an inappropriate purpose

The lender disbursed part of the loan proceeds inappropriately. [FOIA Ex. 6]. According to 13 CFR 120.120, loan proceeds must be used for sound business purposes. Also the CFR states that, " SBA will not authorize proceeds for "a purpose which does not benefit the small business". [FOIA Ex. 6].

RECOMMENDATION

We recommend that the National Guaranty Purchase Center take the following action:

1. Seek recovery of $142,549 from the lender for the guaranty paid on loan number 1848264005.

Management Response

The Associate Administrator for Portfolio Management (AA/PM) generally agreed with the finding and indicated that the matter will be pursued with the lender. The AA/PM agreed that it was incorrect to exclude lease payments from the cash flow analysis, but disagreed that the lender erred by excluding a pending working capital loan from the cash flow analysis. The AA/PM also did not agree that the [FOIA Ex. 6]. The response did not specifically address the inappropriate disbursement beyond noting that it was a concern of the OIG.

OIG Response

The response is partially responsive to the audit finding and recommendation and we concur with the decision to seek a response from the lender and the Office of General Counsel, if necessary. The AA/PM took exception with many of the adverse conditions noted in the audit report and did not indicate if SBA will seek full recovery of the guaranty as recommended.

We disagree with the AA/PM that it was acceptable to disregard the impact of a pending $327,375 working capital loan on the borrower's repayment ability. Working capital represents current assets available to meet the current expenses (current liabilities), such as salaries, supplies, and current portion of long term liabilities. The inability of a business to meet current liabilities with current assets indicates insolvency. The discovery of the loan application prior to the SBA loan should have prompted the lender to query the borrower about the need for additional working capital and to assess the potential impact of the loan on repayment ability. To simply ignore this fact and its potential consequences on cash flow was imprudent lending.

[FOIA Ex. 6].

In conclusion, we continue to recommend full recovery of the guaranty based on the conditions discussed in the audit report.

U.S. SMALL BUSINESS ADMINISTRATION

WASHINGTON, D.C. 20416

DATE: June 24, 2004

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: Audit of SBA Guaranteed Loan
Loan: Wynn Telecom, Inc.
PLP 18482640-05
Lender: GE Capital (loan originated by Heller First Capital Corp.) St. Louis, MO

We have reviewed the Office of Inspector General (OIG) memorandum and accompanying draft audit report for this loan that recommends full recovery of the guaranty payment of $142,549, less any subsequent recoveries. The basis for the OIG recommendation is the lender did not follow prudent lending procedures in processing the loan.

We concur that the lender erred in not including in its credit analysis the payments required on five leases that the borrower had executed prior to loan approval. We do not agree, however, that the lender was deficient by not including the payments that would have been required on a new working capital loan of which the lender was advised the day before the SBA loan was approved. We note that the lender was apparently merely informed that the borrower had applied for this loan. There was no certainty that the loan would have been granted, nor did the audit report take into account any additional cash flow that the business might have generated as a result of the new loan. Such cash flow could have offset some or all of the payments required under the loan.

[FOIA Ex. 6].

We have advised the lender of the findings of the audit report and have requested the lender's response. If we cannot satisfactorily resolve this matter with the lender, we will seek a legal opinion from OGC with respect to the possibility of pursuing enforced collection.

Appendix B

AUDIT REPORT DISTRIBUTION

Recipient	Number of Copies
District Director Dallas/Ft Worth District Office	1
Deputy Associate Administrator for Capital Access	1
General Counsel	3
Associate Administrator for Financial Assistance	1
Associate Administrator for Field Operations	1
Office of Chief Financial Officers Attn: Jeff Brown	1
General Accounting Office	1