

**ORIGINATION AND CLOSING DEFICIENCIES IDENTIFIED IN
7(A) RECOVERY ACT LOAN APPROVALS**

**Report Number: ROM 11-07
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**Prepared by the
Office of Inspector General
U.S. Small Business Administration**



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Grady Hedgespeth
Director, Office of Financial Assistance

Date: September 30, 2011

John A. Miller
Director, Office of Financial Program Operations

/s/ Original Signed
From: John K. Needham
Assistant Inspector General for Auditing

Subject: Origination and Closing Deficiencies Identified in 7(a) Recovery Act Loan Approvals
ROM 11-07

This report presents the results of the audit of 7(a) loans approved pursuant to the American Recovery and Reinvestment Act of 2009, Public Law 111-5 (Recovery Act). The Recovery Act provided the Small Business Administration (SBA) with \$730 million to expand the Agency's lending and investment programs and create new programs to stimulate lending to small businesses. Of the \$730 million received, \$375 million was authorized for the SBA to (1) eliminate or reduce fees charged to lenders and borrowers for 7(a) and 504 loans, and (2) increase its maximum loan guaranty to 90 percent for eligible 7(a) loans.¹ Pursuant to this authorization, SBA eliminated guaranty fees charged to borrowers and increased the maximum loan guaranty percentage, but did not reduce or eliminate the ongoing yearly servicing fee charged to lenders. The Recovery Act, and Office of Management and Budget guidance, encouraged Offices of Inspectors General (OIGs) to conduct oversight of potential risks posed by Recovery Act programs implemented by their respective agencies. Accordingly, we conducted this audit due to concerns that (1) lenders would not exercise due diligence in originating and closing loans given the 90 percent SBA guaranty reduced lender risk, and (2) the SBA would not properly underwrite loans given the higher loan demand and resource constraints.

The audit objectives were to (1) determine if 7(a) Recovery Act loans approved for more than \$150,000 were originated and closed in accordance with SBA's policies and procedures and prudent lending practices, and (2) identify any evidence of suspicious activity. While the audit did not include an objective to assess actions taken by the SBA to mitigate the above mentioned risks, as part of our general oversight of the SBA's implementation of the Recovery Act, we reviewed SBA's Risk Mitigation Plans for

¹ The maximum guaranty for *SBAExpress* loans remained at 50 percent.

its Recovery Act programs. To assess the internal controls relevant to our objectives, we reviewed SBA's Standard Operating Procedures (SOP) 50 10 5(A) and 50 10 5(B).

To answer the audit objectives, we randomly selected and reviewed sixty 7(a) Recovery Act loans that (1) were approved for more than \$150,000; (2) were made between June 1, 2009 and January 31, 2010; and (3) had at least one disbursement as of January 31, 2010. A total of 6,467 loans with gross loan approvals totaling approximately \$3.9 billion met the three sample criteria. Our sample included 30 randomly selected loans for which the SBA reviewed the underwriting and 30 randomly selected loans made by lenders with delegated authority for which the SBA did not review the underwriting. As of January 31, 2011, fifty-eight, or 97 percent of the 60 sampled loans reviewed had been fully disbursed. See Appendix I for further details on our sampling methodology, Appendices II and III for the lists of sampled loans, and Appendix IV for a summary of loan deficiencies.

The majority of the audit fieldwork was performed by RER Solutions, Inc. (RER) under a contract with the SBA OIG. Fieldwork was conducted from May 2010 to May 2011, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States. Competing audit priorities and resource constraints delayed progress on this audit. RER reviewed SBA and lender loan files using an OIG-approved checklist. For all loans examined, RER also reviewed information in SBA's Loan Accounting System.

RESULTS IN BRIEF

Documentation deficiencies² identified in twenty-four, or 40 percent, of the sixty 7(a) loans reviewed, resulted in inappropriate or unsupported loan approvals of approximately \$14.2 million. The documentation in the loan files was inadequate to ensure the loans:

- were made to creditworthy borrowers,
- met SBA's eligibility criteria, and/or
- had adequate evidence of equity injection, use of proceeds, or Internal Revenue Service (IRS) verification.

Of the 24 deficient loans, 14 were lender-approved with inappropriate or unsupported loan approvals totaling \$6.9 million and 10 were SBA-approved with inappropriate or unsupported loan approvals totaling \$7.3 million. As of March 31, 2011, one of these 24 loans exhibited signs of early repayment problems. Suspicious activity was identified in one loan, which was referred to our Investigations Division for further review. Furthermore, problems with a lender's verification of equity injection and a missing gasoline supply agreement were identified on a loan that was not part of the random sample but was reviewed inadvertently by the OIG's contractor.

The results of the randomly selected and statistically valid samples were projected onto the universe of 6,467 7(a) Recovery Act loans with gross loan approvals totaling approximately \$3.9 billion. Based on the sample results, we estimate that at least 1,996

² For purposes of this report, documentation deficiencies are defined as those which resulted in improper loan approvals.

of the loans in the universe were not originated and closed in compliance with SBA's policies and procedures, resulting in at least \$869.5 million in inappropriate or unsupported loan approvals. Of the 1,996 loans, we estimate that at least 1,351 were lender-approved with inappropriate or unsupported approvals totaling at least an approximate \$424.7 million, and at least 403 were SBA-approved with inappropriate or unsupported approvals totaling at least an approximate \$214.4 million.³ While the actual financial impact of our estimated projections cannot be determined because the audit focused on loan approvals as opposed to loan defaults, the deficiencies identified in 15 of the 24 loans pose an approximate \$5 million risk of loss to the SBA (see Appendix V). Furthermore, the missing gasoline supply agreement on the one loan inadvertently reviewed by the OIG's contractor, poses an additional \$115,063 risk of loss to the SBA if the borrower defaults on the loan.

In order to address the loan deficiencies, we recommended that the SBA flag in its Loan Accounting System the 10 lender-approved loans that pose an approximate \$3 million risk of loss to the SBA. This will ensure the deficiencies are properly addressed should the loans default and be submitted for purchase. We also recommended that the SBA notify the OIG of any denials, repairs, withdrawals, or cancellations of SBA's guaranties made as a result of the deficiencies identified during purchase review. Additionally, to prevent the occurrence of similar deficiencies in other SBA-approved 7(a) loans, we recommended that the SBA determine how the deficiencies in the 10 SBA-approved loans occurred and take corrective action. Deficiencies on five of these loans pose an approximate \$2 million risk of loss to the SBA.

To ensure appropriate estimation of improper payments in the 7(a) loan program, we recommended that the SBA notify the improper payment review team of the high rate of improper 7(a) loan guaranties identified during this audit.

The projected volume of inappropriate or unsupported loan approvals demonstrates the inherent risk of these loans and the importance of careful review by the SBA during purchase review. Therefore, the SBA needs to notify the National Guaranty Purchase Center (NGPC) of the high number of deficiencies identified. This will ensure the NGPC is prepared to thoroughly review Recovery Act loans that default for compliance with the SBA's requirements (particularly in the areas of creditworthiness, eligibility, use of proceeds, equity injection, and IRS tax verification).

Finally, we recommended that the SBA flag the additional non-sampled loan that we identified with deficiencies that pose a \$115,063 risk of loss to the SBA to ensure that the deficiencies are properly addressed if the loan defaults and is submitted for purchase. Further, for this loan, we recommended that the SBA notify the OIG of any denial, repair, withdrawal or cancellation of SBA's guaranty made as a result of the deficiencies

³ To be conservative in our projections, we are using lower-limit projections rather than point estimate projections. The precision of the statistics from which our projections were derived is specific to each individual stratum from which we sampled (lender-approved vs. SBA-approved loans). As a result, when summed, the lower-limit projections of 1,351 lender-approved loans and 403 SBA-approved loans and their associated dollar values will not equal the overall projection of 1,996 loans with \$869.5 million in loan approvals. See projection calculations in Appendix I.

identified during the purchase review. The SBA fully agreed or partially agreed with all of the recommendations and proposed actions that were generally responsive.

BACKGROUND

The SBA implemented the fee elimination provision of the Recovery Act for loans approved on or after February 17, 2009 and implemented the increased guaranty percentage provision for eligible 7(a) loans approved on or after March 16, 2009. While these Recovery Act provisions were available until September 30, 2010, the funding provided by the Act was only sufficient to allow the SBA to eliminate the borrower fees and provide increased guaranties through November 2009. The President signed the Department of Defense Appropriations Act on December 19, 2009, which provided an additional \$125 million for fee eliminations and increased guaranties until February 28, 2010.

The 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. The SBA's 7(a) loans are made by participating lenders under an agreement to originate, service, and liquidate loans in accordance with SBA's rules and regulations and prudent lending standards. Some 7(a) loans are made by lenders using delegated authority, which undergo very limited review by SBA prior to loan disbursement, and others are subject to more extensive underwriting and eligibility review and approval by the SBA. The SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any SBA loan program requirement or does not make, close, service or liquidate the loan in a prudent manner.

In compliance with the Improper Payments Information Act of 2002 (the Act), the SBA was required to review all programs and activities for fiscal years 2009 and 2010 to determine whether they were susceptible to significant improper payments. For such programs, the SBA was required to produce an estimate of the annual amount of improper payments and submit those estimates to Congress. The Act defines an improper payment as any payment that should not have been made or that was made in an incorrect amount, including any payment to an ineligible recipient or for an ineligible service. The Act also defines a payment as any payment or commitment for future payment of Federal funds, including a loan guaranty that is made by a Federal agency. The Improper Payments Elimination and Recovery Act of 2010, requires similar reviews and estimations for future fiscal years. When a loan is made and an origination or closing deficiency is identified that cannot be corrected, an improper loan approval has occurred. When a loan defaults and a deficiency has been identified, the SBA needs to determine whether the deficiency can be corrected before paying the guaranty. If the lender or SBA cannot correct the deficiency, and the guaranty is paid; an improper purchase has occurred.

RESULTS

Origination and Closing Deficiencies in Forty Percent of Loans Reviewed

Origination and closing deficiencies were identified in twenty-four, or 40 percent of the sixty loans reviewed which resulted in inappropriate or unsupported loan approvals of approximately \$14.2 million. Of the 24 loans, 14 with inappropriate or unsupported approvals of approximately \$6.9 million were lender-approved and 10 with inappropriate or unsupported approvals of approximately \$7.3 million were SBA-approved.⁴ As shown in Table 1 below, the majority of the deficiencies identified in the 24 loans involved inadequate support to demonstrate borrower creditworthiness and eligibility. Further, some loans did not have adequate support for the use of proceeds, equity injections, and IRS tax verifications. As of March 31, 2011, one of these 24 loans exhibited signs of early repayment problems.

The results of the randomly selected and statistically valid samples were projected onto the universe of 6,467 7(a) Recovery Act loans with gross loan approvals totaling approximately \$3.9 billion. These loans were (1) approved for more than \$150,000 between June 1, 2009 and January 31, 2010, and (2) had at least one disbursement as of January 31, 2010. Based on the sample results, we estimate that at least 1,996 of the loans in the universe were not originated and closed in compliance with SBA's policies and procedures, resulting in at least \$869.5 million in inappropriate or unsupported loan approvals. Of the 1,996 loans, we estimate that at least 1,351 were lender-approved with inappropriate or unsupported approvals totaling at least an approximate \$424.7 million, and at least 403 were SBA-approved with inappropriate or unsupported approvals totaling at least an approximate \$214.4 million.

It is possible that lenders may be able to locate documentation to cure the deficiencies that were noted on some of the loans at issue. Furthermore, the actual financial impact of our estimated projections cannot be determined because the audit focused on loan approvals as opposed to loan defaults. As of June 14, 2011, the initial disbursements on nearly all 24 Recovery Act loans with identified deficiencies were made more than 18 months prior and only one showed indications of early repayment problems. As a result, with the exception of the one early problem loan, even if these loans default, they will not be reviewed for compliance with creditworthiness, equity injection, and IRS tax verification requirements during the SBA's purchase reviews. Therefore, the deficiencies in these areas will not be considered to have resulted in a loss to the SBA upon purchase. Nevertheless, the 1 early-problem lender-approved loan and 14 other loans (9 lender-approved and 5 SBA-approved) with eligibility and use of proceeds deficiencies, pose an approximate \$5 million risk of loss to the SBA. Finally, the missing gasoline supply agreement on the one loan inadvertently reviewed by the OIG's contractor, poses an approximate \$115,063 risk of loss to the SBA if the borrower defaults on the loan. See Appendix V for a listing of the loans that present a risk of loss to SBA. Our sampling methodology and projections are provided in Appendix I, a listing of the sampled loans is

⁴ These 24 loans have SBA guaranties totaling approximately \$11.5 million.

provided in Appendices II and III, and a summary of the loan deficiencies is provided in Appendix IV.

Table 1. Material Deficiencies Noted in 24 Loans

Deficiency Type	Number of deficient loans*	Description of Deficiency	Number of deficiencies*	Amounts allocated to deficiency**
Credit-worthiness	12	Repayment ability not adequately supported	9	\$7,770,381
		Missing or incomplete financial statements	5	
		Missing or unsupported projections	7	
Eligibility	10	Lack of required borrower certifications	5	\$2,598,454
		Affiliates not disclosed	2	
		Loan exceeds SBA's maximum guaranty	1	
		Noncompliance with change of ownership requirements	3	
		Noncompliance with environmental requirements	1	
		Ineligible broker fee	1	
		Missing Form 912	1	
Use of Proceeds	7	Unsupported disbursements	2	\$1,594,123
		Noncompliance with debt financing requirements	2	
		Unsupported business use of credit card debt	2	
		Missing Form 159	1	
Equity Injection	3	No verification of equity injection	2	\$455,000
		No required standby agreement	1	
IRS Tax Verification	5	No IRS verification of seller tax returns	2	\$1,801,815
		No IRS verification of operating companies	2	
		Inadequate follow-up with IRS	1	
TOTAL	24		50	\$14,219,773

Source: Lender and SBA loan files

* Some loans had multiple deficiencies.

** Dollar values are allocated to each deficiency and do not overlap.

Creditworthiness Not Always Demonstrated

The audit determined that 12 loans approved for \$9.5 million, which included 7 SBA-approved and 5 lender-approved loans, did not demonstrate borrower creditworthiness. In accordance with Title 13 CFR 120.150, applicants must be creditworthy and loans must be so sound as to reasonably assure repayment considering past earnings, projected cash flow, future prospects, the ability to repay the loan with earnings from the business, and the effects of any affiliates. According to SOP 50 10 5(A) and 50 10 5(B), the cash flow of the business is the primary source of repayment. Thus, if the lender's financial analysis demonstrates that the business lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the loan request must be declined. The SOPs also state that repayment ability based on projections must be supported by reasonable assumptions. Further, the SOPs state that all 7(a) loan applications must include personal financial statements for all owners who have a 20 percent or more

interest, officers, and proposed guarantors, including spouses. Business financial statements, including year-end balance sheets and profit and loss statements for the last three years, as well as interim balance sheets and profit and loss statements are also required. Additionally, financial statements from affiliates and subsidiaries must be obtained.

The audit found that these 12 loans (1) did not demonstrate borrower repayment ability, (2) had missing or incomplete financial statements, and/or (3) had missing or unsupported cash flow projections. The following examples illustrate the deficiencies identified in the 12 loans:

- A lender approved a \$1,786,000 loan without obtaining required interim financial statements or projections for a borrower with negative credit indicators, making repayment ability questionable. Lenders also approved 2 other loans totaling \$945,100 to borrowers who had historical negative debt service coverage, interim losses, and missing or speculative projections.
- The SBA approved a \$900,000 loan to a borrower that had negative historical debt service coverage, an interim operating loss of \$189,393, and highly speculative projections. Furthermore, repayment ability was questionable because SBA inappropriately added back officer compensation to the borrower's cash flow. Financial statements showed that the officers took an average of more than \$500,000 of compensation during the previous 3 years. There was no evidence that the officers would not continue to take this level of compensation and there was no explanation why SBA added back the compensation. When the compensation add-back was removed, business cash flow was not sufficient to cover debt service.

Eligibility Support was Inadequate for Ten Loans Reviewed

The audit determined there was inadequate eligibility support for 10 loans approved for \$6.7 million due to (1) missing borrower certifications, (2) non-disclosure of affiliates, (3) SBA's maximum guaranty amount being exceeded, (4) noncompliance with change of ownership requirements, (5) noncompliance with environmental policies, (6) an ineligible broker fee, and/or (7) a missing form 912.

The Recovery Act states "No loan guarantee may be made under this section for a loan to any entity found, based on a determination by the Secretary of Homeland Security or the Attorney General to have engaged in a pattern or practice of hiring, recruiting or referring for a fee, for employment in the United States an alien knowing the person is an unauthorized alien." The Recovery Act also prohibits the use of funds for a casino or other gambling establishment, aquarium, zoo, golf course, or swimming pool. SBA Policy Notice 5000-1098 requires borrowers and operating companies to provide certifications that they have complied with these provisions of the Recovery Act.

As defined by SOP 50 10 5(A), affiliation exists when one individual or entity controls or has the power to control another or a third party or parties controls or has the power to

control both. The SBA considers factors such as ownership, management, previous relationships with or ties to another entity, and contractual relationships when determining whether affiliation exists. The SOP requires disclosure of all affiliates and a determination of the effect any affiliates have on the size of the business in terms of SBA's size standards and whether SBA's \$1.5 million maximum guaranty limit that was in place during the period of time covered by the audit has been exceeded. Under Title 13 CFR 120.150, the SBA is also required to consider the effect of any affiliates on the ultimate repayment ability of the applicant.

For change of ownership transactions involving a close relationship between the buyer and seller, SOP 50 10 5(B) requires an independent business valuation from a qualified source. Additionally, SOP 50 10 5(A) states that the lender may finance a limited amount of goodwill, but in no event may the amount of goodwill financed by an SBA-guaranteed loan exceed 50 percent of the loan amount up to \$250,000.

In accordance with SOP 50 10 5(B), a lender or its associates may not charge the borrower any commitment, bonus, origination, broker, commission, referral or similar fees. Lastly, SOP 50 10 5(A) requires that every proprietor, partner, officer, director, and owner of 20 percent or more be of good character and complete SBA Form 912, Statement of Personal History.

The following examples illustrate the deficiencies identified in the 10 loans:

- Lenders approved five loans totaling \$3 million without the required immigration or restricted use borrower certifications.
- One lender approved a \$1,786,000 loan that exceeded SBA's maximum guaranty amount by approximately \$107,000 and when this loan and an affiliate loan are considered, SBA's maximum guaranty limit is exceeded by over \$585,000. It was SBA's responsibility to determine if the loan exceeded SBA's maximum guaranty amount before it provided the lender with a loan number for this Preferred Lender Program (PLP) loan.
- The SBA and lenders approved three loans totaling \$1.5 million that did not comply with change of ownership requirements because (1) there was no evidence that independent business valuations were obtained for transactions involving a close relationship between the buyer and seller, and (2) the amount of goodwill exceeded SBA policy limits.

Use of Proceeds Not Always Supported

The audit determined that the use of proceeds was not fully supported for 7 loans approved for \$6.1 million. In accordance with SOP 50 10 5(A), lenders must disburse the loan proceeds in accordance with the loan authorization, document each disbursement, and obtain evidence to support disbursements, such as cancelled checks or paid receipts. When a lender uses loan proceeds to refinance its own debt, the SOP requires the lender to provide transcripts and certify in writing that such debt is, and has been, current for the

last 36 months. Further, for credit card debt being refinanced with loan proceeds that is in the name of the individual, SOP 50 10 5(B) requires lenders to document the business purpose of the credit card debt and obtain a borrower certification that the loan proceeds are being used for business related debt.

However, we found that lenders approved 5 loans and the SBA approved 2 loans that did not contain adequate support for the use of proceeds. For example, one lender disbursed a \$1,165,000 loan, but there was no final closing statement in the file to determine how the loan proceeds were used. Another lender disbursed \$44,615 of loan proceeds to refinance credit card debt without adequate support for business use. Additionally, the SBA allowed \$603,500 of loan proceeds to be used to refinance same institution debt without the required support and allowed \$60,000 in loan proceeds to be used to refinance credit card debt without adequate support for business use.

Equity Injection Not Adequately Verified in Three Loans

The audit found that lenders approved 3 loans totaling \$2 million without adequately verifying the required equity injections. Lenders must verify equity injections prior to disbursing loan proceeds to be in compliance with SOP 50 10 5 (A) and 50 10 5(B). Verification of a cash injection requires documentation, such as a copy of a check along with evidence, such as a recent bank statement, showing that the funds were deposited into the borrower's account, or a copy of an escrow settlement statement accompanied by a bank account statement showing that injection into the business was made prior to disbursement. However, our review found that one lender approved a \$1,165,000 loan without adequately verifying the \$395,000 required equity injection. Specifically, the lender did not ensure that the borrower's personal \$365,000 certificate of deposit was liquidated and injected into the business as planned and did not verify the sources of the remaining \$30,000 of deposits made to the borrower's business account.

IRS Verification Not Adequately Performed for Five Loans

The audit determined that lenders approved 5 loans without evidence demonstrating that IRS verification of financial information was adequately performed. With the exception of start-up businesses, SOP 50 10 5(A) and 50 10 5(B) require lenders to verify the financial information of borrowers, operating companies, and/or sellers of a business by comparing IRS tax transcripts with the financial data or tax returns submitted with the loan application. If the lender does not receive tax transcripts from the IRS within 10 business days of its request, the lender is required to follow-up with the IRS by resubmitting its request and documenting the follow-up with a dated copy of the submission. Nonetheless, our audit found that lenders approved 2 loans for \$1.4 million without evidence they verified the sellers' financial information, approved another 2 loans for \$2.8 million without evidence they verified the operating companies' financial information, and approved 1 loan for \$705,000 without evidence they performed the required follow-up with the IRS to verify the borrower's financial information.

Improper Payments Information Act of 2002

In accordance with the Act, if adequate support cannot be obtained to overcome the identified deficiencies in the 15 loans which pose a risk of loss to SBA, in the event of loan default, these improper loan guaranties should not be paid. If the SBA pays the guaranties on these loans, the payments would be considered improper purchases.

Suspicious Activity

We identified suspicious activity in 1 of the 60 loans reviewed. This loan has been referred to the OIG Investigations Division.

OTHER MATTER

Additional Loan Deficiency Identified – Allen Xpress Mart, Loan No. 3746145009

Due to a data error in SBA's Loan Accounting System, a loan was inadvertently reviewed during the audit that was not properly part of the randomly selected sample pools. An incorrect borrower name was recorded in SBA's Loan Accounting System for one of the sampled loans and, due to miscommunication between the OIG's contractor and the lender; the incorrect file was sent and reviewed. Although this error was detected and the appropriate sample loan was eventually reviewed, the deficiencies identified on this non-sample loan are being reported as an other matter so SBA can take appropriate action.

For this \$175,000 loan, we identified that the lender did not properly verify the \$85,500 of equity injection and that there was no gasoline supply agreement in file as required. As a result, we are recommending that the SBA flag this loan to ensure the deficiencies are properly addressed if the loan defaults and is submitted for purchase.

CONCLUSION

Forty percent of the audited 7(a) Recovery Act loans approved for more than \$150,000 were not originated and closed in accordance with SBA's policies and procedures, resulting in an estimated \$869.5 million in inappropriate or unsupported loan approvals. The projected volume of inappropriate or unsupported loan approvals demonstrates the inherent risk of these loans and the importance of careful review by the SBA during purchase review. While the actual financial impact of our estimated projection cannot be determined because the audit focused on loan approvals as opposed to loan defaults, the deficiencies identified pose an approximate \$5 million risk of loss to the SBA. Finally, the eligibility deficiency identified on the one non-sampled loan poses an additional \$115,063 risk of loss to the SBA. We provided a draft of this report to the SBA for comment. The SBA fully agreed with three of the recommendations and partially agreed with the two other recommendations. The actions proposed by the SBA were generally responsive to the recommendations.

RECOMMENDATIONS

We recommend that the Director, Office of Financial Program Operations:

1. Flag the 10 lender-approved loans with identified deficiencies that pose an approximate \$3 million risk of loss to the SBA (see Table 1 in Appendix V) to ensure the deficiencies are properly addressed if the loans default and are submitted for purchase. Further, notify the OIG of any denials, repairs, withdrawals, or cancellations of SBA's guaranties made as a result of the deficiencies identified during the purchase reviews.
2. Determine how the deficiencies in the 10 SBA-approved loans occurred and take corrective action to prevent the occurrence of similar deficiencies in other SBA-approved 7(a) loans. Deficiencies on five of these loans pose an approximate \$2 million risk of loss to the SBA (see Table 2 in Appendix V).
3. Notify the improper payment review team of the high rate of improper 7(a) loan guaranties identified during this audit to ensure the proper estimation of improper payments in the 7(a) loan program.
4. Notify the National Guaranty Purchase Center of the high number of deficiencies identified and require the center to carefully review Recovery Act loans that default for compliance with SBA's requirements, (particularly in the areas of creditworthiness, eligibility, use of proceeds, equity injection, and IRS tax verification).
5. Flag the loan identified in the Other Matters section of the report to ensure the deficiencies are properly addressed if the loan defaults and is submitted for purchase. This loan poses an approximate \$115,063 risk of loss to the SBA. Further, for this loan, notify the OIG of any denial, repair, withdrawal, or cancellation of SBA's guaranty made as a result of the deficiencies identified during the purchase review.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On August 5, 2011, we provided a draft of the report to the SBA for comment. On September 19, 2011, the SBA provided written comments, which are contained in their entirety in Appendix VI. The SBA fully agreed or partially agreed with all of the recommendations and proposed actions that were generally responsive to the recommendations.

General Comments

The SBA acknowledged that our audit revealed documentation deficiencies on 24 of the 60 loans, but stated that most of these documentation deficiencies were non-material. The SBA also stated that our report affirms that the creditworthiness, equity injection, and IRS verification deficiencies cited in the report were not likely to be considered

material for the majority of the loans cited as most of the loans had already performed for more than 18 months. The SBA stated that it had checked the current status of the 60 loans and confirmed that as of August 31, 2011, none of the loans had defaulted. Therefore, the SBA concluded that the majority of the underwriting and closing deficiencies noted by OIG are not material and will not result in a loss to SBA.

The SBA's comments about the materiality of the creditworthiness, equity injection and IRS verification deficiencies do not adequately reflect the statements presented in our report and indicate the SBA has missed the importance of our findings. Regardless of the fact that most of the loans will not be reviewed for compliance with creditworthiness, equity injection, and IRS verification requirements in the event of loan default and guaranty purchase, lenders and the SBA originated and closed at least 1,996 loans representing \$869.5 million in inappropriate or unsupported loan approvals over an 8-month period. This level of noncompliance is certainly material and raises questions about the integrity of the program. While the loans in our sample have not yet defaulted, others with similar deficiencies have defaulted. Therefore, management should be very concerned about the risk presented by the high rate of noncompliance and take our findings seriously rather than sending the message that noncompliance is acceptable as long as the loans do not default early. The creditworthiness, equity injection, and IRS verification deficiencies are also material to the agency's compliance with the Improper Payment Act of 2002. If they cannot be resolved, these loans must be reported as improper loan guaranties in accordance with the Act.

The SBA stated that it considers the eligibility deficiencies identified on the lender-approved loans to be program integrity issues. Therefore, the SBA stated it will attempt to obtain documentation for the lenders to cure these deficiencies and will take appropriate action, including reducing or canceling SBA's guaranty on loans where the eligibility deficiencies cannot be cured.

Finally, at the time our draft report was issued, two of the loans with identified deficiencies were delinquent. As SBA noted in their response, none of the loans reviewed have defaulted. Nevertheless, one of these loans exhibited early repayment problems and is considered an early problem loan. We have revised our report accordingly to accurately reflect the status of the loans.

Recommendation 1

The SBA fully agreed with our recommendation and will attempt to obtain documentation from the lenders to cure the deficiencies on the 10 lender-approved loans posing a risk of loss to SBA. If the lenders are unable to overcome the deficiencies related to the origination and closing of the loans, the SBA will flag those loans in the chron system. Furthermore, for those loans with eligibility deficiencies, the SBA will contact the lender and notify them that the guaranty will be reduced or terminated if they are unable to overcome the deficiencies. Finally, the SBA will review the flagged loans submitted for guaranty purchase and will notify the OIG of any denials, repairs, withdrawals, or cancellations. The SBA's proposed actions are responsive to recommendation 1.

Recommendation 2

The SBA fully agreed with our recommendation. The Citrus Heights 7(a) loan-processing center will review the 10 SBA-approved loans to determine how the deficiencies occurred. The SBA will flag the loans in the chron system to ensure the deficiencies are addressed if the loans are submitted for guaranty purchase. Furthermore, the SBA will incorporate feedback based on the identified deficiencies into its continuous loan processing training in order to prevent the occurrence of similar deficiencies in other SBA-approved 7(a) loans. The SBA's proposed actions are responsive to recommendation 2.

Recommendation 3

The SBA will notify the team conducting improper payment reviews to use the findings in this audit as training for individuals involved in subsequent improper payment reviews. The SBA's proposed action is responsive to recommendation 3 in regards to future improper payment reviews. However, the SBA was provided the preliminary results of this audit, including the summary of loan deficiencies, in April 2011, prior to the start of their FY 2011 improper payment reviews. Therefore, we expect that these results will also be considered in the FY 2011 estimation of improper payments in the 7(a) loan program.

Recommendation 4

The SBA will notify the National Guaranty Purchase Center of the findings in this audit and will use the information to train center staff involved in the guaranty purchase process for all loans, with special emphasis on Recovery Act loans. Furthermore, the SBA will stress compliance with eligibility requirements and material compliance with credit requirements. The SBA's proposed actions are responsive to recommendation 4 in regards to notifying the Center of the high number of deficiencies, but are not responsive in regards to requiring a careful review of Recovery Act loans for compliance with origination and closing requirements.

Recommendation 5

The SBA fully agreed with our recommendation and flagged the loan in the chron system to ensure the deficiencies are properly addressed if the loan defaults and is submitted for guaranty purchase. Furthermore, the SBA provided a note in the chron system advising the purchase center to provide notice on any denial, repair, withdrawal or cancellation of guaranty resulting from the identified deficiencies to Office of Inspector General. The actions taken by the SBA are responsive to recommendation 5.

ACTIONS REQUIRED

Please provide your management response for each recommendation on SBA Forms 1824, *Recommendation Action Sheet*, within 30 days from the date of this report. Your responses should identify the specific actions taken or planned to fully address each recommendation and the target dates for completion.

We appreciate the courtesies and cooperation of the Office of Capital Access during this audit. If you have any questions concerning this report, please call me at 202-205-7390 or Terry Settle, Director, Credit Programs Group at 703-487-9940.

APPENDIX I. SAMPLING METHODOLOGY AND PROJECTIONS

The universe consisted of 6,467 7(a) Recovery Act loans approved for greater than \$150,000 that were made between June 1, 2009 and January 31, 2010, with at least one disbursement as of January 31, 2010. The universe was broken into two strata – one with 2,141 SBA approved 7(a) Recovery Act loans totaling \$1,421,131,346 and another with 4,326 Lender approved 7(a) Recovery Act loans totaling \$2,512,472,514. Upon consultation with a statistician, we used Interactive Data Extraction and Analysis Software (IDEA) to randomly select 30 loans from each stratum for a total sample size of 60 loans.

In statistical sampling, the projected population estimates are subject to sampling error. Sampling error is a measure of the expected difference between the value found in the sample and the value of the same characteristics that would have been found if a 100 percent review had been completed using the same techniques. Sampling error is indicated by ranges, or confidence intervals, that have upper and lower limits and a certain confidence level. Calculating at a 90 percent confidence level means the chances are 9 out of 10 that, if we reviewed all of the loans in the total population, the resulting values would be between the lower and upper limits, with the population point estimate being the most likely outcome.

In consultation with a statistician, the following projections based on a stratified random sample design calculate the precision statistics at a 90 percent confidence level.⁵ Projecting our sample results to the universe of 6,467 7(a) Recovery Act loans with gross loan approvals totaling approximately \$3.9 billion, we estimate that at least 1,996 7(a) Recovery Act loans approved for greater than \$150,000 made between June 1, 2009 and January 31, 2010 with at least one disbursement as of January 31, 2010, were not originated and closed in compliance with SBA's policies and procedures, resulting in at least an approximate \$869.5 million in inappropriate or unsupported loan approvals.

As the tables below will illustrate, we estimated that at least 1,351 lender-approved loans were not originated and closed in compliance with SBA's policies totaling at least an approximate \$424.7 million. In addition, we estimated at least 403 SBA-approved loans with the same distinction of noncompliance totaling at least an approximate \$214.4 million.⁶

⁵ Calculations were performed using Stata v.11, a professional standard statistical software program.

⁶ The estimates reported in this paragraph are the lower bounds of symmetric confidence intervals at a 90 percent confidence. The interpretation is that there is only a 5 percent chance that the true population statistic is less than the reported lower bound.

Table 1: Projected Error Counts by Strata⁷

Strata	Projected Error Count	Standard Error	Lower Limit (90% CI)	Upper Limit (90% CI)
SBA-Approved	713.7	186.1	402.6	1,024.7
Lender-Approved	2,018.8	399.4	1,351.2	2,686.4
Total	2,732.5	440.6	1,996.0	3,469.0

The lower and upper limits of a point estimate are driven by the sampling design used for selecting the sample, which in turn dictates the calculation of the precision statistics. Specifically, the precision statistics of each stratum result from the values of its population and sample size, along with its sample average and standard deviation of the attribute of interest. Since the precision statistics are stratum specific, the ability to perform a straightforward summation across stratum is inappropriate.

Table 2: Projected Deficiency Amounts per Strata⁸

Strata	Projected Deficiency Amount	Standard Error	Lower Limit (90% CI)	Upper Limit (90% CI)
SBA-Approved	\$ 523,011	\$ 184,602	\$ 214,438	\$ 831,583
Lender-Approved	\$ 993,722	\$ 340,400	\$ 424,725	\$ 1,562,718
Total	\$ 1,516,732	\$ 387,234	\$ 869,450	\$ 2,164,014

⁷ Figures rounded to the nearest tenth.

⁸ Figures expressed in thousands of dollars.

APPENDIX II: SAMPLED LENDER-APPROVED LOANS AND DEFICIENCIES

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
1	3760655005	Tropical Smoothie Cafe	-		\$265,000	\$0
2	3725425000	Koper Enterprises, Inc	-		\$362,100	\$0
3	3715035008	Alameda Company	-		\$1,540,000	\$0
4	3708545010	ING Wireless	-		\$200,000	\$0
5	3844955009	Ligia I. Morrison, DDS	-		\$455,000	\$0
6	[FOIA ex. 4]	[FOIA ex. 4]	A,C,E	(A) No restricted use or immigration certifications, (C) Questionable repayment ability due to excluded fee that significantly impacts debt service coverage when included in analysis, (E) No IRS verification of seller tax returns	\$227,800	\$227,800
7	3670895003	L Petro 34th Street Mobile	B,D,E	(B) Unable to verify use of proceeds because there was no final closing statement in file, (D) Unable to verify equity injection because there was no final closing statement in file, (E) Inadequate IRS verification of seller tax returns.	\$1,165,000	\$1,165,000
8	3761855008	Vanguard International Cinema	B	(B) Missing Form 159 for a \$2,400 packaging fee.	\$531,000	\$2,400
9	3663655003	Infinite Learning Academy	-		\$185,000	\$0
10	3652265009	Yong Ja Hong	-		\$600,000	\$0
11	3672595000	Brainy Bunch Learning Center	A,D	(A) Goodwill amount exceeded SBA policy limits, (D) Third party equity injection not verified	\$647,000	\$647,000
12	3645065010	Meticulous Manufacturing, Inc	A	(A) No restricted use or immigration certifications	\$600,000	\$90,000
13	[FOIA ex. 3, 4]	[FOIA ex. 3, 4]	A,C	(A) Missing immigration certification, Affiliates were not disclosed and therefore, repayment ability could not be determined, (C) No Financial Statements from Corporate Guarantor	\$168,500	\$168,500
14	3722245010	Occidental Benefits	-		\$516,000	\$0
15	3784250007	Ascendent ID Inc	-		\$319,000	\$0
16	3640705002	Matawan Enterprises, LLC	-		\$270,000	\$0
17	3607165004	Internal Medicine and Family Practice	B	(B) \$63,608 in use of proceeds unsupported including \$25,000 that was disbursed directly to the borrowers for equipment purchases and \$38,608 that was disbursed as working capital when it was for a debt refinance.	\$350,000	\$63,608
18	[FOIA ex. 4, 6]	[FOIA ex. 4, 6]	C	(C) Negative debt service coverage for prior year, current interim loss, and no projections	\$445,100	\$445,100
19	3630155010	2792 Ocean Realty LLC	-		\$788,300	\$0
20	3692825005	Progressive '2000' Home Health	E	(E) No copies of tax Returns or IRS Verification for OC	\$1,000,000	\$1,000,000
21	3834645006	Innovative Finishers	A,D	(A) Ineligible broker fee of \$2,500, No restricted use certification, (D) No seller standby agreement in file - \$10,000	\$225,000	\$46,250

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
22	[FOIA ex. 4]	[FOIA ex. 4]	A,B,C,E	(A) Loan exceeded SBA's maximum guaranty amount and further exceeded SBA's guaranty limit when an affiliate loan is considered, Missing form 912 from Principal, No restricted use certification, (B) Missing required support for \$50,000 debt refinance, (C) Repayment ability questionable – no interim financial statements or projections and negative credit indicators, (E) No evidence of IRS verification for Operating Companies	\$1,786,000	\$1,786,000
23	3781515008	Fina Mart	B	(B) Business use of credit card debt was not adequately supported	\$641,500	\$44,615
24	3747715005	TTS Granite Inc	-		\$870,000	0
25	3721175000	Gina White Byrd & Roger L. Byr	-		\$450,000	\$0
26	3486065001	Dairy Queen	-		\$170,000	\$0
27	3466985009	Sam An's Corporation	-		\$507,000	\$0
28	[FOIA ex. 4]	[FOIA ex. 4]	C	(C)) Negative debt service coverage for prior year and interim period and speculative projections	\$500,000	\$500,000
29	3472555005	Dynamic Turbine, LLC	E	(E) Inadequate follow-up with IRS to complete verification of financial information	\$705,000	\$705,000
30	3669955000	Bhikhabhai V. Patel	-		\$857,000	\$0
	Totals				\$17,346,300	\$6,891,273

*Deficiency amount was calculated by allocating the loan approval amounts to specific identified deficiencies.

Deficiency Type Legend:

- A. Eligibility
- B. Use of Proceeds
- C. Creditworthiness
- D. Equity Injection
- E. IRS Verification

APPENDIX III: SAMPLED SBA-APPROVED LOANS AND DEFICIENCIES

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
1	3827345001	The Homeland Company	-		\$402,000	\$0
2	3530285006	Ramada Inn Warner Robins	-		\$1,709,000	\$0
3	[FOIA ex. 3, 4]	[FOIA ex. 3, 4]	A,C	(A) Some affiliates were not disclosed (C) Operating Company was not a co-borrower as required and cash flow projections were not adequately supported - Borrower was not State licensed or Medicare/Medicaid certified yet projections assumed all patients were Medicare recipients.	\$760,000	\$760,000
4	[FOIA ex. 4, 6]	[FOIA ex. 4, 6]	B	(B) Business use of credit card debt not adequately supported.	\$280,000	\$60,000
5	3693565001	Pro Nails & Spa	-		\$1,427,000	\$0
6	[FOIA ex. 4]	[FOIA ex. 4]	C	(C) More than 90% of revenue derived from Federal contracts with no progress report or projections in file and no discussion of the contract terms or renewals.	\$293,000	\$293,000
7	3556005001	Pineapple Technology, Inc	-		\$275,000	\$0
8	3567575003	Sports Clips	-		\$220,000	\$0
9	3463945002	Jimmy John's	-		\$425,000	\$0
10	3546245010	The Elk Stop	-		\$445,700	\$0
11	3753625009	Melton Poultry Farm	-		\$815,000	\$0
12	3695175006	Image Dentistry of Glendale	-		\$531,500	\$0
13	3472645008	J&S Transport, Co, Inc	-		\$900,000	\$0
14	3734795008	Dickey's Barbeque Pit	-		\$356,500	\$0
15	[FOIA ex. 4]	[FOIA ex. 4]	C	(C) Repayment ability was questionable. It was calculated using old financial information. Further, the purpose of the loan was to refinance debt but there were no current financial statements from the EPC in the file and not all debts were disclosed.	\$576,500	\$576,500
16	[FOIA ex. 4, 6]	[FOIA ex. 4, 6]	C	(C) Repayment ability was questionable because there were no current financial statements from the affiliates to verify the lender's cash flow analysis and SBA's analysis was unsupported and appeared to be unrelated to this loan.	\$500,000	\$500,000
17	3779635010	U.S. Tower Services, Inc	A	(A) No independent business valuation as required for this non arm's-length change of ownership transaction.	\$450,000	\$450,000

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Deficiency Description	Approved Amount	Deficiency Amount*
18	3520185007	Kidzone, Inc	-		\$450,000	\$0
19	3679305008	Nurture Spa, LLC	-		\$300,000	\$0
20	[FOIA ex. 4]	[FOIA ex. 4]	A,B,C	(A) No evidence of required environmental investigation,(B) Noncompliance with debt refinance requirements, (C) Unsupported projections.	\$1,390,000	\$1,390,000
21	3754435002	All About Kids Day Care	A	(A) No independent business valuation as required for this non arm's-length change of ownership transaction and no evidence of site visit as required.	\$400,000	\$400,000
22	3772745005	JS-Bell Enterprises, LLC	-		\$270,000	\$0
23	3536955007	Proedge, Inc	-		\$877,500	\$0
24	[FOIA ex. 4]	[FOIA ex. 4]	C	(C) No interim financial statements in file and therefore, repayment ability is questionable.	\$1,999,000	\$1,999,000
25	3575815003	The Healey Werks, LLC	-		\$656,900	\$0
26	3634985009	Rabey Electric Co, Inc	-		\$763,000	\$0
27	3552725008	United Colors of Benetton	-		\$330,000	\$0
28	3629445006	WCP, Inc/West Coast Vinyl	-		\$1,000,000	\$0
29	[FOIA ex. 4]	[FOIA ex. 4]	C	(C) Negative historical debt service coverage, interim operating loss, highly speculative projections. Further, SBA inappropriately added back officer compensation to demonstrate repayment ability.	\$900,000	\$900,000
30	3695625010	Big Fish Entertainment, LLC	-		\$341,700	\$0
	Totals				\$20,044,300	\$7,328,500

*Deficiency amount was calculated by allocating the loan approval amounts to specific identified deficiencies.

Deficiency Type Legend:

- A. Eligibility
- B. Use of Proceeds
- C. Creditworthiness

APPENDIX IV: SUMMARY OF LOAN DEFICIENCIES

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$227,800 because (1) there were no restricted use or immigration certifications in the file, (2) repayment ability was questionable, and (3) there was no IRS verification of the seller's financial information. The seller's interim income statement showed a \$32,000 management fee which the lender added back to cash flow to demonstrate repayment ability. This fee, however, also appeared on the seller's previous income statements and the lender provided no explanation of the fee and why it would not continue to be incurred by the borrower. If the fee had not been added back, cash flow would not have been sufficient to cover debt service. Additionally, since this was a change of ownership transaction, seller tax returns were required. In this case, there were no tax returns in the file or evidence of IRS verification. As a result, the accuracy of the seller's financial information could not be verified and should not have been relied upon for loan approval.

L Petro 34th Street Mobile

Loan Number 3670895003

We questioned the entire loan approval amount of \$1,165,000 because (1) the use of proceeds were not supported, (2) the equity injection was not verified, and (3) verification of the seller's financial information was inadequate. Although the lender signed the SBA Settlement Sheet on October 7, 2009, the loan did not actually close until October 22, 2009. Furthermore, there was no final closing statement in the loan file. As a result, we could not determine if the loan proceeds were disbursed in accordance with the loan authorization or if the required equity was injected into the business. Additionally, since this was a change of ownership transaction, IRS verification of the seller's financial information was required. In this case, the IRS reported "Record Not Found" for two of the three years in question. According to SOP 50 10 5(A), the lender was required to report this issue to the appropriate SBA Commercial Loan Servicing Center and cancel the loan or postpone closing until the issue was resolved. There was no evidence this was done.

Vanguard International Cinema

Loan Number 3761855008

The SBA requires completion of Form 159 if a packager or referral agent was used or the lender charged a fee associated with the application. The form is important as it documents the lender's certification that: (1) the services rendered and amounts charged are reasonable and satisfactory; (2) they have no knowledge that any other agent was engaged by, represented, or worked on behalf of the applicant other than in another executed compensation agreement; and (3) referral fees were not charged directly or indirectly to the applicant. Since there was no SBA Form 159 in file for a \$2,400 packaging fee, we questioned this amount.

Brainy Bunch Learning Center**Loan Number 3672595000**

We questioned the entire loan approval amount of \$647,000 because (1) goodwill exceeded SBA policy limits, and (2) the lender did not verify the third-party equity injection. The lender approved the loan on September 29, 2009 and pursuant to SOP 50 10 5(A), while a lender may finance a limited amount of goodwill, in no event may the amount of goodwill financed by an SBA-guaranteed loan exceed 50 percent of the loan amount up to a maximum of \$250,000. In this case, the amount of goodwill was \$446,000, or 69 percent of the loan amount. Additionally, the lender did not verify that \$50,000 of equity injection provided by the principal's mother was actually deposited into the business as required.

Meticulous Manufacturing, Inc.**Loan Number 3645065010**

To qualify for the 90 percent guaranty under the Recovery Act, lenders were required to obtain restricted use and immigration certifications. In this case, there were no restricted use or immigration certifications in file. As a result, we calculated the deficiency at \$90,000.⁹

[FOIA ex. 3, 4]

Loan Number [FOIA ex. 3, 4]

We questioned the entire loan approval amount of \$168,500 because (1) the loan file did not contain the borrower's immigration certification, (2) not all affiliates were disclosed, and (3) there were no financial statements from the affiliates. Although the lender reported that there were no affiliates on the Eligibility Checklist, the principal's most recent Federal tax return showed [FOIA ex. 3] State of Florida records showed that the principal was a Director of this company. The file also showed that the principal was Vice President of Zaknoun II, the entity that guaranteed the loan. Since no affiliate financial statements were provided, we could not determine what effect the affiliates had on repayment ability.

Internal Medicine and Family Practice**Loan Number 3607165004**

We questioned \$63,608 of the \$350,000 loan approval due to the misuse of proceeds. The lender disbursed \$25,000 directly to the borrower for equipment purchases without obtaining paid receipts of invoices to support the purchases. Additionally, the lender disbursed \$38,608 to refinance the principal's home equity line of credit (HELOC) without evidence it was used for business purposes.

[FOIA ex. 4, 6]

Loan Number [FOIA ex. 4, 6]

We questioned the entire loan approval amount of \$445,100 because repayment ability was not supported. The borrower's debt service coverage was negative for the year preceding the loan, the current period showed an operating loss, and no projections and

⁹ The deficiency was calculated at 15 percent of the \$600,000 loan amount. Fifteen percent is the difference between the 90 percent guaranty allowed under the Recovery Act and SBA's standard guaranty of 75 percent.

assumptions were provided to support how the borrower's historical performance would change to ensure repayment ability. Historically, the principal took large distributions which negatively impacted cash flow and there was no assurance he would discontinue doing so.

Progressive '2000' Home Health

Loan Number 3692825005

We questioned the entire loan approval amount of \$1,000,000 because there were no Federal tax returns for the operating company in file and there was no evidence that the lender conducted the IRS verification. While the lender cited the operating company's Federal tax returns in its credit memo, the returns were not in file and there was no evidence that the lender verified the returns with the IRS as required. As a result, the financial information should not have been relied upon for loan approval.

Innovative Finishers

Loan Number 3834645006

We questioned \$46,250 of the \$225,000 loan approval amount because (1) there was no restricted use certification in file, (2) the borrower was charged an ineligible broker fee, and (3) there was no seller standby agreement in file. To qualify for the 90 percent guaranty under the Recovery Act, the lender was required to obtain a restricted use certification from the borrower. In this case, there was no certification in file and therefore, we questioned \$33,750.¹⁰ Additionally, the file contained an SBA Form 159 which showed that the borrower paid a \$2,500 broker fee for the loan referral. Because SOP 50 10 5(B) and Title 13 CFR 120.222 specifically prohibit these fees, we questioned \$2,500. Lastly, while the loan authorization called for a \$10,000 seller standby agreement, there was none in file and therefore, we questioned \$10,000. In all, these three deficiencies totaled \$46,250.

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$1,786,000 because (1) the loan exceeded SBA's maximum guaranty amount and the guaranty limit was further exceeded when an existing SBA loan to an affiliate was considered, (2) there was no restricted use certification in file, (3) an SBA Form 912 was missing from the file, (4) \$50,000 of debt refinancing was not supported, (5) repayment ability was questionable, and (6) there was no evidence of IRS verification for the operating companies. Although the Recovery Act increased SBA's guaranty percentage for eligible 7(a) loans, it did not increase SBA's maximum guaranty amount which remained at \$1.5 million for total borrower and affiliate loans. In this case, the guaranty amount on the subject loan (\$1,607,400) and the guaranty amount on the affiliate loan (\$478,359) totaled over \$2 million. As a result, these two loans exceeded SBA's maximum guaranty amount by over \$500,000. The lender's credit memo and eligibility checklist also reported that the business was jointly owned by the husband and wife and as a result, each of them should have provided an SBA Form 912. However, in this case, only the husband provided an SBA Form 912

¹⁰ The deficiency was calculated at 15 percent of the \$225,000 loan amount. Fifteen percent is the difference between the 90 percent guaranty allowed under the Recovery Act and SBA's standard guaranty of 75 percent.

which showed him to be the sole owner. Furthermore, there were no interim financial statements or projections in file and as a result, we could not determine if the borrower had repayment ability. Past due invoices and declining credit scores indicated that the business was having financial difficulty. Additionally, there was no evidence that the lender verified the financial information of the operating companies as required. Other deficiencies included no support for \$50,000 of debt refinance and a missing restricted use certification.

Fina Mart

Loan Number 3781515008

We questioned \$44,615 of the \$641,500 loan approval amount because the business use of credit card debt that was refinanced with SBA loan proceeds was not adequately supported. There was no evidence that the lender confirmed the credit card obligations as having been used for business-related purposes and there was no certification from the borrower that the amounts were exclusively used for business purposes as required by SOP 50 10 5(B).

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$500,000 because the borrower had negative debt service coverage for the year preceding the loan and interim period, and provided speculative projections. According to the lender's credit memo, debt service coverage for 2008 was a negative 1.89 and for the seven months ending July 31, 2009, was a negative 2.67. For the remainder of 2009, the lender expected the borrower to break even. While the borrower's projections showed positive cash flow, they were difficult to follow and not adequately supported.

Dynamic Turbine, LLC

Loan Number 3472555005

We questioned the entire loan approval amount of \$705,000 because the lender did not properly follow-up with the IRS to complete verification of the borrower's financial information as required. While the lender appropriately filed Form 4506-T with the IRS to obtain transcripts of the borrower's tax returns, there was no evidence that a second request was submitted, as required, when it did not receive a response. As a result, there was no evidence that the lender obtained the transcripts or conducted the required verification of financial information prior or subsequent to closing.

[FOIA ex. 3, 4]

Loan Number [FOIA ex. 3, 4]

We questioned the entire loan amount of \$760,000 because (1) some affiliates were not disclosed, (2) the operating company was not a co-borrower or guarantor, and (3) the cash flow projections were not adequately supported. According to the lender's Eligibility Checklist, there were six affiliates. However, the principal's 2008 Federal tax return listed [FOIA ex. 3] Of the seven companies that were not disclosed on the Eligibility Checklist, State of Louisiana records showed that the principal was an officer, member, director, or partner in six of them.

We also found that the borrower's wholly-owned subsidiary, Pathway Rehabilitation Hospital of Bossier, LLC, was going to be the operating company. As a result, in accordance with SOP 50 10 5(A), Pathway Rehabilitation of Bossier, LLC should have been a co-borrower or guarantor, but was not. Lastly, since the borrower was a start-up, repayment ability was based on projections. The projections assumed that the facility would be state-licensed, Medicare certified and that all revenue would be derived from Medicare patients. At the time of loan approval, however, the borrower was neither state-licensed or Medicare certified. Furthermore, the business plan stated that the licensing and certification processes were very bureaucratic and could cause significant delays. As a result, the projections were not adequately supported.

[FOIA ex. 4, 6]

Loan Number [FOIA ex. 4, 6]

We questioned \$60,000 of the \$280,000 loan approval amount because the business use of the credit card debt that was refinanced with SBA loan proceeds was not adequately supported. There was no evidence that two GM business card accounts totaling \$20,038 even existed. Furthermore, the remaining credit cards were issued to the principals personally, but the balances shown on their credit reports did not always match the amounts paid from loan proceeds. Additionally, the credit card statements and receipts were not provided as required to ensure the credit cards were used exclusively for business purposes.

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$293,000 because more than 90 percent of the borrower's revenue was to be derived from Federal contracts, but there were no work in progress reports, discussions of contract terms/renewals, or projections in file. According to the lender's credit memo, the business was specialized and derived more than 90 percent of its revenue from US Department of Transportation research contracts. While the lender requested progress reports, there were none in file. Furthermore, the credit memo stated that the loan decision was based on the historical performance of the operating company and projections were not required. This is contrary to SOP 50 10 5(B) which requires a financial analysis of repayment ability based on historical income statement and/or tax returns and projections, including reasonable assumptions. Projections and reasonable assumptions were necessary in this case given the uncertainty of the contract terms, work in progress, and potential new contracts. The credit memo, however, simply stated that the operating company was in a prime position to bid on new contracts and expected revenue growth of more than 40 percent. Without projections, reasonable assumptions, progress reports, or contract renewal information, repayment ability was not adequately supported.

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$576,500 because repayment ability was questionable as there were no current financial statements from the Eligible Passive Company (EPC) in file and not all debts were disclosed. The purpose of the loan was to

refinance existing debts of the EPC and the operating company. While the file contained current financial statements for the operating company, there were no current interim financial statements for the EPC in file. Under SOP 50 10 5(A), business financial statements dated within 90 days of submission of the loan application are required. Additionally, only those debts being refinanced with the SBA loan were reported in the loan application, when other debts existed. As a result, we could not verify the total debt service or determine repayment ability. Additionally, SBA's repayment analysis contained multiple errors such as using net sales instead of net income as the starting point for calculating business cash flow and significantly overstating the debt service on the SBA companion loan.

[FOIA ex. 4, 6]

Loan Number [FOIA ex. 4, 6]

We questioned the entire loan approval amount of \$500,000 because repayment ability was questionable. The lender's 2008 global repayment analysis, which included the borrower's affiliates, showed that cash flow was insufficient to cover debt service. We could not verify the lender's 2009 global repayment analysis because the file did not contain current financial statements as required for all but one of the borrower's affiliates. SBA's repayment ability analysis also could not be relied upon due to a mix-up in the loan application numbers, causing the SBA to perform its analysis on an unrelated loan that involved a farm. As a result of these deficiencies, there is no assurance the borrower had repayment ability.

US Tower Services, Inc.

Loan Number 3779635010

We questioned the entire loan approval amount of \$450,000 because the sale of the business was not an arm's-length transaction and there was no independent business valuation in file. According to SOP 50 10 5(B), if there is a close relationship between the buyer and the seller, the lender must obtain an independent valuation from a qualified source. In this case, the business was being sold to a group of current employees. Nevertheless, the business valuation was obtained by the seller and prepared by the seller's tax accountant, who acknowledged that the valuation was not independent.

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$1,390,000 because (1) there was no evidence of an environmental investigation, (2) debt refinancing was not in compliance with SBA's policies, and (3) the projections were unsupported. Although the loan was secured by a first mortgage on commercial real estate, there was no evidence of an environmental investigation in file. Under SOP 50 10 5(B), the lender is required to submit the environmental investigation report to the SBA Center processing the application. Additionally, the purpose of the loan was to refinance same institution debt and while SOP 50 10 5(B) required the lender to provide SBA with transcripts and a certification that the loans were current; there was no transcript or certification in file. Furthermore, the borrower's first year cash flow projections were unsupported. There was no lender analysis or discussion of underlying assumptions.

All About Kids Day Care**Loan Number 3754435002**

We questioned the entire loan approval amount of \$400,000 because the sale of the business was not an arm's-length transaction; there was no independent business valuation in file; and there was no evidence of the required site visit. According to SOP 50 10 5(B), if there is a close relationship between the buyer and the seller, the lender must obtain an independent valuation from a qualified source. In this case, the change of ownership was between a brother and sister and there was no independent business valuation in file. The SOP also required the lender to document a site visit of the assets being acquired in the change of ownership and in this case, there was no documentation of a site visit.

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$1,999,000 because there were no interim financial statements in file and repayment ability was not adequately supported. Although the loan was approved in August 2009, the most recent financial statements in file were as of December 2008. Under SOP 50 10 5(A), business financial statements dated within 90 days of submission of the loan application are required. As 2008 cash flow just barely covered the proposed debt service, current financial statements were needed to determine how the business was currently performing and to assess whether the lender's projections were reasonable.

[FOIA ex. 4]

Loan Number [FOIA ex. 4]

We questioned the entire loan approval amount of \$900,000 because the borrower had negative historical debt service coverage, an interim operating loss, and provided highly speculative projections. For 2008 and the interim period, cash flow was insufficient to cover debt service. In order to demonstrate repayment ability, the SBA added back officer compensation in its analysis but did not provide an explanation or justification for why this add-back was made. There was no evidence the principals would or could discontinue taking the officer compensation that the historical financial statements reflected. According to SOP 50 10 5(B), if the small business lacks reasonable assurance of repayment in a timely manner from the cash flow of the business, the request must be declined. Furthermore, the projections were highly speculative and not adequately supported.

APPENDIX V: RISK OF LOSS

Table 1. Sampled Lender-Approved Loans Presenting a Risk of Loss

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Approved Amount	Risk of Loss*
1	[FOIA ex. 4]	[FOIA ex. 4]	A,C,E	\$227,800	\$34,170
2	3670895003	L Petro 34 th Street Mobile	B,D,E	\$1,165,000	\$770,000
3	3761855008	Vanguard International Cinema	B	\$531,000	\$2,400
4	3672595000	Brainy Bunch Learning Center	A,D	\$647,000	\$527,910
5	3645065010	Meticulous Manufacturing, Inc	A	\$600,000	\$90,000
6	[FOIA ex. 3, 4]	[FOIA ex. 3, 4]	A,C	\$168,500	\$25,275
7	3607165004	Internal Medicine and Family Practice	B	\$350,000	\$63,608
8	3834645006	Innovative Finishers	A,D	\$225,000	\$36,250
9	[FOIA ex. 4]	[FOIA ex. 4]	A,B,C,E	\$1,786,000	\$1,496,359
10	3781515008	Fina Mart	B	\$641,500	\$44,615
Totals				\$6,341,800	\$3,090,587

*The risk of loss was calculated as the SBA's share of the outstanding balance as of February 28, 2011 or the loan approval amount allocated to the deficiencies that pose a risk of loss, whichever was less.

Table 2. Sampled SBA-Approved Loans Presenting a Risk of Loss

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Approved Amount	Risk of Loss*
1	[FOIA ex. 3, 4]	[FOIA ex. 3, 4]	A,C	\$760,000	\$631,253
2	[FOIA ex. 4, 6]	[FOIA ex. 4, 6]	B	\$280,000	\$60,000
3	3779635010	U.S. Tower Services, Inc.	A	\$450,000	\$352,304
4	[FOIA ex. 4]	[FOIA ex. 4]	A,B,C	\$1,390,000	\$603,500
5	3754435002	All About Kids Day Care	A	\$400,000	\$304,457
Totals				\$3,280,000	\$1,951,514

*The risk of loss was calculated as the SBA's share of the outstanding balance as of February 28, 2011 or the loan approval amount allocated to the deficiencies that pose a risk of loss, whichever was less.

Table 3. Other Matter Loan Presenting a Risk of Loss

#	Loan Number	Borrower Name	Deficiency Type (See Legend)	Approved Amount	Risk of Loss*
1	3746145009	Allen Xpress Mart	A,D	\$175,000	\$115,063

*The risk of loss was calculated as the SBA's share of the outstanding balance as of February 28, 2011.

Deficiency Type Legend:

- A. Eligibility
- B. Use of Proceeds
- C. Creditworthiness
- D. Equity Injection
- E. IRS Verification

APPENDIX VI. AGENCY COMMENTS

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

MEMORANDUM
September 19, 2011

To: John K. Needham
Assistant Inspector General for Auditing

From: John A. Miller
Director, Office of Financial Program Operations

Subject: Response to Draft Report on the Origination and Closing Deficiencies
Resulted in an Estimated \$869.5 Million in Inappropriate or Unsupported
7(A) Recovery Act Loan Approvals, Project No. 10505B

Thank you for the opportunity to review the draft report. We appreciate the role of the Office of Inspector General (OIG) plays in assisting management in ensuring that these programs are effectively managed.

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Recovery Act") (P.L. 111-5). The Recovery Act provided the SBA with \$730 million to expand the Agency's lending and investment programs and create new programs to stimulate lending to small businesses. Of the \$730 million received, \$375 million was authorized for the SBA to (1) eliminate or reduce fees charged to lenders and borrowers for 7(a) and 504 loans, and (2) increase its maximum loan guaranty to 90 percent for eligible 7(a) loans. The OIG conducted this audit due to concerns that (1) lenders would not exercise due diligence in originating and closing loans given the 90 percent SBA guaranty reduced lender risk, and (2) the SBA would not properly underwrite loans given the higher loan demand and resource constraints.

The loans reviewed in the audit were approved during the initial stages of the Recovery Act, between June 1, 2009 and January 31, 2010. SBA had recently added a large number of new employees with commercial underwriting background to augment the existing center staff. The new staff were immediately provided comprehensive SBA loan underwriting training in order for them to become familiar with SBA requirements. In addition all work was, and continues to be closely reviewed to ensure quality and

consistency with SBA loan underwriting policies. Center loan processing staff has also undergone continuous training based on commercial lending practices as well as feedback from quality control and audits.

The audit revealed documentation deficiencies, most of which were non-material, in 24, or 40 percent, of the 60, 7(a) loans reviewed (14 lender approved and 10 SBA approved) resulting in what the OIG believes were inappropriate or unsupported loan approvals of approximately \$14.2 million. This amount was then extrapolated to \$869.5 million. According to the OIG, the documentation in the loan files was inadequate to ensure that the loans:

- Were made to creditworthy borrowers,
- Met SBA's eligibility criteria, and/or
- Had inadequate evidence of equity injection, use of proceeds, or Internal Revenue Service (IRS) verification.

The draft audit report states on page 5 that that lenders may be able to locate documentation to cure the deficiencies that were noted on some of the loans at issue. The report also asserts the financial impact of the estimated projections cannot be determined because the audit focused on loan approvals as opposed to loan defaults. Finally, the report affirms the creditworthiness, equity injection and IRS verification deficiencies cited in the report were not likely to be considered material for the majority of the loans cited as most of the loans had already performed for more than 18 months. SBA checked the current status of the 60 loans and confirmed that as of August 31, 2011, none of the loans have defaulted. Therefore, the majority of the underwriting and closing deficiencies noted by OIG are not material and will not result in a loss to SBA. SBA considers the eligibility deficiencies identified on the lender-approved loans as program integrity issues. Therefore, SBA will attempt to obtain documentation from the lenders to cure these deficiencies and will take appropriate action, including reducing or canceling SBA's guaranty, on loans where the eligibility deficiencies cannot be cured.

Management's response to the recommendations in the draft report is noted as follows:

1. Flag the 10 lender-approved loans with identified deficiencies that pose an approximate \$3 million risk of loss to the SBA (see Table 1 in Appendix V) to ensure the deficiencies are properly addressed if the loans default and are submitted for purchase. Further, notify the OIG of any denials, repairs, withdrawals, or cancellations of SBA's guaranties made as a result of the deficiencies identified during purchase.

OFPO concurs with this recommendation and plans the following actions:

- SBA will attempt to obtain documentation from the lenders to cure the deficiencies identified in the report as posing a risk of loss to SBA. In the event the documentation deficiencies cannot be cured, SBA will take the following action based upon the type of deficiency:

- Underwriting and Closing: flag all loans identified in the audit report by notating the identified deficiencies in the chron system.
- Eligibility: contact the lender and notify them that the guaranty will be reduced or terminated if they are not able to cure the deficiency.
- All flagged loans will be reviewed by the SBA if submitted for guaranty purchase and if any denials, repairs, withdrawals, or cancellations are found, the OFPO will notify the OIG of the results. The chron system will be updated accordingly.

2. Determine how the deficiencies in the 10 SBA-approved loans occurred and take corrective action to prevent the occurrence of similar deficiencies in other SBA-approved 7(A) loans. Deficiencies on five of these loans pose an approximate \$2 million risk of loss to the SBA (see Table 2 in Appendix V).

OFPO concurs with this recommendation. As stated above, these loans were approved early in the Recovery Act when a large number of new staff had arrived. Since that time substantial loan processing training has taken place.

OFPO will take the following actions in response to this recommendation:

- The Citrus Heights 7(a) loan processing center will review the 10 SBA-approved loans to determine how the deficiencies occurred. All 10 loans will be flagged in the chron system in order to properly address the deficiencies if submitted for guaranty purchase.
- OFPO will incorporate feedback based on the deficiencies identified in this report into its continuous loan processing training, in order to prevent the occurrence of similar deficiencies in other SBA-approved 7(a) loans

3. Notify the improper payment review team of the high rate of improper 7(a) loan guaranties identified during this audit to ensure the proper estimation of improper payment in the 7(a) loan program.

OFPO will notify the team conducting improper payment reviews to use the findings in this audit as training for individuals involved in subsequent improper payment reviews.

4. Notify the National Guaranty Purchase Center of the high number of deficiencies identified and require the center to carefully review Recovery Act loans that default for compliance with SBA's requirements, (particularly in the areas of creditworthiness, eligibility, use of proceeds, equity injection, and IRS tax verification).

OFPO will notify the National Guaranty Purchase Center of the findings in this audit, and will use the information for training of center staff involved in the guaranty purchase process for all loans, with special emphasis on Recovery Act loans. OFPO will stress compliance with eligibility requirements and material compliance with credit requirements.

5. Flag the loan identified in the Other Matters section of the report to ensure the deficiencies are properly addressed if the loan defaults and is submitted for purchase. This loan poses an approximate \$115,063 risk of loss to the SBA. Further, for this loan, notify the OIG of any denial, repair, withdrawal, or cancellation of SBA's guaranty made as a result of the deficiencies identified during the purchase review.

OFPO concurs with this recommendation and has already taken the following actions:

- Flagged the loan identified in the Other Matters section by noting the identified deficiencies in the chron system to ensure the deficiencies are properly addressed if the loan defaults and is submitted for guaranty purchase.
- Provided a brief note in the chron system advising the purchase center to provide notice on any denial, repair, withdrawal or cancellation of guaranty resulting from the identified deficiencies to Office of Inspector General.

Again, thank you for the opportunity to review the draft report. Please let us know if you need additional information or have any questions regarding our response.