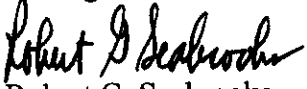




U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, DC 20416

<b>AUDIT REPORT</b>
<b>ISSUE DATE: September 30, 2002</b>
<b>REPORT NUMBER: 2-35</b>

**TO:** Terri Denison, District Director  
Georgia District Office

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

**Subject:** Audit of Early Defaulted Loan to Kalindi LLC/Magnet Properties, LLC.

Attached is a copy of the subject audit report. The report contains one finding and three recommendations addressed to your office. While you agreed with the facts disclosed in the report and the recommendations, changes were made to the report to reflect your suggestion on presentation of the finding. Your comments are synopsised in the report and included as an Appendix.

The recommendations in this report are 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 Forms 1824, Recommendation and Action Sheet.

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

Attachment

**AUDIT REPORT**

**EARLY DEFAULTED LOAN TO**

**KALINDI, LLC./MAGNET PROPERTIES, LLC.**

**WARNER ROBBINS, GEORGIA**

**REPORT NO. 2-35**

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

**AUDIT REPORT**  
**EARLY DEFAULTED LOAN TO**  
**KALINDI, LLC. / MAGNET PROPERTIES, LLC.**  
**WARNER ROBBINS, 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 guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with Administration rules and regulations. SBA is released from liability on the guarantee, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations, the loan authorization, or fails to make, close, service, or liquidate the loan in a prudent manner.

In April 1998, Business Loan Center, Inc. (lender) approved a \$1.556 million SBA guaranteed loan to Kalindi, LLC (borrower #1) to acquire land, make building renovations, pay off an interim construction loan, and pay working capital and closing costs. Kalindi was composed of four partners whose ownership percentages ranged from 15 to 55 percent. Kalindi, unable to pay for cost overruns and to service the debt, defaulted on the loan in May 1999.

In July 1999, Magnet Properties, LLC (borrower #2) was formed by two of the four partners of borrower #1 and a previously unaffiliated principal. The lender, in December 1999, approved a new SBA guaranteed loan for \$1.583 million to borrower #2. The purpose of the new loan was to purchase an existing motel and real property from borrower #1, pay off the existing accounts payable and complete renovations. This loan was in second position behind a \$650,000 piggyback loan from Zions First National Bank.

The loan to borrower #2 defaulted on [Ex. 4] and was placed in liquidation status on [Ex. 4] with an outstanding balance of \$1.577 million. On October 3, 2000, the SBA repurchased the outstanding guarantee for \$747,308.87.

## AUDIT SCOPE AND OBJECTIVES

The audit objective was to determine if the early loan defaults were caused by lender or borrower noncompliance with SBA's requirements. We reviewed the SBA and lender's loan files and borrowers' bank records for both loans. We interviewed district office, lender, and borrower personnel. Audit fieldwork was conducted between September and November 2001. The audit was performed in accordance with generally accepted Government Auditing Standards.

The loans were 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).

## RESULTS OF AUDIT

### FINDING    **The Lender did not Comply with SBA Guidance**

The lender did not comply with SBA's policies and procedures for two related loans. For the first loan, the lender did not ensure that borrower #1 complied with SBA regulations and material conditions of the Loan Authorization. We found that borrower #1 used loan proceeds for unauthorized, improper, and unsupported purposes, and that the lender did not ensure that:

- lien waivers were obtained, as required,
- borrower #1 had the ability to pay additional construction expenses, and
- performance and payment bonds were obtained from an approved source.

These noncompliances reduced the amount of funds available to complete the project and contributed to the loan default. The lender became aware of the noncompliances and, in lieu of submitting the defaulted loan for SBA to honor the guarantee, attempted to complete the project and remedy the default by making a subsequent loan to borrower #2. Borrower #2 was formed by two of borrower #1's partners. The loan to borrower #2 did not meet SBA's eligibility criteria for change of ownership and refinancing, and the lender did not ensure that an equity injection of \$410,000 was made as required by the Loan Authorization. The effect of the subsequent loan was to transfer the lender's loss to SBA. SBA paid about \$747,000 to honor the guarantee.

#### Use of loan proceeds

The lender disbursed the loan proceeds for the first loan to the construction contractor, [ ex. 4 ] based on certifications by the contractor, borrower #1, and the lender's independent inspector. The contractor, in turn, either disbursed the proceeds to specific payees or to [ ex. 4 ] a company owned by one of the borrower's principals. [ ex. 6 ] disbursed some of the proceeds it received to the ultimate payees. A review of the borrower's records disclosed the following:

#### *Unauthorized use of loan proceeds*

Approximately \$170,000 in loan proceeds was inappropriately provided to associates of borrower #1. Two of borrower #1's partners were president or chief executive officer of companies that received payments from the loan proceeds. After the loan defaulted, a review of the use of proceeds would have disclosed these unauthorized payments.

DATE	PAYEE	TYPE OF RELATIONSHIP	AMOUNT	SOURCE/CHECK#
August 28, 1998	[ ]	Associate/Unaffiliated Business	\$10,000.00	[ ]
August 28, 1998	ex. 4,	Associate/Unaffiliated Business	\$30,000.00	ex. 4
August 28, 1998	6	Associate/Unaffiliated Business	\$100,000.00	
September 28, 1998	[ ]	Associate/Unaffiliated Business	\$30,000.00	[ ]
		Total	\$170,000.00?	

Chapter 2, paragraph 11(a) of Standard Operating Procedure (SOP) 50 10 (4) states that loan proceeds cannot be used to make payments to any associate of the borrower, other than to reimburse the associate for services actually rendered, and then at a fair and reasonable rate. Neither the lender nor borrower #1 could provide support that the payments were for services rendered or products obtained at a fair and reasonable rate.

*Improper and unsupported use of loan proceeds*

Additionally, \$49,600 of loan proceeds were used for improper purposes. Each of these improper uses was in violation of SOP 50 10 (4) and the requirements for completing various SBA forms. A review of borrower #1's records disclosed the following transactions:

- Funds totaling \$21,600 improperly paid for loan packaging fees. These fees were not disclosed on the SBA Form 4, Application for Business Loan, or SBA Form 159, Compensation Agreement, as required by SOP 50 10(4).
- Funds totaling \$2,000 improperly paid for attorney fees. These fees were not part of the closing costs and were not reported on the SBA FORM 4 or SBA Form 159, as required.
- Funds totaling \$26,000 were improperly used to pay an undisclosed partnership debt due to a third party. Per two of borrower #1's principals, this amount was interest applicable to funds borrowed for the purchase of the business real property.

Also, our review disclosed the expenditure of \$97,000 of the loan proceeds was unsupported.

- Payment of \$97,000 for contractor general costs and performance and payment bonds was not supported by appropriate documentation. Neither the lender nor borrower #1 had evidence showing dates the contractor services were performed or describing the services rendered, and we could not find an invoice or receipt showing the actual cost of the bonds. SOP 50 10 (4) requires the lender to document that the loan proceeds were used for authorized purposes.

**Lien waivers not obtained**

Lien waivers for the first loan were not obtained for construction costs totaling about \$185,835. After the loan defaulted, the lender became aware that a portion of the loan funds would be used to pay off mechanic liens that had been placed on the property. The lender was aware that these liens would be a liability that took priority over the SBA and lender security position. All lien holders were eventually paid from proceeds of a subsequent loan. The following table provides a list of material men, contractors, and subcontractors who were not paid by borrower #1 and, therefore, did not provide lien waivers.

Purpose	Unpaid Liens and Payables
	\$21,861.88
	\$3,335.46
	\$33,000.00
	\$22,000.00
	\$4,501.64
Ex. 4 + 6	\$26,161.54
	\$15,384.00
	\$30,000.00
	\$7,544.33
	\$17,115.84
	\$4,794.00
	\$138.42
<b>Total Liens and Payables</b>	<b>\$185,835.43</b>

SOP 50 10 (4), SUBPART A, Chapter 6, paragraph (6)(e)(5)(f) requires that, prior to any disbursement, lien waiver be obtained from all contractors, subcontractors, independent workers, and suppliers of material connected with the project.

**Borrower #1's inability to pay additional construction costs**

As a result of damages resulting from an incident of theft and vandalism, borrower #1 incurred additional construction costs totaling \$348,000. On December 23, 1998, the lender approved a modification to the Loan Agreement, increasing the authorized amount for construction purposes from \$1,156,240 to \$1,319,200.

We found no evidence that the lender, prior to approving the contract modification, performed an analysis to determine whether borrower #1 had the ability to pay additional construction costs. Evidence found in the lender's credit analysis of the subsequent loan to borrower #2 disclosed that borrower #1 did not have additional financial resources to pay the additional costs.

Section I (7)(d)(1) of the Loan Authorization stated that the lender must obtain evidence of borrower's ability to pay cost overruns or additional construction financing expenses prior to approving any contract modification.

**An approved surety not used to obtain bonds**

The lender did not ensure that an approved surety issued the required performance and payment bonds for the first loan. Borrower #1 provided evidence that bonding was obtained by the contractor from [ Ex. 4 ] We contacted the U. S. Department of Treasury and the State of Florida Insurance Commission to determine whether the surety had the proper approval. Neither government entity had a record of the surety and, therefore, could not attest that the surety had the proper approval.

Section 120.200 of Title 13 of the Code of Federal Regulations states that the borrower must supply a 100 percent payment and performance bond and builder's risk insurance, unless waived by SBA. Section I(7)(c)(1) of the Loan Authorization states that the lender must obtain evidence from the borrower of his having obtained the performance and payment bond from a

surety approved by the U.S. Department of Treasury. We found no evidence that either SBA or the lender waived the requirement for surety bonding or the qualification of the surety. Our efforts to contact the surety indicate that the surety may not exist, and therefore, the project never had the required bonding.

### **Impact of noncompliances**

As a result of the aforementioned noncompliances, borrower #1 had insufficient funds to complete the project, defaulted on the first loan, and placed SBA at risk for the guarantee amount. The lender became aware of the aforementioned noncompliances after borrower #1 defaulted and prior to approving a subsequent loan to borrower #2. In lieu of submitting the loan to SBA for a purchase review which may have identified some or all of the noncompliances, the lender approved a new loan to borrower #2 using preferred lender processing procedures. Preferred lender procedures did not provide SBA the opportunity to review the loan file or the subsequent loan application package. As a result, the noncompliances applicable to borrower #1 and the deficiencies in the subsequent loan application of borrower #2 were concealed.

The subsequent loan to borrower #2 was not eligible for an SBA guarantee because it did not meet change of ownership financing requirements. In addition, the lender did not ensure that the borrower made the required equity injection or, in the event the change of ownership criteria was not applicable, met required refinancing criteria. As a result, SBA paid about \$747,000 to honor a guarantee that should not have been made. Details follow.

### **The loan to Magnet did not qualify as a change of ownership**

Borrower #2's original two partners each had a 15 percent partnership interest in borrower #1. Initially, they each owned 50 percent of borrower #2, but their ownership percentages were reduced to 15 percent when a third partner was added in October 1999 and was given 70 percent ownership. His partnership percentage was the result of a \$30,000 loan he made to borrower #1 in August 1999.

A purchase agreement executed between borrower #1 and borrower #2 in November 1999 stated that borrower #2 would acquire all of borrower #1's tangible and intangible assets for a purchase price of about \$2.5 million. The sale price was composed of the following:

Pay off existing loan and taxes	\$1,632,141
Existing bills and liens on property	232,315
Standby notes to two Kalindi partners not in Magnet	258,783
Credit for equity of 2 Kalindi partners in Magnet	<u>410,000</u>
Total	\$2,533,239

This purchase price appears to be based on borrower #1's outstanding debt and the equity interest of its principals. We noted that the purchase price was about \$500,000 more than the original deal even though the renovations had not been completed and construction had ceased. There was no evidence that a business valuation was obtained to support the purchase price.



Subpart "B" of SOP 50 10(4)(B), paragraph 3(b) requires that a change of ownership be an arms-length transaction and defines arms-length as a "reasonable representation of the fair market value - the price which an independent buyer would be willing to pay." The SOP further states that to determine whether an ownership change qualifies as arms-length a determination of value of what is being acquired must be performed.

Paragraph 3(c) of the same SOP states that the selling price of the business must be compared to the business valuation as determined by an independent party prior to loan approval or disbursement. The SOP applies the requirement for a business valuation to both acquisitions of going concerns and acquisitions of assets. Not only was there no business valuation of borrower # 1's assets, but the "arms length" of the transaction was further compromised by the fact the lender was the same for both loans and two of the partners were the same for both businesses.

Paragraph 3(e) of the SOP states that if a buyer is not an owner of the selling company, the loan proceeds must be used to purchase 100 percent of ownership interest of all owners. The paragraph also states that there can be no purchase directly by an existing partner. Borrower #2 did not purchase 100 percent of the ownership interest of all owners. Two of the Kalindi partners received compensation in the form of standby notes equal to the amount of capital they claimed they put into Kalindi. These notes were incorporated in the Loan Authorization. The remaining two partners received no compensation as they were partners in Magnet.

#### **The required equity injection was not made for loan #2**

An equity injection for the subsequent loan to borrower #2 was not made as required by the Loan Authorization. Evidence of the cash injection provided by borrower #2 and accepted by the lender consisted of photocopies of 28 cancelled checks totaling about \$442,000. Our review of these checks disclosed that all of these checks were applicable to the first loan to borrower #1. We noted that 7 checks, totaling about \$174,000, appeared to be cash from the principals for the building purchase, the franchise fee, and other project related expenses. We determined that 16 checks totaling about \$161,000 were loan proceeds to borrower #1. The remaining 5 checks, totaling about \$107,000, were debt service payments by borrower #1's for its loan.

#### **PLP lender refinanced its own defaulted SBA debt**

As previously stated, the lender declared its loan to borrower #1 in default in May 1999, and, using PLP procedures, approved a loan to borrower #2 in December 1999. The lender was aware that borrower #1 had a poor loan payment history, the new funds would be used for the same project, and two of borrower #1's partners were also partners of borrower #2.

Subpart "A" of SOP 50 10 (4), Chapter 2, paragraph, 12(d)(4) states that loans to refinance or pay off an existing SBA guaranteed loan must be processed under standard procedures. Paragraph 12(e) of the SOP states that no debt already guaranteed by SBA can be refinanced under expeditious loan processing procedures, except for specific circumstances. This loan did not meet those specific circumstances.

SOP Subpart "D", Chapter 3, paragraph 7(a)(4) states that PLP proceeds can only be used to repay debt due the PLP lender when the new loan is an interim non-construction loan approved within 90 days of the PLP application or is an undisbursed interim construction loan. This loan did not meet either of these exceptions.

The Loan Authorization, Section I (5)(a), required the lender to obtain evidence that prior to disbursement at least \$410,000 in cash was injected into the business as equity and used for renovations. If the acquisition of the assets applicable to loan #1 by borrower #2 is a change of ownership transaction as the lender contends, then funds used for the first loan cannot be used to satisfy the equity injection requirements of the subsequent loan.

### **SBA refinancing criteria were not met**

Although the lender categorized the loan as a change of ownership, we believe it could be considered alternatively as a refinancing. However, the loan to borrower #2 could not be considered an eligible refinancing as the loan did not provide at least a 20 percent increase in the business's pro forma cash flow.

A re-calculation of borrower #2's pro forma cash flow showed that the new installment amount decreased the pro forma cash flow by approximately \$1,752 (2.1 percent) when compared with the existing installment amount. If the installment amount for the piggybacked loan were included, the pro forma cash flow decreased by approximately \$79,764 (94.4 percent).

Subpart "A" of the SOP, Chapter 2, paragraph 12(a)(1) states that when refinancing long term debt, the business must receive a permanent substantial benefit and defines substantial benefit as at least a 20 percent increase to the company's cash flow as measured by the changes in the debt service requirement between the existing and new debt. As shown above, Magnet's cash flow did not have a 20 percent improvement as a result of the refinancing.

### **Overall Conclusion**

We conclude that the above described significant deficiencies were egregious acts and warrant SBA's action to seek civil fraud remedies against the lender. Specifically, the lender failed to disclose (a) borrower #1's unauthorized and improper use of loan proceeds, (b) the relationship between the principals of loan #1 and loan #2 prior to approval, and (c) that loan #2 would repay the lender's prior loan to the borrower. Also, the lender did not comply with requirements of the Code of Federal Regulations and the loan authorization concerning (i) properly controlling the use of loan proceeds for loan #1, (ii) analyzing borrower #1's ability to pay additional construction costs prior to modifying the loan agreement, (iii) ensuring borrower #1's compliance with the terms of the loan authorization regarding lien waivers and surety bonds, (iv) ensuring borrower #2's compliance with the requirement for an equity injection, (v) submitting loan #2 to SBA using regular loan procedures, (vi) obtaining an independent business valuation for loan #2, and (vii) ensuring that loan #2 met refinancing criteria. Accordingly, the lender's failure to follow prudent lending practices and materially comply with SBA requirements undermined the integrity of the Section 7(a) business loan program.

## **Recommendations**

We recommend that the District Director, Georgia District Office, take the following actions:

- 1.A** Request the Administrator to deny liability for the loan to Magnet Properties LLC. and seek recovery from the lender of principal totaling \$747,308 plus interest and expenses paid by SBA.
- 1.B.** Consider recommending suspension of the lender's preferred lender program status in the Georgia District Office due to its failure to comply with SBA regulations, policies, and procedures for originating loans.
- 1.C.** Coordinate with the Office of General Counsel to ensure necessary action is taken to pursue civil enforcement remedies against the lender under the False Claims Act, 31 U.S.C. §3729(a).

## **Management Comments**

The District Director, Georgia District Office stated that she did not have access to the file for loan #1, and therefore, could not fully comment on the issues cited in the report. She stated that she deferred to the OIG regarding the facts and dollar values stated in the report and does not dispute OIG's application of the SBA regulations and standard operating procedures.

Concerning loan #2, the district director stated that she concurred with the finding and conclusions regarding the loan's ineligibility as a change of ownership and only partially concurred with the OIG's finding that refinancing criteria was not met. She stated that she thought the report should focus on the ineligibility of the loan as a change of ownership and that if ineligibility as a refinancing was cited, it should be made clear that this is a secondary position of the OIG and not a contention of the lender.

She added that she thought the disclosure that loan #2 should not have been processed under PLP procedures because part of the proceeds were used for the lender to pay off its own debt should be elevated to a separate finding due to its substantive nature. In addition, she stated that there should be a finding that loan #2 was ineligible because it included a flow through of funds to the associates. She concurred with each of the recommendations.

## **Evaluation of Management's Comments**

We concur with management's comments and have modified the report to reflect that the ineligibility of loan number 2 due to refinancing as a secondary issue and we elevated the discussion of the processing of loan number 2 under PLP procedures to a more prominent position in the finding. We did not add the district director's point concerning the flow through of loan proceeds to associates as we believe this fact is indirectly addressed in the discussion about the required equity injection not being made.



## U. S. SMALL BUSINESS ADMINISTRATION

GEORGIA DISTRICT OFFICE  
233 Peachtree Street, N.E., Suite 1900  
Atlanta, Georgia 30303

### Appendix A

Date: September 30, 2002

From: Terri L. Denison  
District Director  
Georgia District Office

To: Robert G. Seabrooks, Assistant Inspector General for Auditing  
Office of the Inspector General

Subject: Response To Draft Audit Report-- Kalindi, LLC/Magnet Properties, LLC, Warner Robbins, GA

#### Limitations on Comments

The Georgia District Office (GDO) does not have access to files for the guaranteed loan made to Kalindi, LLC (Borrower/Loan #1) on which OIG based its findings regarding Loan #1. Therefore, GDO cannot fully comment on the issues cited in the draft report related to Loan #1, which are:

- Use of loan proceeds
  - Unauthorized use of loan proceeds
  - Improper and unsupported use of loan proceeds
- Lien waivers not obtained
- Borrower #1's inability to pay additional construction costs
- An approved surety not used to obtain bonds

GDO defers to OIG regarding the facts and dollar values stated in the draft report since it obtained and reviewed the lender's files for Loan #1. Assuming that these facts and figures are correct, GDO does not dispute OIG's application of the SBA regulations or standard operating procedures cited for the above findings.

GDO does concur with the synopsis of the "Impact of Noncompliance" stated on page 5 of the draft audit report.

GDO concurs with the follow sections of the draft report in their entirety:

- The loan to Magnet did not qualify as a change of ownership
- The required equity injection was not made for loan #2

GDO concurs with the findings and conclusions regarding Loan #2 ineligibility as a change of ownership

GDO does not fully concur with the finding "SBA refinancing criteria were not met"

- One can argue that the lender, Business Loan Center, most likely classified Loan #2 as a change of ownership to justify processing the loan under PLP procedures. However, since the lender has asserted that change of ownership was the basis for its processing Loan #2 under PLP procedures, the audit report should focus on the ineligibility of this loan as a change of ownership.
- If OIG still feels strongly about leaving in the citing of the loan's ineligibility as a refinancing, it should be made clear in the final report that this point is a secondary position of OIG, not a contention of the lender. That is, even if Loan #2 was miscategorized as a change of ownership

and was now evaluated as a refinancing, it still would be ineligible for the reasons cited in the report. Of the two reasons cited under this finding, the stronger of the two is the fact that the PLP lender refinanced its own defaulted SBA debt. Citing the lack of substantial benefit to the borrower does not contribute to the strength of the argument and may even dilute it. If OIG chooses to keep the refinancing issue in to final report and cite both of these justifications, we recommend that the refinancing of the lender's own defaulted SBA debt should be stated first.

In addition to the findings cited in the draft report, there are two other findings that we feel should be included in the final audit report:

- 1) Loan #2 should not have been processed under PLP procedures since part of the proceeds were used for the lender to pay off its own debt. The draft audit report correctly cites SOP 50-10, Subpart D, Chapter 3, paragraph 7(a)(4), which gives the only condition under which a loan processed under the PLP can repay debt due the PLP lender. We concur with OIG's finding that Loan #2 does not meet this condition. However, it is our contention that this is a substantive and distinct finding. Therefore, it should be stated in the final report as a separate finding since the SOP makes a distinction between refinancing and paying off debt due a PLP lender.
- 2) Loan #2 ineligible use of proceeds included a flow through of funds to the associates. See SOP 50-10, Subpart A, Chapter 2, Paragraph 11a. The draft audit report states, and we concur, that the \$410,000 required cash injection was not made. Therefore, the \$410,000 credit for equity of the two Kalindi partners in Magnet, this credit being a component of the sales price of Kalindi LLC to Magnet LLC, is really a flow through of that portion of the loan proceeds from Loan #2 to these two associates.

Regarding the recommendations outlined in the draft report:

1. A. Request the Administrator to deny liability. We agree that the Lender should reimburse the agency for the guaranty purchase. However, consistent with standard operating procedures regarding liability denials, the GDO should first give the lender an opportunity to voluntarily agree to repay the amount of the Agency's purchase or pay another mutually agreed upon amount representing actual loss to the agency (for instance, if some of the figures or facts cited are successfully disputed by the lender later).
1. B. Consider recommending suspension of the lender's preferred lender program status in the GDO. We concur with this recommendation.
1. C. Coordinate with the Office of General Counsel to ensure necessary action to pursue civil enforcement remedies against the lender under the False Claims Act. We will cooperate with OGC and OIG in any further legal actions they pursue, as required by law.

Please feel to contact me or Frank Hagan, Assistant District Director for Economic Development, if you have additional questions or comments.

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