



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

Advisory Memorandum Report

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TO: Herbert L. Mitchell, Associate Administrator,
Office of Disaster Assistance

Michael C. Allen, Area Director,
Atlanta Disaster Office - Area 2

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

SUBJECT: Audit of Early Defaulted Disaster Loan [FOIA EX. 6]

The Office of Inspector General, Auditing Division, is conducting an ongoing evaluation of Early Defaulted Disaster Loans. The results of early defaulted disaster loan audits are being provided on each individual loan reviewed. Our results are intended to bring deficient processing issues to your attention so that you can assess whether any actions are needed to prevent similar issues in the future.

The Small Business Administration (SBA) disaster loan program is the primary Federal disaster-assistance program for funding long-range recovery for victims of hurricanes, floods, earthquakes, tornadoes, wild fires, and other physical disasters. Disaster loans help business owners, individuals, and nonprofit organizations to fund rebuilding, replace personal property, and compensate for economic injury. When disaster victims need to borrow to repair or replace uninsured damages, the low interest rates and long terms available from SBA make recovery affordable. Standard Operating Procedures (SOP) 50 30 4 and 50 31 2 provide specific policy and procedural guidance for making disaster loans.

SBA approved a \$136,600 disaster loan to the [FOIA EX. 6] (borrowers) in [FOIA EX. 6] to repair/replace damaged manufactured housing, personal property, landscaping and cleanup and debris removal. Over a period of 28 months, from February 1999 to June 2001, the borrowers made payments of varying amounts culminating in a 6-month delinquency. The loan was a collection problem starting with the 4th installment

payment due in May 1999. The loan was placed in liquidation in October 1999. Two months after the Office of Inspector General field visit in June 2001, the borrowers made five payments totaling \$4,950 that brought the loan current.

Our audit was conducted during the period June through September, 2001. The audit was conducted in accordance with government auditing standards.

OBJECTIVES & SCOPE

The objective of the audit was to determine whether the early loan default was due to: SBA non-compliance with its policies and procedures, borrower non-compliance with the loan agreement, or borrower misrepresentations.

We reviewed documents in the SBA loan file and interviewed the borrower. Borrower tax returns, financial statements, and accounting records were examined. Additionally, we analyzed the borrower's credit report and searched SBA's Delinquent Loan Collection System (DLCS) database. Finally, the borrower's cash flow and repayment ability were recalculated.

RESULTS

The loan was brought current after our contact during the audit indicating that the borrower may have had the ability to repay the loan. We identified four issues warranting management's attention involving the following areas: (1) unverified information relied on to determine borrower benefits; (2) use of loan proceeds for unauthorized purposes; (3) lack of support for 80 percent of funds received, and (4) false statements by the borrower which were not referred to the OIG. Details of the audit results are discussed below.

1. Unverified Information Relied on to Determine Borrower Benefits

SBA provided excessive disaster benefits to the borrower because the loss verifier and Supervisory Loss Verifier did not accurately record or verify the destroyed property dimensions. As a result, the borrower received a disaster assistance loan greater than the amount needed to replace his loss. Agency procedures do not preclude such a benefit determination.

SOP 50 31 2, Instructions for Disaster Loss Verifiers, states that accurate information and expeditious action by verifiers are necessary for efficient implementation of the disaster loan program. Also, the supervisor is required to review and analyze completed cases for compliance with SBA directives; quality of observation, calculations, and conclusions; and substantiating data.

The loss verifier did not obtain accurate dimensions of the destroyed property (mobile home). The verifier's report, dated July 27, 1998, showed that he accepted borrower provided dimensions of the destroyed mobile home as 2,592 square feet without confirming evidence. The borrower provided figure was over inflated by 40 percent. The

verifier's report also contained the following statement, "Dimensions supplied by A [Applicant]. Lot has been cleared." Based on the borrower provided figures, the verifier calculated the replacement value of the mobile home at \$96,749. In July 1998, the verifier's supervisor signed the report without comment.

We obtained the contract for the pre-disaster purchase of the mobile home from the borrower and found the dimensions were actually 1,848 square feet. Disaster Area Office-2 (DAO-2) management personnel agreed the verifier obtained the wrong square footage and did not verify the dimensions. We were told that the dimensions should have been verified through county tax collector records or other available information such as insurance records or the mobile home purchase contract. At our request, DAO-2 officials recalculated the replacement cost based on 1,848 square feet. Based on the revised square footage, we were told that the borrower should have received \$63,299 for the mobile home replacement.

2. Loan Proceeds were not used for Authorized Purposes

SBA did not ensure the borrower always used proceeds for authorized purposes. Although SBA initialed a Borrower Progress Certification (Form 1366) indicating SBA supervisory review of use of proceeds, SBA officials were unable to explain why the borrower misused proceeds to pay \$2,693 for real estate taxes and \$582 for homeowner's insurance.

The Form 1366 requires the borrower to use loan funds in accordance with the Use-of-Loan-Proceeds paragraph of the Loan Authorization and Agreement. The agreement required the borrower to use the proceeds solely to rehabilitate or replace property damaged or destroyed by the disaster. SOP 50 30 4 Par. 95(c) requires SBA to review the borrower's Form 1366 and necessary receipts, to ensure proper use of proceeds before authorizing further disbursement.

The borrow listed on Form 1366 that they had spent funds to pay for four years of delinquent real estate taxes totaling \$2,267; homeowner's insurance in the amount of \$582; and 1998 real estate taxes totaling \$426. Although SBA initialed the Form 1366 as having been reviewed, we found no indication that the misuse was noted nor was the borrower notified of the misuse. DAO-2 officials stated that the misuse should have been noticed, a note made to the file, and the borrower instructed to cease future misuse. 13 Code of Federal Regulation 123.9 also gives SBA the ability to assess the borrower one and a half times the proceeds that were wrongfully misapplied. Proper review of loan disbursements is a safeguarding control that helps ensure proceeds are used for their intended purpose.

3. Accounting for Use of Loan Proceeds

The borrowers did not provide support for 80 percent of the funds received through any of the five disbursements for this loan, nor did SBA ensure borrower

accountability. As a result, SBA made subsequent disbursements that potentially increased its vulnerability to additional borrower misuse of proceeds.

Borrowers are required to report how loan proceeds were used for at least 80 percent of funds received on the Borrower's Progress Certification, SBA Form 1366, before SBA authorizes subsequent disbursements.

Borrower reporting of use of funds for the 5 disbursements ranged from 0 to 75 percent. Further, there was no indication that SBA addressed these discrepancies before making subsequent disbursements. The borrower accounted for only 48 percent of the total funds disbursed. Although SBA increased its susceptibility to misuse of funds, we determined the borrower used most of the proceeds as authorized. DAO-2 officials stated it appeared they should have issued two-payee checks and sent the verifier back out to confirm use of proceeds. Failure to effectively account for individual loan disbursements increased the potential vulnerability for borrower misuse of proceeds.

4. The Borrower Made False Statements

The Borrower made a false statement by twice not disclosing four years of delinquent real estate taxes. Though there was no opportunity to verify the truthfulness of the borrower statement during the application process, SBA subsequently became aware of the delinquent taxes during loan disbursement. SBA eventually permitted the borrower to cure the problem, but did not refer the false statements issue to the Office of Inspector General. SBA stated that the false statement was not material enough to warrant taking action against the borrower. We have referred this matter to our Investigations Division.

SBA's Home Loan Application, Section F Lines 13, states "All the information on this application and any attachments is true to the best of my knowledge and you may rely on it to provide disaster loan assistance. I understand that I could lose my benefits and could be prosecuted by the U.S. Attorney for making false statements". Additionally, the Affidavit of Ownership to Real Property states "There are no unsatisfied judgements and said premises are free from all leases, mortgages, taxes, assessments, liens, encumbrances and claims, or interest of any other party". SOP 50 30 4 Par. 10 states that questions about truthfulness or accuracy of an application or supporting data and information should be referred to the Office of Inspector General.

The contents of this report were discussed with the Atlanta Disaster Office on August 23, 2001. We are not making recommendations relating to the above instances. You should, however, maintain documentation of any actions you take to address the above issues for future review and follow-up.