



**U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
WASHINGTON, D.C. 20416**

<b>AUDIT REPORT</b>
<b>Issue Date: March 20, 2006</b>
<b>Report Number: 6-17</b>

**To:** James E. Rivera  
Associate Administrator for Financial Assistance

**From:** /S/ original signed  
Robert G. Seabrooks  
Assistant Inspector General for Auditing

**Subject:** Audit of an SBA Guaranteed Loan to [FOIA Ex. 6]

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to you. Your response and the response of the lender have been synopsized and included in the report. Based on these responses, we have reduced the recommended recovery amount from \$176,538 to \$88,269.

The recommendation in this report is 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 Form 1824, Recommendation Action Sheet.

Should you or your staff have any questions, please contact Stephen Seifert, Director, Credit Programs Group, at 703-487-[FOIA Ex. 2].

Attachment

cc: Acting IG

**AUDIT OF AN SBA GUARANTIED LOAN TO**

**[FOIA Ex. 6]**

**West Lafayette, Indiana**

**March 20, 2006**

**The finding in this report is the conclusion of the Office of Inspector General'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.**

**AUDIT OF AN SBA GUARANTIED LOAN TO  
[FOIA EX. 6]**

**West Lafayette, Indiana**

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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.

During an on-going review of the guaranty purchase process at the National Guaranty Purchase Center (Center) in Herndon, Virginia, we identified a problematic loan made by Lafayette Bank and Trust (lender) to [FOIA Ex. 6] (borrower), which is the subject of this audit report. The loan was part of a sample selected from a universe of 7(a) loan purchase requests processed at the Center by Headquarters personnel from the Office of Financial Assistance (OFA).

The loan was processed as a regular 7(a) guaranteed loan; therefore, SBA was responsible for determining if the borrower met eligibility and credit requirements. The lender was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

The \$500,000 loan (No. 523-602-4000) was a Standard Asset Based (SAB) CAPLines loan approved on February 26, 2002, with a 75 percent SBA guaranty. The purpose of the loan was for short term working capital/operating needs. The loan was disbursed between March 28, 2002 and May 29, 2002. The borrower defaulted on November 13, 2002, less than six months after the last disbursement. SBA purchased the guaranty for \$176,538 on July 23, 2004.

## **AUDIT OBJECTIVE AND SCOPE**

The objective of the audit was to determine if the lender originated, serviced, and liquidated the purchased loan in accordance with SBA rules and regulations. During the audit, we examined loan files maintained by SBA and the lender, interviewed SBA officials in OFA, and interviewed lender officials. The audit was conducted in Herndon, Virginia during March and April 2005, in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### **Finding 1 - The Lender Exceeded Loan Limits Due to Improper Disbursements**

The lender did not perform the required analysis before making disbursements on the Standard Asset Based (SAB) CAPLines loan. The loan authorization required the lender to comply with SAB CAPLines loan procedures found in SBA Standard Operating Procedures (SOP) 50-10(4) and 50-50. Prior to each of the five disbursements for the loan, the lender was required to perform an analysis to determine the allowable limit for each disbursement. The five disbursements exceeded the allowable loan limits computed for each disbursement and therefore, the loan was over-disbursed by between \$78,210 and \$276,008. SBA, however, did not qualify the lender to make SAB CAPLines loans and therefore, must share responsibility for the lender's inadequate servicing of the loan. As a result, we are questioning \$88,269, or 50 percent, of the \$176,538 SBA paid the lender when it purchased the guaranty.

SOP 50-10(4) Subpart C, Chapter 1, Paragraph 19 describes a SAB CAPLines loan as a revolving loan that supports an increase in accounts receivable and/or inventory and must be used for short term working capital/operating needs. A borrowing base certificate is required with each loan advance to enable the lender to determine the amount available for disbursement. The borrowing base is derived by multiplying eligible accounts receivable and/or inventory by the approved advance rates. A borrowing base certificate is a form which enables the lender to: (i) determine the available borrowing base; (ii) reconcile sales, receivables, and inventories; and (iii) determine the amount available for disbursement from the current loan balance and eligible borrowing base.

Lines one through seven of Table I on page 3 of this report depict the reconciliations that should have been computed on borrowing base certificates for this loan. These certificates would have provided the lender with the amounts of proceeds available for each of the five loan disbursements (See Table I for detailed computations).

#### *Disbursement 1:*

Based on an analysis of the borrower's financial statements dated March 31, 2002, the maximum allowable disbursement amount on March 28, 2002 should have been approximately \$219,964.<sup>1</sup> A borrowing base certificate was not prepared before the lender disbursed \$300,938, which was \$80,974 more than the allowable limit.

#### *Disbursements 2-4:*

Between April 5 and April 18, 2002, the lender continued to make disbursements totaling \$116,824 without preparing the necessary borrower base certificates. An analysis of lender

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<sup>1</sup> This is an approximation due to the difference between the date of disbursement and the date of the financial statements used to calculate the maximum allowable disbursement amount.

records showed that the borrower had a negative \$13,497 available for disbursement as of April 18, 2002, (\$287,441 in eligible assets minus the \$300,938 disbursement). As a result, all of the April loan disbursements were inappropriate.

*Disbursement 5:*

On May 29, 2002, the lender made a final disbursement of \$80,009. Although a borrowing base certificate was prepared two days prior to the disbursement, it showed that only \$1,799 was available for disbursement. Consequently, the lender exceeded the allowable limit by \$78,210.

As a result of the lender's imprudent actions, the loan was over-disbursed by as much as \$276,008 as explained below.

**TABLE I**  
**SAB CAPLines Loan Borrowing Base Certificates**  
**Reconciliation Computations**

Line	Certificate computation	March 31, 2002 (Disbursement 1)	April 18, 2002 (Disbursements 2-4)	May 27, 2002 (Disbursement 5)	Totals
1	Eligible A/R (less than 60 days old) x 80%	\$52,190	\$40,000	\$113,512.80	
2	Eligible Inventory x 50%	\$167,774	\$247,441	\$305,976.50	
3	Total Available Assets (line 1 + line 2)	\$219,964	\$287,441	\$419,489	
4	Total Loan amount	\$500,000	\$500,000	\$500,000	
5	Borrowing Base Lesser of line 3 and line 4	\$219,964	\$287,441	\$419,489	
6	Outstanding loan balance	\$0	\$300,938	\$417,690 <sup>2</sup>	
7	Available for disbursement (line 5 – line 6)	\$219,964	\$0 <sup>3</sup>	\$1,799	
8	Actual Disbursement(s)	\$300,938	\$116,824	\$80,009	\$497,771
9	<b>Over-disbursement (line 8 – line 7)</b>	<b>\$80,974</b>	<b>\$116,824</b>	<b>\$78,210</b>	<b>\$276,008</b>

The lender acknowledged that the loan officer who approved the disbursements misunderstood the SBA requirement and was unaware that a borrowing base certificate was required prior to each disbursement. The lender believed the May 27, 2002 borrowing base

<sup>2</sup> While the outstanding loan balance as of May 27, 2002, was actually \$417,762, the lender erroneously reported the outstanding loan balance to be \$417,690 on the May 27, 2002, borrowing base certificate. The difference between these amounts is immaterial and has no effect on the finding. We used the amount reported on the May 27, 2002 borrowing base certificate in order to be conservative in our estimation of the amount over-disbursed.

<sup>3</sup> Amount available for disbursement was negative \$13,497.

supported the extent of draws at that time and therefore, felt the last disbursement was the only over-draw. The May 27, 2002 borrowing base, however, does not mitigate the first four over-disbursements because the borrower may not have had an adequate borrowing base as of that date if the lender had not previously over-disbursed the loan. The over disbursements provided the borrower with additional funds to purchase inventory, which in turn, increased the future borrowing bases. Without the over-disbursements, it is possible that the lender would not have had any funds available for draws 2 through 5. Therefore, we can only estimate that the total over-disbursement would have been between \$78,210 (the amount of over-disbursement calculated for the last draw) and \$276,008 (the sum of all over-disbursements). Nevertheless, if the lender had complied with SAB CAPLines loan disbursement requirements, SBA may not have suffered any loss on this loan because the amount recovered from collateral may have been sufficient to pay off the outstanding loan balance at the time of default.

In accordance with SOP 50-10(4) Subpart C, paragraph 19(d), the SBA Indiana District Office was required to review and approve a Lender Qualification Survey to determine whether the lender was qualified to participate in asset based lending. Although the Indiana District Office approved the guaranty for this loan, it did not review and approve a Lender Qualification Survey as required. Therefore, SBA officials believe the agency must share responsibility for the lender's inadequate servicing of this loan. As a result, we are questioning \$88,269, or 50 percent, of the \$176,538 SBA paid to the lender when it purchased the guaranty.

## **RECOMMENDATION**

We recommend that the Associate Administrator, Office of Financial Assistance, take the following action:

1. Seek recovery of \$88,269 from the lender on the guaranty paid for loan number 523-602-4000, less subsequent collections.

## **Lender Response**

The lender feels the borrower corrected the deficient borrowing bases after the first four advances and stated the advances did not cause the demise of the borrower. The lender claimed the failure of the business was a function of adverse weather conditions and market conditions. The lender admitted borrowing base certificates were not prepared for each draw and stated the SBA requirement was not apparent in the SBA authorization. The lender stated that the borrowing base dated May 27, 2002 supported the extent of draws at that time, but admitted the \$80,008.77 draw made on May 29, 2002 represented an over line. The lender claimed, however, that the borrowing base after the draw would have shown a \$38,204.64 over-disbursement considering the additional inventory purchased with the May 29, 2002 draw. The lender stated that it would seem inconceivable that such a small variance (eight percent of the total available assets) could have resulted in any risk to SBA, especially considering the ebb and flow of a revolving line of credit. The lender does not feel that a refund of the SBA guaranty funds previously paid is appropriate. The lender's response, less attachments, is included as Appendix A.

## **SBA Management Response**

SBA stated that the OIG's concept of combining the over advances and giving them a cumulative effect is not valid because such practice would double count the advances made against receivables and inventory that were only counted once. SBA stated that the amount over advanced at one point in time is not in addition to (cumulative to) other amounts advanced at different times. Therefore, SBA calculated the over-advancement on the loan to be \$69,225 as of May 30, 2002, the day after the final loan disbursement was made.

SBA also stated that in order to be eligible to make a standard asset based loan guaranteed by SBA, the agency requires lenders to complete a Lender Qualification Survey which includes an acknowledgement that the lender has read the CAPLines guide and understands the requirements associated with making and servicing a standard asset based CAPLines loan. The Indiana District Office approved the guaranty for this loan, but did not obtain the Lender Qualification Survey from the lender. Consequently, the district office failed to ensure that the lender had the qualifications necessary to adequately administer the account. SBA stated that since the district office approved the loan but did not adequately qualify the lender, the agency should share responsibility in the lender's inadequate administration of this account.

SBA also stated that the actual dollar amount of the lender's deficient analysis is not easily determined without the receivables aging since one would not know how much to exclude. SBA recommended that the lender repay half the amount that was disbursed at the time of guaranty purchase, less subsequent collections. SBA's response is included as Appendix B.

## **OIG Analysis of Lender and SBA Management Responses**

The audit report was revised to address the concerns of the lender and SBA with regard to our concept of combining the over-draws to calculate the total over-disbursement on the loan. The report now reflects that the loan was over-disbursed by between \$78,210 and \$276,008. As described in our audit report, however, the borrowing base after the first four draws did not mitigate the previous over-disbursements and it would be inappropriate to calculate the total over-disbursement on the loan after the final draw. Such calculation would not consider the inflated borrowing base that would have existed after the final loan draw as a result of the previous over-disbursements which were used to purchase inventory. Although the lender claimed that the failure of the business was a function of adverse weather and market conditions, the over-disbursements increased SBA's loss on the loan and therefore, justifies a repair to the guaranty paid.

The report was also modified to reflect SBA's position with regard to the district office's failure to obtain a Lender Qualification Survey from the lender. Furthermore, we agree that the actual amount of loss attributable to the lenders deficient analysis cannot be easily determined. As a result, we concurred with SBA's suggestion to recommend recovery of half the amount disbursed at the time of purchase, less subsequent recoveries.





Lafayette Bank & Trust Company

Appendix A  
Page 1 of 2  
133 NORTH FOURTH STREET | P.O. BOX 1130 | LAFAYETTE, IN 47902-1130  
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October 21, 2005

Stephen Seifert  
SBA Office of Inspector General  
1145 Herndon Parkway  
Suite 900  
Herndon, Virginia 20170

Re: Audit of an SBA Guaranteed Loan #523-602-4000 to [FOIA Ex. 6]

Dear Mr. Seifert:

Thank you for giving us some extra time to complete our review of your audit. In response to your audit findings, we would like to explain our position with the draws made on said loan and how the borrowing base deficiencies were corrected.

In reviewing the SBA's standard operating procedures 50-51-2 dated December 1, 1997 on page 13-2, it states that "The decision to deny liability on the SBA loan guaranty requires a thorough review of the facts involved.....Before pursuing a recommendation of denial, you must do the following....All options must be explored to resolve the problem prior to processing a denial of liability. Examples are: (1) Lender corrects deficiencies..." Based on these statements, we feel that the borrower corrected the deficient borrowing bases after the first four advances. In addition, these advances did not cause the demise of [ ] The failure of the business was a function of adverse weather conditions and market conditions. FOIA Ex. 6

At the time we opened said line of credit, [ ] was in the process of opening a new retail facility. This was the primary reason for the line increase. They were purchasing inventory to stock the new facility using their own funds as well as the line of credit. This is why the majority of the draws were made within one month. There were not borrowing bases submitted for each draw. The SBA requirement for borrowing base certificates for every draw was not apparent in the SBA Authorization. The borrowing base dated 5-27-02 supported the extent of draws at that time which is when most of the borrower's initial inventory was in place. The borrowing base provided to the bank on 5-27-02 was in compliance showing an excess amount available to draw of \$1,799.30. FOIA Ex. 6



LAFAYETTE BANK AND TRUST COMPANY, NATIONAL ASSOCIATION

AN AFFILIATE OF FIRST MERCHANTS CORPORATION



## Appendix A

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The draw made on 5-29-02 for \$80,008.77 did in fact represent an over line; however, this draw was made two days after the borrowing base was submitted and was advanced to acquire additional inventory. After the draw (see attached), the borrowing base would have shown:

1. Eligible A/R (less than 60 days old) X 80%	\$113,512.80
2. Eligible Inventory X 50%	305,976.50
3. Eligible Inventory purchased with draw (5/29/02) X 50%	<u>40,004.39</u>
4. Total Available Assets (line 1 + line 2 + line 3)	\$459,493.69
5. Outstanding loan amount	\$500,000.00
6. Borrowing Base (lesser of line 4 and line 5)	\$459,493.69
7. Outstanding loan balance	\$497,698.32
8. Available for disbursement (line 6 - line 7)	(\$38,204.64)
9. Over-disbursement (line 8)	(\$38,204.64)

It would seem inconceivable that such a small variance of 8% could have resulted in any risk to SBA, especially when one considers the ebb and flow of a revolving credit line. At any one moment in time such a variance can be expected in any revolving line of credit utilizing a borrowing base.

In conclusion, I would like to summarize the bank's stance with the following points:

1. At no time were the actions of the bank identified as imposing any risk to the SBA.
2. It is a common practice in the banking industry to permit a debtor a reasonable period of time to correct any non-compliance issues. With the exception of the last draw of \$80,008.77, which was taken two days after the 5/27/02 borrowing base, it is clear that the debtor was in compliance as reflected in the 5/27/02 borrowing base. The balances of both inventory and accounts receivable on said borrowing base were balances after the first four advances.
3. Given the extent of the credit line, a variance of \$38,204.64, 8% of the total line, at any one time is not viewed as material and did not represent a loss risk to SBA. It would be an extremely long stretch of the imagination to infer this small variance would have caused the failure of the operation.

Based on the above points, Lafayette Bank and Trust Company does not feel that a refund of the SBA guaranty funds previously paid is appropriate. Thank you.

Sincerely

[FOIA Ex. 6 ]

Mark W. Molter, CLBB  
Vice President





U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, D.C. 20418

Appendix B  
Page 1 of 2

DATE: February 9, 2006  
TO: Stephen C. Seifert  
FROM: James W. Hammersley, Acting AA/PM  
SUBJECT: Audit of SBA Guaranteed Loan to [FOIA Ex. 6]

FOIA Ex. 6

In February 2002, SBA guaranteed a one-year \$500,000 line of credit loan through Lafayette Bank & Trust (Indiana) under the Agency's Standard Asset Based CAPLines program to [redacted] The FOIA Ex. 6 lender disbursed approximately \$497,698 between March and May of 2002. The initial \$300,938 was used to refinance an existing \$300,000 non-guaranteed line of credit with the same institution plus reimburse the lender for payment of the short-term loan guaranty fee. The loan didn't revolve or perform well and the lender classified it as a defaulted loan in November of 2002.

The lender asked SBA to purchase the loan in December of 2003. Personnel in the National Guaranty Purchase Center (NGPC) approved the request and the Agency purchased 75% of the defaulted balance of \$222,397 in July of 2004. As part of its on-going review of purchase cases, the Office of the Inspector General (OIG) determined that the NGPC should not have purchased this loan. In response to the OIG draft audit and your memo of January 18, 2006, we have the following comments:

First, page 292 of SOP 50-10(4) provides that:

After initial disbursement, lenders have unilateral authority to increase/decrease the advance rate for receivables (NOT the loan amount) by as much as 5 percent above/below the rate stated in the Authorization without SBA concurrence.

Therefore, since CAPLine lenders have the authority to increase the advance rates by 5%, if the authorization stipulates advance rates of 80 and 50 percent for receivables and inventory, the lender can increase the rates to 85 percent for receivables and 55 percent for inventory without specific SBA approval.

Second, the concept of combining the over advances and giving them a cumulative effect as set forth in the OIG draft audit is not a valid concept because such a practice would double count the advances made against receivables and inventory that were only counted once. On any given borrowing base the borrower will most likely have some receivables that were also outstanding on the prior borrowing base. The only difference is that rather than being in the 0 to 30 or 31 to 60 day categories, they will be in the 31 to 60 or 61 to 90 day categories. However, the receivables are not excluded from the borrowing base just because they remain uncollected for another 30 days. To be excluded, receivables must either be classified as past 90 days or collected. It is characteristic of asset base financing for a portion of the borrowing base to be (1) recently generated and recently added, (2) recently over aged or recently paid off so the receivables are removed, and (3) still included but older in age (by an allowable amount). This means that some of the assets making up any given borrowing base are the same assets that comprised the prior borrowing base. Each borrowing base is looked at independently from the other borrowing bases. Likewise, each over advance is a function of the borrowing base and the amount outstanding at a given point in time. The amount over advanced at one point in time is not in addition to (cumulative to) other amounts advanced at different times.

## Appendix B

## Page 2 of 2

Set forth in the table below are the receivable and inventory levels as reported prior to the disbursements, as shown in financial information in the loan file. This information is used to determine the disbursement amounts that the lender made which were not supported by receivables and inventory available to the borrower at the time of disbursement.

Date of F/S	Date of Disb	Receivables at Full Value	Inventory	Borrowing Base 80/50	Balance	Over Advance
12-31-01		214,000	137,000	239,700	0	\$ 0
	03-28-02				301,009	\$ 61,309
03-31-02		65,238	323,760	214,070	301,009	\$ 86,939
	04-05-02				348,009	\$133,939
	04-11-02				372,689	\$158,619
	04-18-02				417,689	\$257,619
04-30-02		157,692	514,060	383,183	417,689	\$ 34,506
	05-29-02				497,698	\$114,515
05-30-02		203,905	530,698	428,473	497,698	\$ 69,225

Third, the underwriting and administration of a Standard Asset Based CAPLines loan requires the lender to possess certain skills, have certain knowledge, and engage in certain actions to make sure the account is controlled and that repayment occurs when the borrower receives payments. To be eligible to make a standard asset based loan guaranteed by SBA, the Agency requires lenders to complete a Lender Qualification Survey which includes an acknowledgement that the lender has read the CAPLines guide and understands the requirements associated with making and servicing a standard asset base CAPLines loan.

The Indiana District approved the guaranty for this loan. The office analyzed the lender's credit memorandum, approved the guaranty and prescribed the terms of the loan authorization. The Indiana office was contacted on January 30, 2006 and it was determined that the office failed to obtain the Lender Qualification Survey from Lafayette Bank & Trust. Consequently, the district office failed to ensure that the lender had the qualifications necessary to adequately administer this account. In this regard, the issued loan authorization stated that the lender needed to comply with CAPLines SOP requirements, including Appendix 9. However, SBA was responsible to make sure the lender had knowledge of these requirements. Since the district office approved the loan but did not adequately qualify the lender, the Agency may be said to share responsibility in the lender's inadequate administration of this account.

**Conclusion.** The actual dollar amount of the lender's deficient analysis is not easily determined without the receivables aging since one would not know how much to exclude. Based on the 5-27-02 borrowing base, it appears that 21 percent of the receivables were over 90 days and therefore not acceptable (\$31,812 vs. \$148,170)

It is recommended that the lender repay half the amount that was disbursed at the time of guaranty purchase, less subsequent collections.

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