

AUDIT OF A SBA GUARANTIED LOAN TO

ROSE ENTERPRISES, INC.

BRUNSWICK, GEORGIA

AUDIT REPORT NO. 4-32

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendation is 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.



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

AUDIT REPORT
ISSUE DATE: July 29, 2004
REPORT NUMBER 4-32

To: James E. Rivera
Associate Administrator for Financial Assistance

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

Subject: Audit of a SBA Guaranteed Loan to Rose Enterprises, Inc.

Attached is a copy of the subject audit report. The report contains one finding and 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-[FOIA Ex. 2].

Attachments

**AUDIT OF A SBA GUARANTIED LOAN TO
ROSE ENTERPRISES, INC.**

BRUNSWICK, GEORGIA

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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-guaranteed 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 guaranteed loans under the Preferred Lender Program (PLP). The lender was allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior approval by SBA. Heller stopped making SBA loans in February 2001, and was acquired by General Electric Capital Corporation in October 2001.

Prior audits of early default loans found that the 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 SBA PLP review that combined growth in volume and processing locations across the country was not in the best interest of their or SBA's lending program. 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 (OIG) initiated an audit of all loans originated by the lender and purchased by SBA. The loans included those purchased 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 Rose Enterprises, Inc. (borrower) and is the subject of this report.

In January 1998, the lender approved a loan (number 1810424010) for \$1,250,000 to the borrower using PLP procedures. The purpose of the loan was to refinance debt of \$179,000, purchase machinery and equipment of \$117,563, site preparation and construction of \$911,437, interim interest financing of \$30,000, and working capital (for closing costs) of \$12,000. The last disbursement was in June 1998. The borrower closed the business after operating it for approximately three months. The loan was placed in liquidation status in December 1998 and SBA purchased it in August 1999, for \$542,663.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, disbursed, and liquidated the loan in accordance with SBA rules and regulations. The subject loan was reviewed for compliance with 11 requirements found in SBA rules and regulations and the guaranty agreements. All identified lender deficiencies were evaluated to determine if a material loss to SBA resulted. A material loss was defined as exceeding [FOIA Ex. 2]. The audit was conducted in Dallas, Texas, in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

Finding 1: The Lender Originated a SBA Guaranteed Loan in Material Noncompliance with SBA Regulations.

The lender did not exercise prudent lending practices in determining that repayment ability existed. As a result of the lender's lack of due diligence, SBA made an improper payment of \$542,663 when it honored the guaranty.

Borrower Lacked Repayment Ability

The lender provided no justification for projected earnings that were 52 percent higher than the norm for Putt-Putt franchises operating in tourist areas. SBA's Standard Operating Procedure (SOP) 50 10 (4) provides that projected cash flow must be realistic and tested against industry averages. Significant variations must be explained. The SOP further provides that the lack of repayment ability from the cash flow of the business requires that the application be denied.

The loan was made to Rose Enterprises Inc. (borrower), which was an eligible passive company, to assist Rose Family Fun Centers, Inc., the operating company. The borrower owned the real estate and facilities which it leased to the operating company. The borrower's sole source of revenue came from the lease payments received from the operating company. Consequently, the success of the operating company was crucial to the survival of the borrower.

The operating company was a start-up business located in Glynn County, Georgia. It consisted of two 18-hole miniature golf courses (a franchise of Putt-Putt Golf Courses of America), seven batting cages, and a 10,000 square foot building that housed a soft play area, video game room, concession area, four party rooms, and a pizza parlor. Glynn County was also home to the "Golden Isles of Georgia," consisting of four off shore islands which were the primary tourist attraction in the area. Although the operating company was on the main land between 5 to 10 miles from the Golden Isles, it was considered by the local Chamber of Commerce to be on the tourist area fringe.

The lender's loan officer report noted that a typical Putt-Putt received about 80 percent of its clientele and revenue from local residents and 20 percent from out of town visitors. The report further noted that according to other franchise owners, the number of outside visitors approached 35 to 40 percent when located in a tourist area. The lender, however, disregarded this information and without any apparent support or justification, projected that the start-up business would receive as much as 71 percent of its customers from tourists.

Comment:

The lender estimated that five percent of the 1.4 million tourists to the Golden Isles annually, or 70,000, would visit the operating business. The lender further estimated that ten percent of the local population (70,000 at the time of loan approval) would visit the recreational facility four times a year, for a total of 2,800 visits. Each customer was expected to spend about \$12 per

visit¹. Based on these estimates, the lender believed about 71 percent of the customers would come from tourists and 29 percent from local residents. As shown in the following table, the lender estimated that these customers would spend \$1.176 million annually at the recreational facility.

**Table 1
Lender's Cash Flow Projection**

Customer Type	Projection		
	Number of Visits	Percentage	Total Revenue (visits x \$12) ²
Tourists	70,000	71.4 %	\$839,143
Local	28,000*	28.6 %	\$335,657
Total	98,000	100%	\$1,174,800

* Calculation of the number of local visits (0.10 x 70,000) x 4 = 28,000

The lender, however, did not explain its basis for deviating from the tourist estimates provided by the other franchise owners or how the operating company would exceed those estimates by 77 percent ((71 - 40)/40) while operating from the fringe of the tourist area. When the expected level of tourists provided by other franchise owners is applied to the cash flow formula; projected revenue drops by more than 52 percent, as shown in Tables 2.

**Table 2
Cash Flow Projection Comparison**

A	B	C	D	E	F	G	H
Type of Customer	Number	Visits per year	Total Visits	Percentage of Visits by Customer	Total Rev. (Visits x \$12) ³	Lender Projections	Percent Difference (F-G / G)
Local	7,000	4	28,000	60%	\$335,657	\$335,657	0%
Tourists	18,667	1	18,667	40%	\$223,775	\$839,143	(73.3%)
Total	25,667		46,667	100%	\$559,432	\$1,174,800	(52.4%)

The revenue of \$559,432 that results from the lower estimate for tourists is supported in the liquidation appraisal report. After performing the appraisal and talking with owners of similar recreational facilities, the appraiser noted that projected revenue for the operating company should have been \$492,000, which is even less than the amount of revenue achieved using the estimates provided by other franchise owners. Also, as shown in Table 3, cash available after debt service goes from a positive to a negative when the lower tourist

¹ When projected revenue is divided by the projected number of customers, the amount per visit approximates \$11.98775

² Ibid.

³ Ibid.

estimate is applied to cash flow. Thus, the borrower lacked repayment ability under standard clientele levels supported by similar recreational operations.

Table 3
Cash Flow Analysis

	Lender Projections	OIG Projections*
Revenues:	\$1,174,800	\$559,432
Less: Cost of Sales	(139,590)	(67,132)
Gross Profit	1,035,210	492,300
Less: Expenses (Minus Interest and Depreciation)	(636,334)	(495,867)
Cash Available for Debt Service	398,876	(3,567)
Less: Debt Service	(189,807)	(189,807)
Cash Available (Shortage) after Debt Service	209,069	(193,374)

*Cost of sales and G&A expense are based on the percentage used by lender, with exception of the rent expense (bldg. and video equipment) which is fixed and salaries which is based on the lender's break even formula.

There were other preexisting problems that may also have had an adverse impact on the projected cash flow of the operating company. When the loan application was submitted to the lender, there were three other miniature golf courses operating within the same trade area; two were located on the Golden Isles where the majority of the tourists visited and the third competitor was located within a block of the borrower's business. According to a site visit report prepared after the borrower defaulted, the nearby competing business had a better location. Also, there was a competitive game room located in a mall within a block. There was no evidence that the lender considered the impact of the competition when analyzing cash flow.

Thus, as a result of the imprudent use of unsupported cash flow estimates that exceeded the norm for similar business operations in tourist areas, the lender failed to recognize that the borrower lacked repayment ability. Under SBA requirements, the lender was required to decline the loan.

RECOMMENDATION

We recommend that the Associate Administrator for Financial Assistance take the following action:

1. Recover from the lender \$542,663 paid to purchase the guaranty for loan number 1810424010.

Management Response

The Associate Administrator for Portfolio Management (AA/PM) generally agreed with the finding and indicated the matter will be pursued with the lender. Management indicated that since the repayment analysis contained unexplained variances, it was appropriate to allow the lender the opportunity to review and address the inconsistencies. Management will provide additional comments after receipt of the lender's response.

OIG Evaluation of Management Comments

Management did not take a position on the finding and recommendation. We will evaluate any action to recover the balance of the amount recommended during the audit follow up process.

Redacted for FOIA

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20418

DATE: June 15, 2004

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing
FOIA Ex. 6

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: Audit of SBA Guaranteed Loan
Loan: Rose Enterprises, Inc. d/b/a Putt-Putt Golf & Games
PLP 18104240-10
Lender: GE Capital (loan originated by Heller First Capital Corp.)
St. Louis, MO

We have received the Office of Inspector General (OIG) March 12, 2003, memorandum and accompanying draft audit report for this loan that recommends full recovery of the guaranty payment of \$542,663, less any subsequent recoveries. The main reason for the OIG recommendation is the lender's failure to identify that the borrower lacked repayment ability in the credit analysis.

Since the credit report contains unexplained variances, we believe it is appropriate to allow the lender the opportunity to review and address the inconsistencies and provide any additional information or documentation to address the matter. Therefore, we have requested that the lender respond to the audit findings within 20 days, and have returned the lender's loan files for use in its review. When we receive the lender's response, we will provide a further reply with regard to the audit findings.

If the lender requests a copy of the audit report, may we release a copy pursuant to the request?

AUDIT REPORT DISTRIBUTION

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Associate Administrator for Field Operations.....	1
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