

AUDIT OF AN SBA GUARANTEED LOAN TO

[Exemption 6]DBA [Exemption 6]

Grand Rapids, Michigan

Audit Report Number: 7-10

January 16, 2007



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

AUDIT REPORT
Issue Date: January 16, 2007
Report Number: 7-10

To: /S/ original signed
Janet A. Tasker
Acting Director for Financial Assistance

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of an SBA Guaranteed Loan to [**Exemption 6**]
dba[**Exemption 6**]

The purpose of this memorandum is to notify you of \$183,297 in improper payments that should be recovered. During our audit of the guarantee purchase process at the National Guaranty Purchase Center, we identified a problematic loan [**Exemption 2**] made by Old Kent Bank to [**Exemption 6**] (borrower). We reviewed the loan to determine if the lender originated, serviced and liquidated the purchased loan in accordance with Small Business Administration (SBA) rules and regulations. The audit was conducted during February 2006 in Herndon, Virginia in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

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. If a lender fails to comply materially with SBA regulations, the loan agreement, or does not make, close, service, or liquidate a loan in a prudent manner, SBA has exclusive discretion to release itself from liability, in whole, or in part, on the loan guarantee.

Old Kent Bank was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, Old Kent Bank was permitted to process, close, service and liquidate SBA loans with limited documentation and review by SBA. On July 21, 2003, Old Kent Bank was acquired by Fifth Third Bank of Cincinnati and Fifth Third Bank became responsible for all decisions regarding SBA loans previously made by Old Kent Bank. Fifth Third Bank was unable to locate its loan

file for the subject loan and, therefore, our audit was limited in scope to a review of only those documents included in the SBA loan file.

On March 15, 2001, the lender approved a \$299,000 SBA-guaranteed loan using PLP procedures for a borrower's purchase of equipment and a video store known as [**Exemption 6**]. The business purchase was reportedly funded by \$299,000 in loan proceeds and \$40,000 of equity injection. The borrower defaulted on July 1, 2002, approximately 15 months after the loan was disbursed on March 27, 2001, thus this loan is considered an early default under SBA policy. The borrower filed Chapter 7 Bankruptcy on August 4, 2003. SBA purchased the guarantee for \$167,518 on January 18, 2005, and reimbursed the lender \$15,779 for its share of legal fees on March 4, 2005, for a total guarantee purchase of \$183,297.

The Lender did not Comply with SBA Loan Origination Requirements

The lender did not comply with SBA requirements in determining the value of the business being purchased, and made an SBA loan for a change of ownership that was not an arm's-length transaction. Furthermore, the borrower's repayment ability was not properly calculated. As a result, SBA made improper payments totaling \$183,297 when it honored the guarantee and reimbursed the lender for legal expenses.

Business Valuation

Standard Operating Procedure (SOP) 50 10(4) requires the lender to determine the value of the business being acquired when a change in ownership occurs. The value of the business must be based on a generally accepted valuation method used for the industry in which the business operates when the change of ownership involves an acquisition of a going concern. The SOP further states that the selling price must be compared to the reasonable value of the business and that purchaser/seller agreement of the selling price is not adequate justification for financing the amount requested.

Policy Notices 5000-677, *Loans to Finance Changes of Ownership*, and 5000-693, *Clarification of Policy Notice 5000-677*, further require the lender to use at least two methods to value the business and to include the substantiating analysis in its loan file.

Our audit disclosed that the lender did not provide SBA any documentation showing the methods used to value the business. Thus, there was no assurance the business was accurately valued. The \$339,000 purchase price of the business per the Buy/Sell Agreement comprised:

- \$110,000 in games and tapes;
- \$50,000 in computer equipment, shelving, countertops, security system, neon sign, television and game system;
- \$134,000 in goodwill and customer list; and
- a \$45,000 non-compete clause.

The \$339,000 selling price is questionable because the income tax returns for the seller's business (including 3 video stores) showed operating losses for 2 of the 3 years prior to the purchase. In particular, the \$134,000 in goodwill and the customer list and the \$45,000 non-compete clause are unsupported.

For loans to finance changes of ownership, SBA Policy Notice 5000-693 requires lenders to verify the historical profit and loss statements of the business being acquired for the last 2 years by verifying tax returns. In addition, when verification of tax returns is not possible, e.g., where only a part of a business is being sold, other means of verification, such as sales tax reports filed with the state government should be used to verify the financial information. The source of the information, such as the lender, packager, accountant, etc., is required to be identified in the lender's documentation.

In its credit memorandum the lender stated, "Although tax returns specific to the store are not available (the current owner combines all three stores into one entity), there are income statements showing strong cash support." The lender, however, did not provide copies of any income statements to SBA for the individual store purchased by the borrower or other documentation used to verify the business' historical information. As this loan was an early default, the lender was required by SBA Policy Notice 5000-831, *7(a) Loan Guaranty Purchase Policy*, to submit financial information to SBA with its purchase package. The Notice also stated that if there was an early default and the lender failed to provide evidence of the required verification of financial information, or a credible explanation for its absence, then a full denial of liability would generally be warranted.

Arm's-Length Transaction

SOP 50 10(4) and Policy Notice 5000-677 require that a change in ownership be an arm's-length transaction. Based on the relationship of the buyer and seller, it does not appear the change of ownership was an arm's-length transaction. According to the lender's credit memorandum, the seller started in business many years ago with the help of the buyer's mother. The seller wanted to repay the favor by helping the buyer purchase one of the seller's stores to get started in the video business. At the time of the sale, the buyer had worked for the seller for about 8 months, earning an annual salary of \$19,500. According to the lender's credit memorandum, the seller gave the borrower a \$40,000 bonus (over 200 percent of his annual salary) to fulfill the \$40,000 equity injection requirement in the loan authorization since the borrower had limited assets and liquidity. The equity injection was to be used towards the purchase of the video store. Since the buyer's mother helped the seller start in business and the equity injection was provided by the seller, it appears the change of ownership was not an arm's-length transaction.

As it appears the \$40,000 equity injection did not come from the borrower's personal funds, SBA may have provided 100 percent financing for the business which is prohibited by SOP 50 10(4). There is no evidence the lender ever questioned the relationship between the parties and the lack of support for the required equity injection.

After the loan went into default and the borrower filed bankruptcy, an individual with the same last name as the seller approached the lender with an offer to purchase a majority of the collateral. Furthermore, another individual with the same last name as the seller actually purchased the collateral at a private sale on December 1, 2003, for \$40,000. As a result, the seller may have received SBA loan proceeds of \$160,000 for the borrower's purchase of his inventory and equipment, and less than 3 years later been able to recoup those items for only \$40,000. This is further evidence that the change of ownership was not an arm's-length transaction.

Repayment Ability Calculation

SOP 50 10(4) states that historical earnings and cash flow are the most reliable bases for determining repayment ability. The repayment ability must include the company's revenues and expenses and consider owner withdrawals and annual fixed obligations including the proposed loan payments. The SOP further provides that the loan application must be denied if the borrower cannot repay the loan from the cash flow of its operations.

According to the lender's credit memorandum, the borrower was going to reduce the previous owner's draw by \$20,000 per year. As a result, the lender inappropriately added \$20,000 to the historical net income of the business in calculating the borrower's repayment ability. Such withdrawals would be reflected in the principal's capital investment in the business, thus would not affect net income. According to generally accepted accounting principles, personal withdrawals by the owner of a sole proprietorship do not affect net income.

As depicted below, the lender's analysis also did not consider all of the principal's consumer debt payments, and there was no documentation in the loan file indicating that the borrower had other sources of income to meet his personal debt obligations. According to the principal's credit report as of October 9, 2000, annual payments for consumer debt totaled \$15,000. The lender, however, calculated the principal's annual consumer debt to be \$7,824. When the lender's cash flow analysis is adjusted for the owner's draw and additional consumer debt, the auditor's calculation shows the principal needed an additional \$4,500 to service his debts.

Cash Flow Analysis

	Lender Calculation	Audit Calculation
Net Income (Historical)	\$46,000	\$46,000
Add:		
Interest	\$2,000	\$2,000
Depreciation	\$94,000	\$94,000
Owner's Draw	\$20,000	\$0
Less:		
Restock Inventory	(\$70,000)	(\$70,000)
Cash Available for Debt Service	\$92,000	\$72,000
Debt Service	(\$61,500)	(\$61,500)
Cash Available for Owner's Draw	\$30,500	\$10,500
Less Owner's Consumer Debt:		
Credit Cards	(\$3,432)	(\$5,196)
Vehicle Lease	(\$4,392)	(\$4,392)
Mortgage	(\$0)	(\$5,412)
Total Consumer Debt	(\$7,824)	(\$15,000)
Cash Overage (Shortage)	\$22,676	(\$4,500)

As a result, the borrower did not have repayment ability at the time the loan was made. Due to the materiality of the lender's errors in originating this loan, full recovery of the \$183,297 paid to purchase the guarantee is warranted.

Recommendation

We recommend that the Acting Director for Financial Assistance:

1. Seek recovery of \$183,297, less any subsequent recoveries, from Fifth Third Bank on the guarantee paid.

Lender Comments

Fifth Third Bank agreed with the finding. The lender's comments are included as Appendix I.

Agency Comments

SBA Management agreed that Fifth Third Bank should be required to repay \$183,297.

Office of Inspector General Response

The lender and Agency comments were responsive to our finding and recommendation.

We appreciate the courtesies and cooperation of the Office of Financial Assistance representatives during this audit. If you have any questions concerning this

report, please call me at (202) 205-[**Exemption 2**] or Robert Hultberg, Director, Credit Programs Group at (202) 205-[**Exemption 2**].



Fifth Third Bank
Special Assets Group
Mail Drop RSCB3C
1830 East Paris Ave.
Grand Rapids, MI 49546

December 13, 2006

VIA Facsimile Only

Dear Terry,

This letter is in response to the draft audit report dated 11/13/06 for [Exempt 6] Fifth Third Bank is in agreement with your findings.

Sincerely,

[Exemption 6]

Mike Waltz
Special Assets Group
Telephone (616) 653-9995 bus.
Facsimile (616) 653-9976 fax

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616-653-5837

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**RECOMMENDATION ACTION SHEET
SBA/OIG FOLLOWUP SYSTEM**

SBA PROGRAM: Office of Financial Assistance

REPORT TITLE, NUMBER: Audit of an SBA Guaranteed Loan to Jaime Sanchez dba Video
Master of Leonard Street

REPORT ISSUE DATE:

RECOMMENDATION NO. 1

We recommend that the Acting Associate Administrator for Financial Assistance seek recovery of \$183,297, less any subsequent recoveries, from Fifth Third Bank on the guarantee paid.

503100	12/11/06	\$183,297	<input checked="" type="checkbox"/> Questioned costs <input type="checkbox"/> Funds for better use <input type="checkbox"/> Non-monetary
Amount unsupported in questioned costs:		\$	

<input checked="" type="checkbox"/> Agree with recommendation <input type="checkbox"/> Partially agree <input type="checkbox"/> Disagree		\$183,297	<input type="checkbox"/> Questioned costs disallowed <input type="checkbox"/> Agreed to funds for better use <input type="checkbox"/> Non-monetary
Amount unsupported in costs disallowed:		\$	

Explanation of proposed action(s):

Originating Official Signature: *Walter Chisholm, OFA* Date: 1/12/07
 Approving Official Signature: _____ Date: _____
 (required only if partially agree or disagree)
 OIG Signature: _____ Date: _____

If checked by OIG, the final action for this recommendation must be reviewed by OIG before it is closed in the OCFO tracking data base.

	\$	\$	\$	\$
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Explanation of action(s) completed:

Originating Official Signature: _____ Date: _____
 Approving Official Signature: _____ Date: _____
 OIG Signature: _____ [Does not indicate verification of the action] Date: _____

FOR OIG USE ONLY: Management Decision Due Date: 04/23/07
 Performance Goal: _____ Performance Objectives: _____ Performance Measure(s): _____