



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

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AUDIT REPORT
ISSUE DATE: November 10, 2003
REPORT NUMBER: 4-01

TO: Wilfredo J. Gonzalez, District Director
North Florida District Office

[FOIA Ex 6]

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

SUBJECT: Audit of an Early Defaulted Loan to FOIA Ex. 4
FOIA Ex. 4

Attached is a copy of the subject audit report. The report contains one finding and one recommendation. The report is being presented as a final document because the lender withdrew its guaranty request prior to completion of the audit. A copy of the letter is attached. Disagreements with the audit finding and recommendation can be addressed during the audit follow-up and resolution process as discussed below.

The finding in this report is the conclusion of the Office of Inspector General, Auditing Division. The finding and recommendation are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution. Please provide your management response 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. The form should be sent to:

Audit Manager
SBA OIG/Atlanta Field Office
233 Peachtree Street, NE, Suite 1803
Atlanta, Georgia 30303

Should you or your staff have further questions or comments, please contact Garry Duncan, Director, Credit Programs Group, at (202)205-7732.

Attachments

AUDIT REPORT
EARLY DEFAULTED LOAN TO

[FOIA Ex. 4]

November 10, 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.

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AUDIT REPORT
EARLY DEFAULTED LOAN TO
[**FOIA Ex. 4**]

Table of Contents

	Page
Background	1
Audit Objective and Scope	1
 RESULTS OF AUDIT	
Finding and Recommendation	
The Lender did not Materially Comply with SBA Requirements and the Loan Authorization	2
 Appendices	
A. Withdrawal of Guaranty Letter	
B. Report Distribution	

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 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 Authorization, or did not make, close, service, or liquidate a loan in a prudent manner.

Bank United (lender) was authorized by SBA to make guaranteed loans under the Preferred Lender's program (PLP). Under PLP procedures, the lender is allowed to process, service, and liquidate loans with reduced requirements for documentation and prior approval by SBA. The lender was purchased by Washington Mutual Bank, also a PLP lender, in February 2001.

[FOIA Ex. 4] (borrower) was established in December 1999 to facilitate the sale of a portion of an existing daycare center, FOIA Ex. 4 [FOIA Ex. 4] . Established in 1986, FOIA Ex. 4 [FOIA Ex. 4] provided childcare services to infants and children and operated from two separate locations in [FOIA Ex. 4] The owner sold both locations as separate businesses to different buyers in November 1999 and January 2000.

In December 1999, the lender approved a \$923,000 SBA guaranteed loan, Number [FOIA Ex. 4], to the borrower using PLP processing procedures. The purpose of the loan was to purchase the business and provide working capital. The loan was disbursed in February 2000. The borrower defaulted in November 2000 with the loan transferring to liquidation status in January 2001. The lender has been unable to liquidate the collateral because the borrower filed a countersuit on its efforts to foreclose on the property. The borrower subsequently filed for bankruptcy and the judge stayed all foreclosure actions. As of the issuance date of this audit report, the lender and borrower are still in litigation.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the lender and borrower materially complied with SBA's requirements when originating, closing, and liquidating the loan. The loan was judgmentally selected for review based on its dollar value 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). We reviewed the loan files, the loan authorization, and the subpoenaed seller's financial records. We also interviewed SBA, lender, and other personnel. The audit was performed in Atlanta, Georgia, during March through August 2003 in accordance with generally accepted Government Auditing Standards.

AUDIT RESULTS

Finding -The Lender did not Materially Comply with SBA Requirements and the Loan Authorization

The lender did not materially comply with SBA rules and regulations and the loan authorization in its approval of a \$923,000 SBA guaranteed loan to the borrower. Specifically, the lender did not:

- use appropriate data in assessing repayment ability,
- verify financial data with the Internal Revenue Service,
- ensure that the purchase price was reasonable, and
- ensure that the borrower was operating lawfully.

Because of these deficiencies, SBA would have made an improper payment of \$692,250 had the lender not withdrawn its guarantee request as a result of the audit.

Inappropriate financial data used to assess repayment ability

The lender used inappropriate financial data in assessing the repayment ability of the borrower. Financial data used by the lender was not accurate because the data represented the combined financial activity of the seller's two childcare locations. As a result, repayment ability was not properly determined.

The seller owned [FOIA Ex. 4], which operated from two locations: [FOIA Ex. 4]. Both locations were sold within 6 weeks of each other in separate transactions to buyers who obtained SBA guaranteed loans from different lenders. We reviewed both loan files and determined that the financial data used to support our borrower's loan included the activities of both locations.¹ There were a number of indicators that should have alerted the lender that the financial data was not accurate.

- Tax returns and financial statements used by the lender did not contain the same name of the school being purchased. Tax returns also reflected a different address from the property being purchased with the SBA loan.
- The appraisal report, issued prior to loan closing, stated that the income for both locations was included in the reported financial data and, therefore, was not an accurate financial picture of the subject property.
- The IRS Form 4506 contained addresses for both locations previously mentioned.
- The balance sheets submitted by the seller identified large assets for both school locations.

¹ The second SBA loan was current as of September 30, 2003.

To determine the financial status for the location being purchased, we obtained the seller's business records. A detailed cash flow analysis of the financial operations disclosed that adequate historical repayment ability did not exist from the business' operations. The lender's analysis was not valid because it relied on historical financial data for both of the seller's childcare locations. Our analysis showed that [FOIA Ex. 4] was available from the 1998 operating year to service SBA annual debt of \$108,564.

Detailed Cash Flow Analysis

	BALANCE SHEET 11/97 (COLUMN A)	BALANCE SHEET 11/98 (COLUMN B)	CASH FLOW COMPUTATION
Net Income (Loss)			
Beginning Cash (As of November 1997)			
Current Assets (Column A-B)		FOIA	
Fixed Assets (Column A-B)		EX. 4	
Other Assets (Column A-B)			
Liabilities (Did not Transfer to New Owner)			
Net Cash After Operations			

*We used the 12-month period from November 1997 through 1998 since balance sheets for the December financial statements were not available.

**We added annual interest expense back to net income since the previous owner's debt was not transferred to the new owner.

SOP 50 10 (4), subpart A, chapter 4 states that the financial strength of a business can be judged by the analysis and consideration of the business' balance sheets, working capital adequacy, and evaluation of repayment ability. The SOP further states the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. Because the lender used improper financial data in assessing the strength and ultimate repayment ability of the SBA loan, the loan approval process was flawed.

IRS verification of financial data

The loan file did not contain evidence that the lender verified the seller's financial data with the Internal Revenue Service. The loan authorization stated that "prior to disbursement of the loan proceeds, the lender must obtain evidence that the financial information submitted to support the loan application is accurate using procedures required by SBA." It further stated that the borrower must resolve any questions on accuracy to the satisfaction of the lender and SBA before loan funds are disbursed.

The loan file contained a signed IRS Form 4506, Request for Copy or Transcript of Tax Form. There was no evidence that the requested information was received by the lender. We obtained the loan file for the second childcare location that was sold about the same time as the

subject loan. IRS verification data was, in fact, in the second lender's file. The same financial information was erroneously used to support both loan transactions.

Business valuation

The lender did not ensure that the purchase price of the business was reasonable. To determine the value of the business, the lender used a real estate appraisal in lieu of a business valuation. In addition, the real estate appraisal contained an unrealistic conclusion about enrollment. Because the value of the business was not properly determined, the lender had no assurance that the purchase price was appropriate.

Valuation Methods

SOP 50 10(4)(e), subpart A, chapter 5 states, "When SBA proceeds are to be used in connection with the acquisition of a going concern, a determination of the value of what is being acquired shall be conducted based on generally accepted valuation methods used for the industry in which the business operates." Also, SBA Policy Notice 5000-693 requires lenders to use at least two methods to establish a range of values. We did not see evidence in the lender's file that two of the generally accepted valuation methods were used to ascertain the appropriateness of the purchase price.

Unrealistic enrollment increases

The appraised value of the facility was based, in large part, on the center's proposed enrollment capacity which would result from the increased square footage of the existing property. The appraiser used the proposed capacity figure of 205 children which was based on the planned conversion of an existing single family residence located on the site. The expansion would increase total capacity by 55 children, or 37 percent. Actual enrollment at the school at the time of the appraisal was about 75 children.

Although the borrower had included the increased enrollment in its business plan, it did not state the source of the funds needed for the planned conversion of the single family residence. Funds for this purpose were not provided in the financing package and there was no evidence that the principals of the borrower had the funds. In addition, there was no requirement in the loan authorization for the borrower to expand the current size of the childcare center. The appraiser should have considered the reasonableness of the proposed expansion in light of the lack of funds and should have adjusted the real property value accordingly.

Required licensing and registration

The lender did not ensure the borrower was operating lawfully. The loan authorization required that, prior to disbursement of the loan proceeds, the lender obtain from the borrower proper corporate documents and evidence that the borrower had all insurance, licenses, permits,

and other approvals necessary to lawfully operate the business. Licensing officials of the Florida Department of Children & Families informed us that new licensing is mandatory upon any change of ownership for a child care facility. Although the loan closed in January 2000, the new owners did not apply for a license until September 2001, approximately 21 months after the purchase of the business.

Also, the lender did not ensure that the name of the business was properly registered. According to the corporate certificate contained in the lender's file and the corporate filing documents, the corporate name of the borrower was FOIA Ex. 4 not FOIA Ex. 4 as shown in the loan documents. The correct name of the business, FOIA Ex. 4 is not reflected on either the lender or SBA's financial records. The name of 'C FOIA Ex. 4 was rejected by the State of Florida in December 1999 because of its similarity to an existing business, presumably the original business' name which is still owned by the seller.]

Lender's Release of the Guaranty

We held a telephone exit conference with the lender on August 27, 2003, to discuss our tentative audit findings. As a result, on September 3, 2003, the lender issued a letter to the North Florida District Office releasing the Agency from its guaranty of \$692,250 for the subject loan (see Appendix A).

Recommendation:

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

- 1.A Annotate SBA's loan accounting system to reflect the lender's release of the loan guaranty of \$692,250.

Management Comments

Our audit results were discussed telephonically with a representative of the district office. The representative stated that she did not have a problem with the findings.

Evaluation of Management Comments

Management's comments are acceptable.



U.S. Small Business Administration
North Florida District Office
7825 Baymeadows Way, 100B
Jacksonville, FL 32256
Attn: Stephen R. Hale

September 3, 2003

business
banking

Re: PLP No. [FOIA Ex. 4]
Borrower Name: [FOIA Ex. 4]

Dear Mr. Hale:

This letter is to advise you that Washington Mutual Bank, PA, successor by merger to Bank United, has decided not to submit a request for payment under the SBA guaranty on the above-referenced loan. WAMU is not waiving any of its rights and remedies against the borrower(s) and the guarantors(s).

Thank you for your time and consideration.

Please call me if you have any questions.

Sincerely,

[FOIA Ex. 4]

Vice President
Credit Administration

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