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

AUDIT REPORT
ISSUE DATE: January 8, 2004
REPORT NUMBER: 4-06

To: Lavan D. Alexander, District Director
Dallas/Fort Worth District Office

/S/ Original Signed
From: Robert G. Seabrooks, Assistant Inspector General
for Auditing

Subject: Audit of a SBA Guaranteed Loan to [FOIA Ex. 4
FOIA Ex. 4]

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your verbal response is included in the report.

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) 205-7732.

Attachments

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AUDIT OF A SBA GUARANTEED LOAN TO

FOIA Ex. 4

FOIA Ex. 4

FOIA Ex. 4

FOIA Ex. 4 TX

AUDIT REPORT NO. 4-06

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.

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AUDIT OF A SBA GUARANTEED LOAN TO

[FOIA Ex. 4]

FOIA Ex. 4 TX

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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 SBA regulations, policies, and procedures. SBA is released from liability on a loan guarantee, in whole or in part, within SBA's exclusive discretion, if a lender did not comply materially with SBA regulations, the Loan Agreement, or failed to originate, service, or liquidate a loan in a prudent manner.

The loan was approved by Associates Commercial Corporation of Delaware (Associates). Associates was a Small Business Lending Company (SBLC) authorized by SBA to make guaranteed loans under the Preferred and Certified Lenders Programs. The SBLC program was established to provide financial assistance to eligible small business concerns in the form of SBA guaranteed loans. Unlike other SBA lenders, SBLCs are non-depository lending institutions that are licensed and regulated by the SBA. SBLCs are authorized to make SBA loans under the Preferred Lender Program (PLP) subject only to an eligibility review by SBA. Associates were purchased by CitiCapital Small Business Finance, Inc (CitiCapital) effective July 1, 2001. CitiCapital became responsible for all decisions regarding SBA loans made by Associates. The term "lender" as used in this report refers to both entities.

The lender approved a SBA guaranteed loan FOIA Ex. 4 for $1.4 million to [FOIA Ex. 4] (borrower), under the Preferred Lenders Program on April 20, 2000. The purpose of the loan was to provide funds for the purchase of land and make improvements for the operation of a convenience store with gasoline pumps in FOIA Ex. 4 TX. The loan was disbursed on May 11, 2000. The borrower defaulted on the loan in August 2000 after making only one loan payment. In October 2000, the borrower abandoned the property. SBA purchased the guaranty for $777,516 in January 2002.

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 requirements found in SBA rules and regulations and the SBA lender guaranty agreement. During the audit, we examined the loan files maintained by SBA and the lender. We also interviewed lender officials. The audit of the subject loan was conducted in Washington, DC during July and August 2003, in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding - The Lender made a Loan to a Borrower that Lacked Repayment Ability

The lender made a material error in assessing the borrower's repayment ability, which led to an incorrect conclusion regarding cash flow potential. As a result, the lender made a loan to a borrower that did not have repayment ability. The borrower defaulted on the loan after only one payment causing SBA to make an improper payment of $777,516 when it honored the guaranty.

Standard Operating Procedure (SOP) 50 10 (4), entitled "Loan Servicing" provides that the most important consideration in the loan making process is the ability to repay a loan from the cash flow of the business. The lack of repayment ability from the cash flow of the business dictates that the application be denied. The SOP further provides that projected cash flow must be realistic and tested against industry averages. Significant variations must be explained.

Market Analysis

The borrowing business consisted of several gasoline pumps and a convenience store that included space for a quick service restaurant and a golf shop. According to the loan officer's report, projected revenue was based on the applicant's operating experience and a 1997 market analysis developed by Ex. 4 Inc. known as the Ex. 4 fires Report. The report identified the total potential demand for gasoline, convenience store, and a co-development such as a franchise, within a three-mile trade area of the borrowing business. Originally, the borrower planned to sell Ex. 4 gasoline, but switched to Ex 4 gasoline because the retail price was slightly lower that other major brands.

The potential demand estimate in the Ex. 4 fires Report was based on three factors: (1) the number of households within the trade area (residential); (2) customers traveling through the trade area (transient), and (3) individuals employed within the trade area (daytime population). According to the report, the total potential demand for gasoline within the three-mile trade area was 925,808 gallons per month or 11.1 million gallons annually. A breakdown of the three demand factors is shown below.

Demand Factor	Monthly Demand	Annual Demand
Residential	414,858	4,978,296
Transient	451,000	5,412,000
Daytime Population	59,950	719,400
Total	925,808	11,109,696

The Ex. 4 fires Report identified 22 competitors operating within the three-mile trade area, 10 of which were considered major competitors. The 22 competing businesses were selling a combined total of just over 10,956,000 gallons of gasoline annually. This left an annual unmet demand for gasoline of 153,696 gallons (11,109,696 – 10,956,000). The report also showed the impact of the borrowing business on competitors in the trade area. It was estimated that the borrower would draw 25,068 gallons of gasoline from the combined sales of its competition or 0.22 percent of total sales annually. Combined with the unmet demand, this increased the borrower's maximum potential gasoline sales to 178,764 gallons annually (153,696 unmet demand + 25,068 drawn from other business), or 14,897 gallons per month.

Projected Sales

The borrower projected gasoline sales of $3.4 million during the the first year of operation. Based on the total amount of unmet demand in the three-mile trade area and the national price for gasoline at time of loan approval ($1.54 per gallon), the borrower's maximum annual sales could only be $275,300, which is 92 percent less than projected sales. In order to achieve projected sales of $3.4 million, the borrower would have to sell 2.2 million gallons of gasoline annually

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($3.4 million \ $1.54), which is more than 11 times the available unmet demand in the borrower's trade area. Thus, projected sales of $3.4 million were unrealistic based on available demand.

The over-projection was likely due to an apparent error in the summary of the 4 fires Report. The summary showed that unmet demand for gasoline in the three-mile trade area was 168,273 gallons per month, or 2,019,276 gallons annually. This was not supported by the detailed market analysis in the body of the report, which showed that unmet gasoline demand in the borrower's trade area was only 14,897 gallons a month, or 178,764 gallons annually. This is less than nine percent of the amount in the report summary. The lender, however, did not detect this error and apparently relied on the erroneous summary figures to support projected sales revenue and repayment ability.

The lender provided the following explantion for the discrepancy in the 4 fires Report:

> *"I believe the 168,273[gallons shown in the summary section] is a monthly figure but appears to be in significant error given the other information presented. The total potential fuel sales in gallons was 925,808/monthly. The current volume based on open store is approx. 913,000. I do not understand how any significant volume can be derived using the figures provided in the 4 fire report."*

Competitors Sales Volume

Table 1 shows adjusted sales for the top ten major competitors within the three-mile trade area compared with the projected sales volume of the borrower.

Table 1

Ten Major Competitors by Volume of Gasoline Sales

Brand Name of Competitors	ANNUAL GASOLINE SALES (GALLONS) Competitor Sales (Adjusted)	Borrower Projected Sales	Amount Borrower Projected Sales Exceed Competitor	% Borrower Projected Sales Exceed Competitor
[	535,620	2,019,276	1,483,656	277
	539,952	2,019,276	1,479,324	274
	597,276	2,019,276	1,422,000	238
FOIA	597,936	2,019,276	1,421,340	238
Ex. 4	598,224	2,019,276	1,421,052	237
	599,964	2,019,276	1,419,312	237
	718,368	2,019,276	1,300,908	181
	777,312	2,019,276	1,241,964	160
	779,904	2,019,276	1,239,372	159
]	1,320,000	2,019,276	699,276	53

As shown above, the borrower was expected to sell more gasoline during its first year of operation than the top ten major competitors in the three-mile trade area by as much as 277 percent.

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Cash Flow Analysis

Table 2 compares the lender's cash flow analysis with a cash flow analysis prepared by the auditor adjusted to reflect the unmet demand for gasoline cited in the body of the 4 fires Report and the national average and highest prices per gallon of gasoline when the loan was disbursed.[1] The cost of sales was determined using the percentage of cost of goods sold to gasoline revenues as used in the lender's analysis.

Table 2
Repayment Ability Calculation

	Prepared by Lender	**Prepared by Auditor**	
	$1.67*/ Gal.	**Nat. Ave. $1.54/Gal.**	**Highest $1.83/Gal.**
REVENUE:			
Projected sales of Gasoline (gallons)	2,019,276	178,764	178,764
Price per gallon	$1.67	$1.54	$1.83
Total Gas Sales	$3,377,047	$275,297	$327,138
C- Store	$824,363	$824,363	$824,363
Other Income	$16,351	$16,351	$16,351
Total Revenue	$4,217,761	$1,116,011	$1,167,852
Expenses:			
Cost of Sales	$(3,684,335)	$(815,217)	$(863,170)
Operating Expenses	$(196,860)	$(196,860)	$(196,860)
Cash Available to Service Debt	$336,566	$103,934	$107,822
Debt Service	$(180,000)	$(180,000)	$(180,000)
Cash Available after Debt Service	$156,566	$(76,066)	$(72,178)

* The $1.67 (rounded) was estimated by the auditor and calculated by dividing the borrower's projected revenue for gasoline sales by the projected gallons (annualized) in the summary section of the Starfires Report.

As shown in Table 2, the borrower lacked repayment ability based on the available unmet demand for gasoline in the three-mile trade area cited in the details of the 4 fires Report. Thus, under SBA regulations, the borrower was ineligible for a SBA guaranteed loan.

Excessive Projections

The lender's loan files provided little evidence to justify the excessive projections or how the business would sell more gasoline than its competitors and the estimated unmet demand for gasoline in the three-mile trade area during the first year of operation. The only support found was a reference to a city approved proposed road extension that would increase traffic flow in the trade area. There were no details, however, such as when the road extension would be completed and the expected increase in traffic. Consequently, the impact of the road extension on projected sales could not be determined.

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1 The national average price for gasoline when the loan was disbursed was $1.54 a gallon and the highest price at the time was $1.83.

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In conclusion, the lender's failure to take prudent measures to ensure that the borrower had the ability to repay the loan from the cash flow of the business violated SBA regulations and provides a basis for SBA to seek full recovery of the guaranty payment of $777,516.

Recommendation

We recommend that the Dallas District Office take the following action:

1. Seek recovery of $777,516, less any subsequent recoveries, from the lender on the guaranty paid for loan FOIA Ex. 4

District Office Comments

The Dallas/Forth Worth District Office verbally concurred with the finding and recommendation and stated that receipt of a check from the lender is pending.

Evaluation of District Office Comments

The District Office comment is responsive to the recommendation.

Appendix A

AUDIT REPORT DISTRIBUTION

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