AUDIT OF PREMIER CERTIFIED LENDERS IN THE SECTION 504 LOAN PROGRAM

Report Number: 10-10
Date Issued: March 23, 2010

Prepared by the
Office of Inspector General
U. S. Small Business Administration

In some instances the SBA OIG has elected to use minor text additions or pseudonyms rather than straight redaction on the public version of this report. We believe these modifications create a more readable product, while still protecting information subject to Exemption 8 of the Freedom of Information Act.

This revised version of Report 10-10, posted May, 2010, is the same as the one issued March 23, 2010, except that the SBA OIG has made revisions to clarify and properly characterize issues noted with loans made by one of the Preferred Certified Lenders. These revisions do not alter the overall report findings and recommendations.

U.S. Small Business Administration
Office Inspector General

Memorandum

To: Eric R. Zarnikow
Associate Administrator, Office of Capital Access

Date: March 23, 2010

/s/ Original Signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Report on Audit of Premier Certified Lenders in the Section 504 Loan Program
Report No. 10-10

This report summarizes the results of our audit of the underwriting practices, compliance, and executive compensation of Premier Certified Lenders (PCL) in the Section 504 Loan Program (CDC/504). The CDC/504 program is administered through cooperative agreements with non-profit organizations, called Certified Development Corporations (CDCs), who work with private sector lenders to provide financing to eligible for-profit businesses. CDCs typically originate CDC/504 loans and forward them to SBA for approval. Lenders granted PCL status are able to approve, close and service CDC/504 loans with SBA only reviewing the loan requests for eligibility.

The audit was initiated based on concerns that PCLs were engaging in risky underwriting practices and that five PCLs were paying their executives excessive compensation. The initial audit objectives were to determine whether (1) PCLs exercised prudent underwriting practices when making SBA loans, and (2) compensation paid to executives of five CDCs was high relative to that of other CDCs. The five named CDCs were: EDF Resource Capital, Inc, Long Island Development Corporation, Capital Access Group, Inc, Mortgage Capital Development Corporation, and Front Range Regional Economic Development Corporation. After the audit was announced, we expanded our review to assess the extent to which CDC/504 loans complied with SBA's eligibility and loan closing requirements based on issues identified during our review of the loan files.

To determine whether PCLs exercised prudent underwriting practices, we statistically selected for review 25 loans from 1,169 loans disbursed in fiscal year (FY) 2008 by three of the largest PCLs—PCL 1, PCL 2, and PCL 3. Loans disbursed by these three PCLs comprised nearly [FOIA ex. 8] percent of the value of SBA's PCL portfolio in FY 2008 and nearly [FOIA ex. 8] percent of SBA's total CDC/504 loan portfolio. Our review of the underwriting practices of the three lenders focused on their determinations of applicant repayment ability.

To determine whether the three PCLs made proper eligibility and loan closing decisions, we analyzed borrower information on trade partners, occupancy, personal guaranties, equity injection, job creation/retention, collateralization, environmental soundness, and adverse financial changes—the required factors for establishing loan eligibility outlined in SBA's Standard Operating Procedure (SOP) 50 10, *Lender Development Company Loan Programs*. We interviewed officials from SBA's Office of Financial Assistance (OFA) responsible for administering the CDC/504 Loan Program, and the Office of Credit Risk Management (OCRM), who oversee the program and are responsible for its biennial reviews. We also relied on reviews made by an SBA District Counsel to determine whether PCLs met SBA requirements for environmental assessments of business collateral. Finally, we interviewed management and staff from the three PCLs and SBA's Sacramento Loan Processing Center.

To evaluate the reasonableness of compensation paid to the executives of the 5 CDCs identified in the complaint, we compared the salaries plus benefits paid to executives identified on Form 990s filed with the Internal Revenue Service to that of the other 51 CDCs that had gross receipts over $1 million. We also reviewed SBA regulations on executive compensation for CDCs, and interviewed SBA officials on this subject.

Our audit scope and methodology is further detailed in Appendix I, our sampling plan and statistical projections are described in Appendix II, and a summary of deficiencies noted in the loans reviewed is provided in Appendix III. We conducted the audit between June 2008 and December 2009 in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

The CDC/504 Loan Program is an economic development program designed to stimulate private sector investment in long-term fixed asset financing, foster economic development; create and preserve jobs, and stimulate the growth, expansion, and modernization of for-profit small businesses. Under the program, loans are issued through partnerships with CDCs and private sector, third-party lenders to finance capital projects. Generally, the private sector lender makes a secured loan equal to 50 percent of the project cost. The CDC, which is a non-profit organization, provides the final portion of the financing, usually representing 40 percent of the project cost, with a CDC/504 loan made from the proceeds of a debenture issued by the CDC that is 100-percent guaranteed by SBA. The borrower's contribution is at least 10 percent.

CDCs that are active lenders in good standing with the Agency and who have demonstrated the ability to properly analyze, close and service CDC/504 loans may be delegated PCL status, which authorizes them to approve and liquidate CDC/504 loans without prior SBA approval. PCLs are responsible for making underwriting and eligibility assessments based on SBA credit standards. SBA's role on PCL loans is limited to reviewing the PCL's certification of applicant eligibility and providing loan numbers.

SBA requires that CDC-approved loans be of such sound value or so secure as to reasonably ensure repayment. According to SOP 50 10, the borrower's ability to repay the loan from the cash flow of the business is the most important consideration in the loan making process. However, SBA allows PCLs to determine repayment ability through either an analysis of actual cash flow or by using the "rule of thumb" method. An actual cash flow analysis relies on realized increases and decreases in business assets and liabilities during an operating cycle to determine the extent cash is available to meet financial obligations. The "rule of thumb" method relies on the net profits of the business, adjusted by non-cash expenses, to demonstrate repayment ability. For both methods, if available cash equals operational expenses plus payments on the new (SBA) loan, the borrower is said to have debt coverage of "1". Borrowers with debt coverage of "1" or greater (based on a debt service to cash ratio) are deemed to have repayment ability.

Further, to be eligible for a CDC-approved loan, an applicant must be an operating small business located in the United States that is organized for profit, and which cannot get credit elsewhere on reasonable terms. The eligibility factors that must be evaluated for each loan are further detailed in SOP 50 10.

Responsibility for the CDC/504 Loan Program is shared by two SBA offices. OFA administers the program, including establishing policy and procedures for program implementation, monitoring loan activity, and reviewing the PCLs' certification of applicant eligibility. OCRM oversees the program by monitoring PCL activity and loan quality and conducting onsite reviews that examine the PCL's lending operations and processes.

As of June 2008, there were 271 CDCs participating in the CDC/504 Program, of which 24 were PCLs. In FY 2008, the 24 PCLs approved 1,639 loans, valued at approximately $1.1 billion under PCL authority. Three of the largest PCLs were responsible for over [FOIA ex. 8] percent of the guaranty value of the PCL loan portfolio.

RESULTS IN BRIEF

We determined that PCLs may not have used prudent practices in approving and disbursing 68 percent of the sampled loans, totaling nearly $8.9 million, due to poor loan underwriting, and eligibility or loan closing issues. Specifically, 40 percent of the loans had faulty underwriting repayment analyses, and 52 percent of the loans had eligibility and/or loan closing issues. Many of the eligibility issues were based on unclear SBA military base closing/Federal cutback criteria. PCL 3 had the highest percentage of problem loans of the three PCLs reviewed. Projecting our sample results to the universe of CDC/504 loans disbursed in 2008 by these three PCLs, we estimate with 90-percent confidence that at least 572 loans, totaling nearly $254.9[1] million in CDC/504 loan proceeds, had weaknesses in the underwriting process, eligibility determinations or loan closing. Of this amount, we estimate that a minimum of 183 loans, totaling $56.4 million or more, were made to borrowers based on faulty repayment analyses. We also estimate that lenders disbursed $209 million or more to borrowers who had eligibility and/or loan closing issues.

Poor underwriting decisions were made primarily because PCLs did not use the most appropriate method of determining the cash flow of businesses, relied on inflated sales forecasts, and/or used understated projections of officer salary expenses when calculating borrower repayment ability. Problematic eligibility decisions resulted from PCLs inaccurately applying SBA procedures, using outdated SOP guidance, and/or inappropriately qualifying loans that were intended to provide funds to areas impacted by Federal budget reductions resulting in base closings that occurred 12 to 15 years previously. While some of the issues identified by the audit were detected in prior years during SBA's onsite reviews of lenders, they continued to exist.

In terms of dollars paid for CDC executive compensation, 4 of the 5 CDCs reviewed were among the top 10 highest for executive compensation.[2] EDF Resource, which was the top ranking CDC, paid in aggregate $2.5 million to its executive pool in FY 2006. In terms of percentage of gross receipts spent on executive compensation, 3 of the 5 questioned CDCs ranked among the top 10 highest of the 56 CDCs that had gross receipts over $1 million. Capital Access Group ranked third, with 29 percent of its gross receipts spent on executive compensation. SBA regulations require that any excess funds remaining after payment of staff and overhead expenses be retained by the CDC as a reserve for future operations or for investment in other local economic activity. Therefore, high compensation expenditures reduce the amount of funds for the reserve or for economic development activity.

We are recommending that the Office of Capital Access (OCA) revise SOP 50 10 to require that lenders use (1) the actual cash flow method to determine borrower

[1] Because many of the loans had more than one deficiency, the numbers do not necessarily add up.
[2] We compared total compensation paid to all CDC officers identified on the Form 990 filed with the Internal Revenue Service in FY 2006. The number of officers reported varied by CDC.

repayment ability for businesses using accrual accounting, (2) historical salary levels to estimate salaries of the borrower's officers, and (3) historical sales data to make sales projections. A process also needs to be developed to ensure that corrective actions are taken in response to the Agency's onsite reviews to ensure these conditions do not continue, and/or guidance for these reviews should be modified, as appropriate, to ensure that reviewers properly assess lender determination of borrower repayment ability and eligibility. Further, we are recommending that OCA clarify how CDCs should evaluate eligibility when the Federal budget reduction public policy goal is used to qualify a borrower for a loan, and consider establishing guidelines on the level of excess funds that CDCs should retain as a reserve or invest in other local economic and development activities.

SBA's comments were not fully responsive to the report findings and recommendations. Specifically, management disagreed that SOP 50 10 should be revised to strengthen lender repayment analyses by requiring the use of the actual cash flow method and historical salary and sales data. The Agency also did not believe an additional process was needed to ensure that corrective actions are taken to improve lender performance, but acknowledged that better use of onsite review results are needed to make more informed lender decisions and programmatic determinations. Finally, management agreed to clarify how eligibility should be evaluated relative to the Federal budget reduction policy goal and to establish guidelines on the retention of CDC reserves. Management also disagreed with several specific loan findings, providing additional data or revised Agency assessments showing that business collateral was environmentally safe. Based on this information, we revised the number of loans that were identified in the draft report as having underwriting, eligibility or closing problems by omitting 2 loans from the list of deficiencies.

RESULTS

Premier Certified Lenders Made Poor Underwriting Decisions

The three PCLs did not adequately analyze 10, or 40 percent, of the loans to provide reasonable assurance that the loans had repayment ability.[3] These loans totaled $5.3 million. Based on SOP 50 10, lenders are responsible for analyzing each loan application in a commercially reasonable manner, consistent with prudent lending standards. The SOP states that cash flow from the business is the primary source of repayment and is the most important consideration in the loan making process. When the financial analysis demonstrates that the applicant cannot repay the loan in a timely manner from the cash flow of the business, the loan request must be declined.

[3] Despite underwriting deficiencies, as of June 2, 2009, 80 percent, or 8 of the 10 loans were current.

We found that the cash flow analyses the PCLs performed on the 10 loans were flawed because they excluded pertinent information from repayment ability calculations; relied on inflated sales projections that were unsupported; and/or used estimates of officer salaries that were not based on historical levels. Further, PCLs applied the "rule of thumb" rather than the preferred actual cash flow method in determining repayment ability for businesses that were on an accrual accounting basis. The traditional "rule of thumb" method of determining cash flow for the repayment of an SBA loan is to add non-cash expenses, such as depreciation and amortization, to the firm's net profit. This method, as illustrated below, can inflate cash flow, and is not the preferred method, based on SOP 50 10 4, for businesses that use the accrual method of accounting:

Net Profits	\$100,000
Depreciation	20,000
Amortization	5,000
Cash flow available for debt service	\$125,000

In this example, cash flow available for debt service is \$125,000. If the SBA loan called for annual payments of \$50,000, one could conclude that the borrower had more than adequate repayment ability because cash flow available for debt service exceeded debt service by two and one-half times, or \$75,000.

A company's actual cash flow is determined by its sources and uses of cash during the repayment period of the loan. Sources and uses of cash can be determined by analyzing the changes that occur in a company's balance sheet accounts. In general, if a company uses accrual accounting, and the "rule of thumb" method is used, an increase in a current asset, such as accounts receivable or inventory would be considered an inflow of cash, and any decreases in such assets would be considered an outlay of cash. Similarly, an increase in a current liability, such as accounts payable or accrued expenses, would be considered a cash outlay and a decrease would be considered a cash inflow. Therefore, to obtain a more accurate analysis of cash flow, further adjustments need to be made. Using the above example, and assuming that the business generated \$1 million of sales of which \$200,000 was recorded as accounts receivable, the actual cash flow would be negative, and therefore, insufficient to cover SBA debt service:

Net Profits	\$100,000
Depreciation	20,000
Amortization	5,000
Less the increase in accounts receivable	(200,000)
Cash flow available for debt service	(\$75,000)

Of the 10 loans determined to be inadequately analyzed, 5 were approved by PCL 3, 3 by PCL 1, and 2 by PCL 2. Following is a detailed discussion of the deficiencies identified by lender. Based on these deficiencies, we estimate that at least $56.4 million in CDC/504 program funds may have been improperly approved in FY 2008.

PCL 3

PCL 3 determined that five applicants had repayment ability based on unsupported sales projections, understated officer salary projections, and/or by using the "rule of thumb" rather than the preferred actual method of determining business cash flow. Specifically, the lender:

- Relied on significantly overstated sales projections on two loans. On the first loan, PCL 3 relied on projections that showed sales would grow from $909,000 to $2.3 million, increasing the applicant's cash margin from $235,500 to more than $1.5 million. Historically, however, the growth trend for the business did not support the use of these projections. For the second loan, PCL 3 relied on sales projections that were 93 percent over prior year sales because the business was adding a new line of service. In neither case were these projections tested against historical operations or industry averages to assess the reasonableness of such increases.

- Under-estimated officer salaries on another two loans, which resulted in business expenses being understated and cash flow from operations being overstated. PCL 3 determined officer salary based on an estimate of the officer's minimum living expenses. For one loan, officer salary was historically reported on Federal tax returns as $227,000; however, the lender estimated officer salary as $71,000. This lower estimate resulted in a debt service coverage score that was greater than 1, which met SBA's repayment standards. However, when the officer's actual salary was used, the applicant's debt service coverage was significantly less than 1, indicating that the borrower lacked repayment ability. For the other loan, the lender estimated officer salary to be $84,000 when historically the salary was $383,000. Had the lender used the higher historical salary, the applicant would not have qualified because the actual debt coverage score would have been less than 1.

- Over-estimated cash flow from business operations for two loans (one of which is discussed in the first bullet) because it used the "rule of thumb" method to determine repayment ability. Had the lender used the actual cash flow method, debt service coverage would have been less than 1, and the applicants would not have met SBA's repayment standards.

PCL 1

PCL 1 determined that applicants on three loans had repayment ability because it did not use higher historical salary data to make projections of officer salary expenses. Additionally, the lender used significantly inflated projected sales for one of the three loans even though historical sales showed a downward trend. When estimated sales were adjusted to reflect historical performance in conjunction with similar adjustments to rent and depreciation, the cash flow projection showed that the applicant lacked repayment ability.

PCL 2

PCL 2 did not use IRS tax verifications to confirm the accuracy of financial information used to determine repayment ability on one loan. It also understated salary expenses and included unsupported applicant rental income on another loan, which resulted in inflating the applicant's cash flow.

In summary, based on the sample results, we estimate that at least 183, or nearly 16 percent[4], of the CDC/504 loans disbursed in 2008 by the three PCLs, totaling at least $56.4 million, were not adequately screened for conformance to SBA's credit requirements.

Over Half of the Loans Reviewed Lacked Adequate Support for its Eligibility Determinations or Did Not Meet Loan Closing Requirements

Of the 25 sampled loans reviewed, 13, totaling $7.6 million did not have adequate support for eligibility determinations or meet all loan closing requirements. In determining eligibility, CDCs are required to evaluate a number of factors before approving loans, including whether applicants had:

- Achieved the program's economic development objective by meeting either job creation/retention, community development, or one of eight public policy goals;
- Partnered with international trade firms that were verified by the Import-Export Bank as being from authorized countries for trade;
- Injected adequate equity into the business;
- Met minimum occupancy percentage requirements;
- Obtained personal guaranties from all required parties;

[4] This number has been rounded up from 15.6 percent.

- Obtained environmental assessments showing that business collateral was environmentally safe; and

- Received assurance that they had not experienced any adverse financial changes within 120 days before loan closing.

However, 13, or 52 percent, of the reviewed loans, totaling $7.6 million, had either eligibility issues or did not meet SBA's loan closing requirements. The majority of loans reviewed for each lender were not properly assessed for eligibility. Specifically, 50 percent of the 10 PCL 3 loans were not properly evaluated; 40 percent of the 10 PCL 1 loans were not properly assessed for eligibility; and 80 percent of the 5 PCL 2 loans were not properly evaluated. In some cases, lenders did not follow SBA guidance, while in other cases SBA's guidance was lacking. For example, SBA regulations and procedural guidance state that loans that can assist businesses in moving to areas affected by Federal budget reductions, including base closings, are eligible for the program.[5] However, because the guidance does not establish time limits for when Federal cutbacks had to have occurred or require CDCs to determine whether adverse economic conditions still existed at the time of loan application, PCLs approved loans for base closures that occurred 12 to 15 years previously for areas that either improved economically or were not related to the base closures. As shown in Table 1 and further discussed below, the lenders did not adequately assess multiple eligibility factors or address all loan closing requirements.

Table 1. Eligibility and Loan Closing Issues by PCL Reviewed

	Percent of Reviewed Loans With Problems	Exporter Verification	Occupancy	Personal Guaranty	Equity Injection	Job Creation/ Retention or Public Policy Goal	Environmental Clearance	Adverse Change
PCL 3	50%			X	X	X		
PCL 1	40%					X		X
PCL 2	80%	X	X	X	X	X	X	X

Source: SBA's CDC/504 Loan Files

PCL 3

Five of the 10 loans made by PCL 3 had one or more weaknesses involving borrower compliance with occupancy, personal guaranty, equity injection, public policy adherence, and/or environmental review requirements. Specifically, we found that the lender:

---

[5] A project that achieves public policy goals are eligible if the CDC's overall portfolio of 504 loans, involving the subject loan, meets or exceeds the CDC's required job opportunity average.

- Qualified applicants for five loans that were to be used to counter the negative economic impacts resulting from base closures to achieve a Federal Cutback public policy goal. However, the cited base closures occurred 12 to 15 years previously, and the impacted areas either had recovered or the current economic conditions were unrelated to the base closures. Also, one of the loans involved a base closure in Long Beach, CA, which is south of Los Angeles, although the business was located in Glendale, north of the city. While the SOP allows the use of base closures as an exception, it does not require lenders to determine whether the adverse economic conditions resulting from the base closures still existed at the time of loan application.

- Approved another loan without obtaining sufficient financial or organizational information to determine whether all parties with a 20-percent interest were financially invested in the project to meet the personal guaranty requirements of the SOP.

- Approved another loan without evidence that $96,500 in required equity was available to the borrower without taking on additional debt.

PCL 1

Four of the 10 loans made by PCL 1 either did not comply with or had inadequate determinations on required standards for one or more of the public policy goals, environmental evaluation, or adverse financial change eligibility factors. Our review of these loans determined that the lender:

- Qualified an applicant for a loan that was to be used to counter the negative economic impact resulting from a base closure, and thus eligible under the Federal Budget Cutback public policy goal exemption. However, while areas affected by Federal budget cutbacks, such as facility closings or cutbacks in defense-related industries, would require economic development assistance, the cited base closure occurred 12 to 15 years ago. Also the impacted area either had recovered or the current economic condition was unrelated to the base closure.

- Qualified another loan on the basis that it met a Community Development goal without an analysis showing how the project would meet the specified goal, as required.

- Did not verify that adverse changes had not occurred in borrower repayment ability prior to loan closing on two loans based on a review of financial statements current within 90 days of loan closing.

PCL 2
Four of the five PCL 2 borrowers did not comply with, or had inadequate determinations on, one or more of SBA's eligibility factors relating to public policy goals, exporter verification, occupancy, personal guaranty, equity injection, environmental assessment, and adverse financial changes. Specifically, we determined that the lender:

- Qualified two borrowers for CDC/504 loans under the Federal Cutback public policy exemption based on base closures that had occurred 12 to 15 years previously. However, the areas impacted by the base closures either had recovered or the current economic conditions were unrelated to the base closures.

- Approved another loan without evidence from the Export/Import Bank that the borrower's international trade partner, who accounted for 95 percent of the borrower's 2007 sales, was an approved trade partner.

- Did not substantiate that the borrower on another loan could meet the 51 percent occupancy requirement for the property purchased with the loan. The lender also did not secure a personal guaranty on the loan from the individual identified as a 40-percent owner, as required by the SOP. Further, the lender incorrectly concluded that the loan required a 10 percent equity injection, when 15 percent was required because documentation was not provided to show that the loan was for an existing business.

- Did not ensure that concerns identified in the environmental assessment for one loan had been resolved prior to loan disbursement, as required by the SOP.

- Did not obtain updated financial data for borrowers on another loan within the required 120 days prior to loan closing to ensure that financial changes had not occurred that could impact the borrowers' repayment ability.

In summary, based on the sample results, we estimate that at least 417, or nearly 36 percent, of CDC/504 loans disbursed in 2008 by the three PCLs, totaling at least $209.5 million, did not meet one or more eligibility or loan closing requirements for the CDC/504 Loan Program.

Deficiencies Noted Were Previously Identified in 2007 Onsite Reviews for the Same CDCs

Every 12 to 24 months SBA performs onsite reviews to assess the quality of the PCL's lending operations to provide assurance that lenders operating under delegated authority are complying with the Agency's lending requirements. Key components of this review are an evaluation of the PCL's credit administration practices, including its ability to determine the creditworthiness of applicants through consideration of applicant repayment ability, and the lender's eligibility determinations.

In 2007, OCRM's review of PCL 2 and PCL 1 identified issues with the lenders' credit analyses and eligibility determinations. For example, OCRM identified weaknesses in PCL 2's analyses of borrower repayment ability, and in the lender's verification and reconciliation of documentation of environmental assessments for eligibility determinations. OCRM also found that PCL 1 did not always obtain IRS transcripts or reconcile borrower financial information, obtain data on borrower equity injection, or ensure that property appraisals were complete.

Four CDCs Ranked Among the Top Ten CDCs Who Paid the Highest Executive Compensation

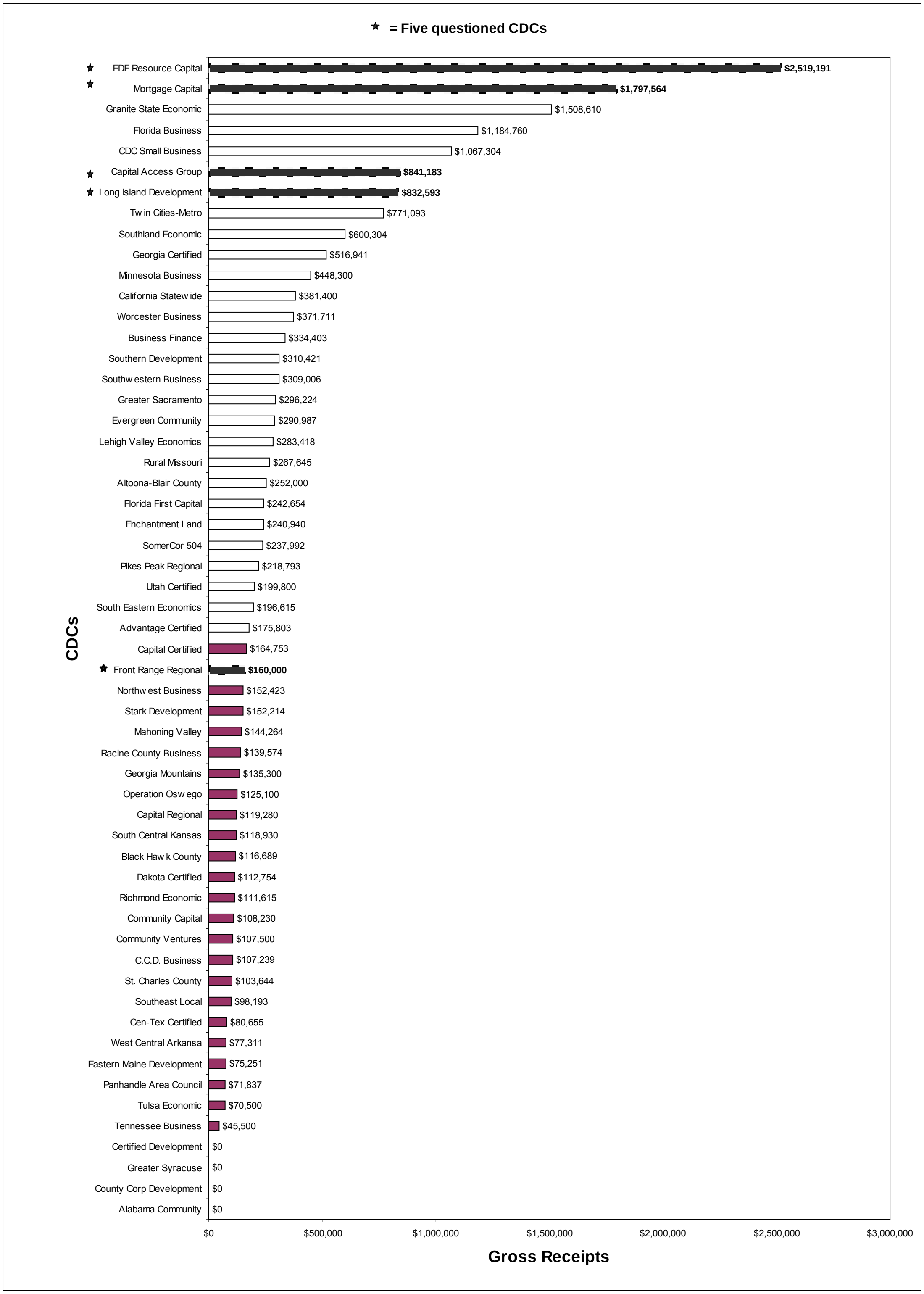
Four of the 5 CDCs reviewed ranked among the top 10 CDCs that paid the highest average executive compensation in FY 2006. Three of these CDCs also ranked among the top five CDCs who paid the highest percentage of their gross receipts in executive compensation that year. As shown in Table 2, EDF Resource, Mortgage Capital, Capital Access, and Long Island were among the top 10 CDCs that paid the highest compensation in FY 2006. According to IRS filings, in 2006, EDF Resource had seven executives, Mortgage Capital had six, Capital Access had two, and Long Island had two. EDF Resource and Mortgage Capital were the top two ranked CDCs, with total compensation of $2.5 million and $1.8 million, respectively.[6]

As shown in Table 3, when total compensation was evaluated as a percentage of gross receipts, Capital Access Group, EDF Resource, and Capital Mortgage were among the top 5 for executive compensation, with 21 to 29 percent of their gross receipts paid to executives. Specifically, executive compensation comprised 28.6 percent of the gross receipts of Capital Access, 25.8 percent of EDF Resource's gross receipts, and 21.3 percent of Mortgage Capital's gross receipts.

---

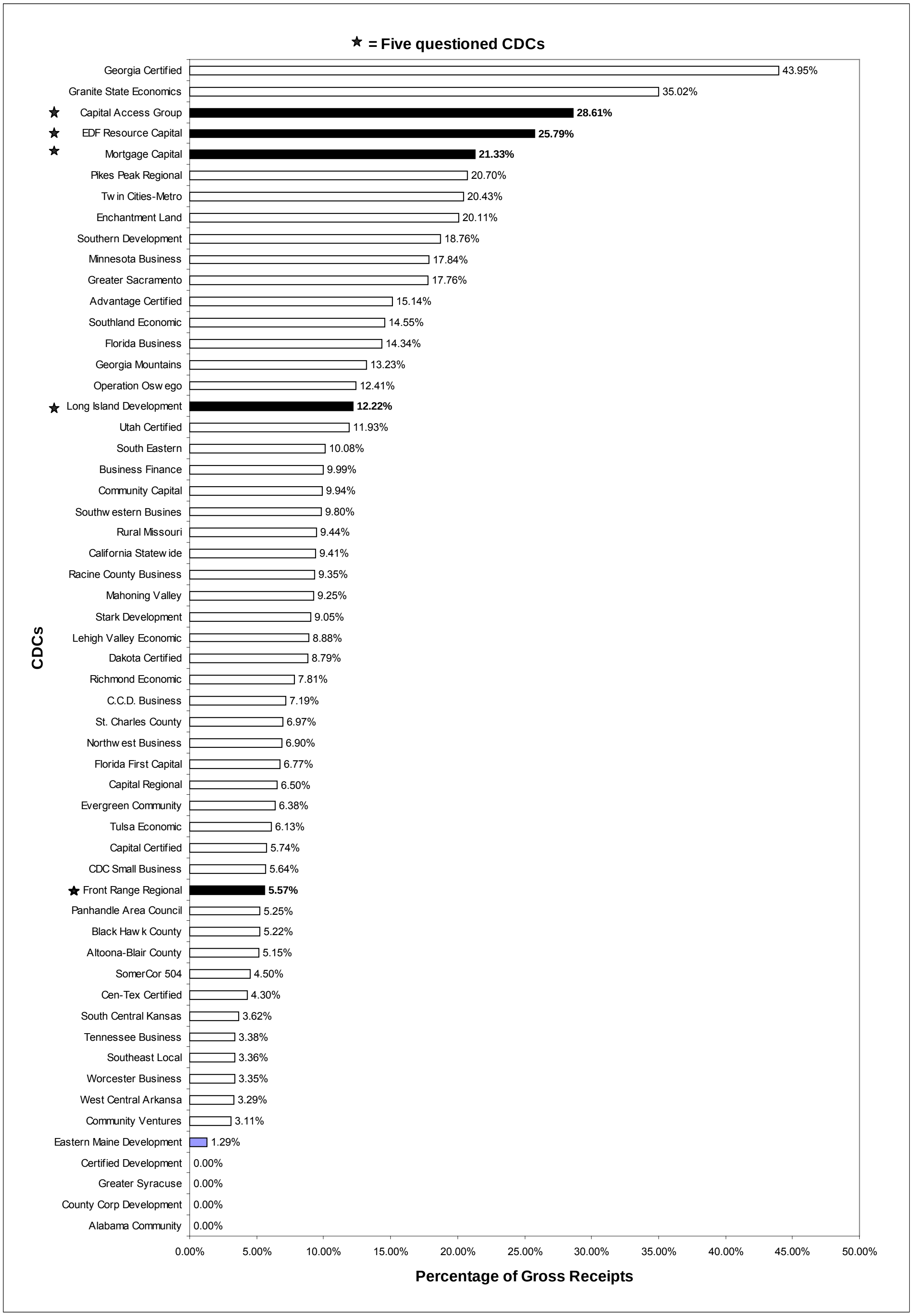
[6] $2.5 million was rounded down from $2.519 million; $1.8 million was rounded up from $1.797 million.

Table 2. Total Dollar Value of Executive Compensation Paid in FY 2006 by CDCs with $1 Million or More in Gross Receipts



Source: IRS Forms 990 provided by GuideStar USA, Inc.

Table 3. Executive Compensation as a Percentage of Gross Receipts Paid in FY 2006 by CDCs with $1 Million or More in Gross Receipts



Source: IRS Forms 990 provided by GuideStar USA, Inc.

While SBA policies and procedures for the CDC/504 Loan Program require CDCs to have full-time, professional management, including an executive director or equivalent, it does not establish limits on the amount of compensation that can be paid to CDC executives. SBA requires that executive compensation be reasonable and customary to that paid for contracted management services, but does not define “reasonable.” According to senior SBA officials, it has not been SBA’s policy to dictate how much its lending partners should compensate its executives.

However, SBA regulations[7] state that funds generated from CDC/504 loan activity that are remaining after the payment of staff and overhead expenses be retained by the CDC as a reserve for future operations or investment in other local economic development activity in its area of operations. Therefore, to the extent that CDCs are spending significant amounts on executive compensation, fewer funds will be available to reinvest in economic development activity or future lending operations of the CDC. If SBA established required reserve levels, there would be greater assurance that CDCs are keeping expenses to a level that would allow the accumulation of reserves for reinvestment or future operations, as intended by the program.

RECOMMENDATIONS

We recommend that the Associate Administrator for Capital Access:

1. Revise SOP 50 10, *Lender and Development Company Loan Programs*, to require that lenders use, among other things, (a) the actual cash flow method to determine borrower repayment ability for businesses using accrual accounting, (b) historical salary levels to estimate officer salary, and (c) historical sales data to make sales projections.

2 Develop a process to ensure that corrective actions are taken in response to OCRM onsite reviews, and/or modify guidance for these reviews, as appropriate, to ensure that reviewers properly assess lender determination of borrower repayment ability and eligibility; including lender validation of financial information used by borrowers to demonstrate repayment ability and assessment of eligibility based on achievement of public policy goals.

3. Revise current guidance to clarify how eligibility should be evaluated in order to ensure the intent of the CDC/504 Loan Program is met when the Federal budget reduction public policy goal is used to qualify a borrower for a CDC loan.

---

[7] 13 CFR 120.825

4. Evaluate the need to establish monetary or other guidelines, on the level of excess funds that CDCs should retain as a reserve for future operations and/or invest in other local economic development activities.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

On January 25, 2010, we provided the Office of Capital Access (OCA) with the draft report for comments. On March 15, 2010, OCA submitted its formal response, which is contained in Appendix IV. Management generally concurred with some of the loan findings, but disagreed with others. Management also disagreed with Recommendation 1, partially agreed with Recommendation 2, and agreed with Recommendations 3 and 4. A summary of management's comments and our response follows.

Recommendation 1

Management Comments

Management disagreed that lenders should be required to use the actual cash flow method to determine borrower repayment ability, and that cash flow projections should be based on historical sales and executive compensation levels. It stated that making lenders rely exclusively on historical data may not be appropriate for all situations, and that some flexibility is necessary to realistically assess project cash flows.

OIG Response

We believe that because PCLs make loans without prior approval from SBA, the Agency needs to implement controls to ensure that lenders are making prudent lending decisions. Our audit results indicate that providing lenders wide flexibility reduces accountability and results in potentially riskier loans. While we believe historical salary and sales should be the starting point from which to determine business cash flow, we are not recommending that CDCs use it exclusively for determining borrower repayment ability. Instead, we are suggesting that deviations from historical data be clearly explained and documented. We noted several loans where the actual salaries were significantly reduced in the cash flow analyses, making more cash available for repayment ability. Had the actual salaries been used, these loans would not have met SBA's test for repayment ability and would not have qualified. Absent a separate agreement limiting salaries, there is no assurance that borrowers will reduce the salaries accordingly. Similarly, we noted instances where sales projections were double that of historical sales levels, without an explanation of how the business would achieve the higher sales. Had the historical sales been used to determine borrower repayment ability, the borrowers would not have qualified for the loans.

SBA acknowledges in SOP 50 10 4 that the actual cash flow method is the preferred method for determining the cash flow of businesses that use the accrual method of accounting because it provides an accurate picture of the cash available to pay the business expenses. While we realize that this requires the borrower to provide additional analyses, the two methods can yield very different results. Therefore, the actual cash flow of the business is relevant to the loan approval decision.

Recommendation 2

Management Comments

OCA stated that it already has a process to correct deficiencies identified in onsite reviews, but expressed its belief that there is an opportunity to better link-up this information with other CDC data in order to make better informed lender specific and programmatic determinations.

OIG Response

Management's comments do not identify steps they would take to ensure lender performance issues are corrected timely. Because deficiencies were not corrected after being identified during onsite reviews, we believe it is necessary to improve the current corrective action process since it does not appear to be effective.

Recommendation 3

Management Comments

Management agreed to clarify guidance on how eligibility should be evaluated in order to ensure that program intent is met when the Federal budget reduction public policy goal is used to qualify a borrower for a 504 loan. However, because current policy does not impose a time limitation on base closures, it believes the eight loans identified as having eligibility deficiencies were properly made.

OIG Response

Management's comments are responsive to the recommendation. However, we believe the public policy clarification needed relates more to assessing the continued existence of the adverse economic impact, and not just establishing time limits for consideration of base closures. We also do not believe the lack of definitive policy excuses PCLs from making a proper evaluation relative to the program's public policy goals. PCLs are required to assess whether the loan will create/retain jobs or economically improve areas adversely impacted by Federal cutbacks, such as base closings. In cases we cited as problematic, we found no assessment of the impact or justification other than a check mark for base closure. However, we found information showing that the areas had significant economic growth, thereby bringing into question whether the adverse impact still existed. While SBA has not defined the documentation needed to establish impact, it seems reasonable that if a PCL were using Federal cutbacks as the basis for qualifying the loan after 12 to 15 years, there should have been an analysis documenting the continued adverse impact. In cases where we did not find evidence of strong economic growth, we did not question that loan. Without an explanation of these impacts, we do not believe the eight borrowers met the standards for the 504 loan program. As such, we deemed them as ineligible for the 504 loans.

Recommendation 4

Management Comments

Management agreed to evaluate the need for guidelines on the level of excess funds that CDCs should retain as a reserve for future operations and/or invest in other local economic development activities.

OIG Response

We believe management's comments are responsive to the recommendation.

Management Disagreements on Specific Loan Findings

Management Comments

In addition to the eight loans cited as exceptions related to the public policy goal, management cited three instances where it believed the environmental review complied with SOP requirements in existence at the time.

Management also identified another six loans where it believed the underwriting issues flagged by the audit were not valid.

OIG Response

As previously stated, we believe the eight loans needed documented justification as to how the areas were adversely impacted by Federal budget cutbacks. Regarding the three loans with environmental review issues, we relied on a district official's assessment in questioning those loans. Upon further review, this official advised us that the three loans met the environmental review requirements. Therefore, we changed the report to reflect the acceptability of the three environmental reviews. This resulted in one loan being dropped from our findings as it had no other deficiencies.

The Agency agreed with the majority of the underwriting issues raised in the report, but disagreed with our underwriting findings for six loans. After further review, we re-categorized one additional loan, which had been identified as having underwriting issues, as being acceptable. However, borrowers on the other five loans we believe lacked repayment ability either because the borrower significantly inflated sales revenue, significantly understated officer salary expenses, or an analysis of actual cash flow showed that the borrowers did not have sufficient debt coverage.

ACTIONS REQUIRED

Please provide your management decision for each recommendation on the attached SBA Forms 1824, Recommendation Action Sheet, within 30 days from the date of this report. Your decision should identify the specific action(s) taken or planned for each recommendation and the target date(s) for completion.

We appreciate the courtesies and cooperation of the Office of Capital Access and Office of the Chief Financial Officer during this audit. If you have any questions concerning this report, please call me at (202) 205- [FOIA ex. 2] or Pamela Steele-Nelson, Acting Director, Credit Programs Group, at (202) 205- [FOIA ex. 2].

APPENDIX I. SCOPE AND METHODOLOGY

The initial audit objectives were to determine whether: (1) CDCs exercised prudent underwriting practices when making SBA loans; and (2) compensation of Certified Development Corporation (CDC) executives was high relative to gross receipts of the CDC. After the audit was announced, we expanded our scope to assess the extent to which CDC/504 loans were approved in accordance with eligibility and loan closing requirements based on issues identified during our review of the loan files.

To assess the underwriting compliance of the CDCs in the Premier Certified Lender Program (PCLP), we reviewed 25 of 100 statistically selected CDC/504 loans approved under Premier Certified Lender (PCL) authority that were disbursed during fiscal year (FY) 2008. The loans had been approved by 3 of the most active of the 24 PCLs---PCL 1, PCL 2, and PCL 3. We used a stratified sample to ensure there was adequate representation from each of the three PCLs. We reviewed 10 loans approved by PCL 1, 5 loans approved by PCL 2, and 10 approved by PCL 3. The 3 PCLs accounted for [FOIA ex. 8] percent of CDC/504 loan funds disbursed in FY 2008. To determine the appropriateness of the underwriting decisions, we assessed the reasonableness and consistency of the PCLs' financial analysis for each loan and the decisions on the applicant's ability to repay the loans in a timely manner based on the businesses' cash flow.

To assess the extent that sampled loans complied with SBA's eligibility and loan closing requirements, we compared borrower information in the loan files for the 25 sampled loans to SBA's eligibility requirements stated in SOP 50 10, *Lender and Development Company Loan Programs*. We determined whether the PCLs ensured that borrowers:

- met general and program eligibility requirements;
- were of sound character;
- were creditworthy, given past personal and business credit history;
- had verified repayment ability per personal and business financial statements based on business and personal tax returns or IRS transcripts;
- met equity injection requirements; and
- had adequate and acceptable collateral, as documented by current appraisals and sound environmental reports.

Lastly, we interviewed SBA officials from the Office of Financial Assistance who are responsible for administering the CDC/504 Loan Program and from the Office of Credit Risk Management, who oversee the CDC/504 Loan Program and are responsible for its biennial reviews and management. We also interviewed management and staff from the three CDCs and SBA's Sacramento Loan

Processing Center. Finally, we relied on reviews made by an SBA district counsel to determine whether PCLs met SBA requirements for environmental assessments of business collateral.

To determine whether compensation paid to five CDC executives was excessive, we evaluated total executive compensation paid by CDCs as reported from Internal Revenue Service (IRS) records for non-profit organizations. To evaluate compensation, we identified executives associated with each of the five CDCs from Form 990s filed with IRS, and compared salary plus other benefits paid to these executives to that of the other 51 CDCs that had gross receipts in excess of $1 million in FY 2006. The five CDCs were EDF Resource Capital, Inc., Long Island Development Corporation, Capital Access Group, Inc., Mortgage Capital Development Corporation, and Front Range Regional Economic Development Corporation. We also reviewed the governing regulations regarding executive compensation for CDCs, and interviewed SBA officials on this subject.

APPENDIX II. STATISTICAL SAMPLING METHODOLOGY

From a population universe of 1,169 Premier Certified Lender (PCL) loans disbursed in fiscal year (FY) 2008 by three of the largest PCLs totaling approximately $780 million, we randomly selected a statistical sample of 25 loans to estimate our population values. In statistical sampling, the estimate of attributes in the population universe has a measurable precision or sampling error. The precision is a measure of the expected difference between the value found in the sample and the value of the same characteristics found if a 100-percent review had been completed using the same techniques.

The population point estimates and the related lower and upper limits for the selected attributes were calculated using the Windows RAT-STATS statistical software program at a 90 percent confidence level. Projecting our sample results to the universe of approximately $780 million in loan disbursements made by the three PCLs, we estimate the rate of poor underwriting and or incomplete eligibility determinations to be nearly 49 percent, or approximately $255 million. The table below shows our calculations for FY 2008 poor underwriting and or eligibility determinations.

PROJECTED OCCURRENCES OF POOR UNDERWRITING DECISIONS AND ELIGIBILITY AND LOAN CLOSING ISSUES				
	Occurrence Sample of 25 Loan Disbursements	**90 Percent Confidence**		
		Population Point Estimate	**Lower Limit**	**Upper Limit**
Number	17	792	572	1,012
Dollar Value	$8,918,062	$401,574,057	$254,971,601	$548,176,513

Individually, projecting our sample results to the universe of approximately $780 million in loan disbursements, we estimate the rate of poor underwriting determinations to be nearly 16 percent, or approximately $56.4 million. The following table shows our calculations for FY 2008 faulty repayment ability conclusions.

PROJECTED OCCURENCES OF POOR UNDERWRITING DECISIONS				
	Occurrence Sample of 25 Loan Disbursements	90 Percent Confidence		
		Population Point Estimate	Lower Limit	Upper Limit
Number	10	413	183	643
Dollar Value	$5,353,600	$213, 648,015	$56,424,473	$370,871, 558

Relative to eligibility determinations, we estimate the rate of loans that did not comply with loan eligibility requirements to be nearly 36 percent, or approximately $209 million. The table below shows our calculations for FY 2008 incomplete eligibility determinations.

PROJECTED OCCURENCES OF LOANS THAT MAY NOT HAVE COMPLIED WITH ELIGIBILITY AND LOAN CLOSING REQUIREMENTS				
	Occurrence Sample of 25 Loan Disbursements	90 Percent Confidence		
		Population Point Estimate	Lower Limit	Upper Limit
Number	13	637	417	858
Dollar Value	$7, 598,938	$355,434,147	$209,497,658	$501, 370,635

APPENDIX III. SAMPLED CDC LOANS REVIEWED

Sample	Loan Number	Deficiency Summary	Outstanding Balance
1	[FOIA ex. 2]	2, 5,	$185,615
2	[FOIA ex. 2]	6	$466,126
3	[FOIA ex. 2]	3	$236,097
4	[FOIA ex. 2]	-	-
5	[FOIA ex. 2]	2	$419,898
6	[FOIA ex. 2]	-	-
7	[FOIA ex. 2]	-	
8	[FOIA ex. 2]	3	$678,884
9	[FOIA ex. 2]	6	$104,551
10	[FOIA ex. 2]	-	-
11	[FOIA ex. 2]	1, 2, 3	$640,262
12	[FOIA ex. 2]	-	-
13	[FOIA ex. 2]	3, 4	$493,365
14	[FOIA ex. 2]	3	$459,152
15	[FOIA ex. 2]	3, 6	$1,149,689
16	[FOIA ex. 2]	3, 5, 7	$1,382,135
17	[FOIA ex. 2]	5	$262,725
18	[FOIA ex. 2]	3	$625,202
19	[FOIA ex. 2]	3, 6	$344,704
20	[FOIA ex. 2]	3, 6	$478,968
21	[FOIA ex. 2]	-	
22	[FOIA ex. 2]	3	$503,967
23	[FOIA ex. 2]	-	-
24	[FOIA ex. 2]	7	$485,722
25	[FOIA ex. 2]	-	-
25	**Totals**		**$8,918,062**

Deficiency Summary Legend

1. Environmental Assessment
2. Adverse Change Evaluation
3. Loan Eligibility -
   Exporter Verification, Occupancy, Personal Guarantees, Equity Injection, Job Creation/Retention Requirement
4. Repayment Ability - General
5. Repayment Ability - Use of Projection
6. Repayment Ability - Use of Net vs. Historical Executive Compensation
7. Repayment Ability - Use of Rule of Thumb vs. Accrual Cash Flow Assessments

APPENDIX IV. MANAGEMENT COMMENTS

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

DATE: March 15, 2010

TO: Debra Ritt
Assistant Inspector General for Auditing

FROM: Eric Zarnikow [FOIA ex. 6]
Associate Administrator, Office of Capital Access

SUBJECT: Response to Draft Audit Report: Underwriting Practices and Compliance Of Premier Certified Lenders in the Section 504 Loan Program, Project 8015

Thank you for the opportunity to review the subject draft audit report. We appreciate the time your staff has taken in reviewing the program. Please find our response to the report recommendations below. We have also attached more detailed information containing our response to the specific loan exceptions noted in the report.

We believe it is important to note that while the report makes broad projections onto the 504 loan portfolio based on the eligibility and underwriting weakness identified, 21 of the 25 loans reviewed by the Office of Inspector General (OIG), or 84%, are currently in a performing status. These loans survived the economic turmoil of late 2008 and 2009 in spite of the loan exceptions noted in the audit.

1. *Revise SOP 50 10, Lender and Development Company Loan Programs, to require that lenders use (a) actual cash flow method to determine borrower repayment ability for businesses using accrual accounting, (b) historical salary levels to estimate officer salary, and (c) historical sales data to make sales projections.*

   (a) SBA disagrees with OIG's recommendation to require lenders to use only the actual cash flow method to determine borrower repayment ability for businesses using accrual accounting. SBA's SOP provides an option to lenders to use the rule of thumb method, and this remains the Agency's policy. The CDCs reviewed in the report followed existing, approved policy and it is inaccurate to cite underwriting exceptions when they were complying with established policy.

   (b) SBA agrees that estimations made with regard to officer compensation levels should be analyzed, substantiated and documented and will evaluate its guidance in this area for adequacy. We disagree, however, with limiting an analysis of executive compensation to historical salary levels. Small business owners generally understand the need to make trade-offs between personal finances and investing in their small businesses. Limiting executive compensation to historical salary levels is not appropriate in all situations.

   (c) Similarly, SBA agrees that cash flow projections should be supported and based on factual matters and will also evaluate its guidance in this area for adequacy. We disagree that projections must be based exclusively on historical sales levels. Projections should be permitted to reflect increased capacity due to expansions. Using solely historical information for projections may not reflect the specifics of a local economy, business fluctuations (up or down) and/or situations where there are unique competitive benefits or constraints. While assumptions must be reasonable and documented, limiting cash flow analyses to historical levels is not appropriate in all cases and some flexibility is necessary to realistically assess project cash flows.

2. *Review guidance for the performance of onsite reviews, and develop a process to ensure that corrective actions are taken in response to OCRM onsite reviews to make sure these conditions do not continue, and/or modify guidance for these reviews, as appropriate, to ensure that reviewers properly assess lender determination of borrower repayment ability and eligibility; including lender validation of financial information used by borrowers to demonstrate repayment ability and assessment of eligibility on achievement of public policy goals.*

   As the draft audit report noted, the OCRM onsite reviews did identify similar concerns with eligibility and underwriting of Section 504 loans. Further, OCRM does have a corrective action process designed to work with CDCs to correct deficiencies identified in its reviews. However, consistent with the Administrator's focus on risk management, we believe there is an opportunity to better link-up this information with other CDC information in order to make better informed lender specific and programmatic determinations.

3. *Revise current guidance to clarify how eligibility should be evaluated in order to ensure the intent of the CDC/504 Loan Program is met when the Federal budget reduction public policy goal is used to qualify a borrower for a CDC loan.*

   We agree that guidance on this matter should be clarified. However, the Federal budget reduction public policy goal is met through a base closure, and there is no time limitation on how long ago the base may have closed. Designation of a Section 504 loan as meeting the Federal budget reduction public policy goal due to a base closure is permissible and, therefore, the eight loans identified as having eligibility deficiencies should not have been so identified.

4. *Evaluate the need to establish guidelines, monetarily or otherwise, on the level of excess funds that CDCs should retain as a reserve for future operations and/or invested in other local economic development activities.*

Updates to the 504 program regulations are on SBA's regulatory agenda for FY2010. SBA will evaluate the need to establish guidelines, monetarily or otherwise, on the level of excess funds that CDCs should retain as a reserve for future operations and/or invest in other local economic development activities as part of the regulatory update.

With regard to the specific loan deficiencies cited in the draft audit report, SBA has reviewed the loans and identified some differences in the specific exceptions and/or the general conclusions made. A summary of our loan specific issues is attached.

Attachment A: Summary of Findings – CDC Loans Reviewed
Attachment B: Summary of Loan Review Concerns

ATTACHMENT A: SUMMARY OF FINDINGS -- CDC LOANS REVIEWED

Sample	Loan Number	OIG Deficiency Summary	SBA Deficiency Summary	Oustanding Balance	Status	Comments
1	[FOIA ex. 2]	2,5,6	2	$ 185,615	Current	CDC actually increased executive comp to meet owner's cash needs Projections supported
2	[FOIA ex. 2]	1,6	--	$ 466,126	Current	Environmental screen obtained as allowed by SOP Credit memorandum explains adjustments made to officer's compensation although no agreement was found that officers would take less compensation
3	[FOIA ex. 2]	3	3	$ 236,097	Current	
4	[FOIA ex. 2]	-	--		Current	
5	[FOIA ex. 2]	2	2	$ 419,898	Current	
6	[FOIA ex. 2]	-	--		Defaulted	
7	[FOIA ex. 2]	4,6	--	$ 249,807	Current	Projections supported
8	[FOIA ex. 2]	3	--	$ 678,884	Current	Base closure policy goal
9	[FOIA ex. 2]	6	6	$ 104,551	Current	
10	[FOIA ex. 2]	-	--		Current	
11	[FOIA ex. 2]	1,2,3	1,2	$ 640,262	Current	Base closure policy goal
12	[FOIA ex. 2]	-	--		Current	
13	[FOIA ex. 2]	3,4	--	$ 493,365	Current	Base closure policy goal IRS verification of income may have been required by SOP; disagree with conclusion that results of repayment ability analysis could not be relied upon; business a Subchapter S Corp and lender obtained IRS transcripts for personal tax returns which verified critical business income data included in the repayment analysis
14	[FOIA ex. 2]	3	3	$ 459,152	Current	
15	[FOIA ex. 2]	3,6	3,6	$ 1,149,689	Current	
16	[FOIA ex. 2]	3,5,7	5	$ 1,382,135	Current	Base closure policy goal Rule of thumb a permissible method of cash flow analysis
17	[FOIA ex. 2]	5	5	$ 262,725	Defaulted	
18	[FOIA ex. 2]	3	--	$ 625,202	Current	Base closure policy goal
19	[FOIA ex. 2]	3,6	3,6	$ 344,704	Current	Agree with eligibility on required equity Do not agree with base closure goal exception

20	[FOIA ex. 2]	1,3,6	6	$ 478,968	Current	Have Phase II environmental, lower level assessments not necessary Base closure policy goal
21	[FOIA ex. 2]	1	--	$ 599,583	Current	Environmental adequate
22	[FOIA ex. 2]	3	--	$ 503,967	Defaulted	Base closure policy goal Occupancy at least 51%
23	[FOIA ex. 2]	-	--		Current	
24	[FOIA ex. 2]	7	--	$ 485,722	Defaulted	Rule of thumb a permissible method of cash flow analysis
25	[FOIA ex. 2]	-	--			
25	TOTALS			$ 9,766,452		

Deficiency Summary Legend

1 Environmental Assesment
2 Adverse Change Evaluation
3 Loan Eligibility -
Exporter Verification, Occupancy, Personal Guarantees, Equity Injection, Job Creation/Retention Requirement
4 Repayment Ability - General
5 Repayment Ability - Use of Projection
6 Repayment Ability - Use of Net vs. Historical Executive Compensation
7 Repayment Ability - Use of Rule of Thumb vs. Accrual Cash Flow Assessments

ATTACHMENT B

SUMMARY OF LOAN REVIEW CONCERNS

Eligibility

In eight instances, the draft report cited exceptions related to the public policy goal that supports budget cutbacks and base closures. In the loans reviewed by OIG, there is no disagreement that a base closure occurred. The concerns identified related to the length of time between the base closure and the Section 504 loan -- in some instances the difference was almost 15 years. We agree that in those instances where there has been a significant period of time between the two events that there should be some nexus established between the two events. However, SBA's guidance does not establish specific requirements for base closures, to qualify a loan as eligible as a Section 504 loan under this public policy goal. Without a specific requirement for a timeframe, we do not believe that the CDCs have made ineligible loans for this factor. This public policy goal is treated in the same manner for regular 504 loans that are approved by SBA. We would agree that the Agency should provide more guidance in this area for CDCs to apply but do not believe these loans should be included in the conclusions and projections made about the eligibility of the loans made by the CDCs.

The second eligibility issue of concern to us relates to the exceptions noted on the environmental reviews conducted for the individual Section 504 loans. The report cited four instances of deficiencies in the environmental reviews conducted by the PCLPs. In three instances, we believe the environmental review complied with SOP requirements in existence at the time (SOP 50 10 4). Since that time, the SOP has been revised and more stringent requirements were put in place (SOP 50 10 5). These loans should be removed from any calculation related to eligibility deficiencies made by the PCLPs.

Lastly, we would like to address the requirement for current financial statements prior to the closing of Section 504 loans. We acknowledge the requirement and agree that the file does not include the required statements. This exception was identified in three loans although the financial statements for one loan were only 13 days older that required. However, we would note that this is not an eligibility issue but a closing deficiency.

Underwriting

The vast majority all of the underwriting exceptions identified in the audit relate to evaluation of repayment ability. They fall into three broad categories – sales projections, the rule of thumb method of calculating cash flows, and net compensation calculations to determine officer compensation. We agree that projections should be supported and based on factual matters. While we believe that some additional guidance to CDCs related to documenting projections may be appropriate, we do not come to the same conclusions as OIG in each specific instance.

The use of historical information and/or industry standards is important in evaluating cash flow projections. However, they must also be considered in the context of the purpose of the loan. If the loan is for expansion, sales projections in excess of historical levels must be made in order to accommodate the additional capacity being obtained through the loan. Similarly, when the industry is unique, with few competitors, the availability of industry comparisons is limited or not available. Reasonableness must prevail in assessing cash flow projections.

The rule of thumb method of establishing cash flow and debt service coverage is permissible, along with the actual cash flow method, in SBA's SOP. Since it is permitted, we do not believe these loans should be included in the conclusions and projections made about the underwriting of the loans made by the CDCs. The OIG only identified two specific exceptions in the underwriting category relating to the use of the rule of thumb method. Two instances do not seem to be a sufficiently substantiated finding to result in a recommendation that SBA eliminate this method from its SOP.

The draft audit report identified numerous instances where the net compensation method was utilized to calculate officer salaries in the cash flow projections. We believe that there are occasions where a small business owner may adjust its compensation based on the actual cash needs of the business and may make reasonable adjustments to compensation in a choice to re-invest those funds into the business. However, we also believe that the analysis of those decisions must be documented in order to properly evaluate a small business' cash flow projections and debt service coverage. SBA will provide additional guidance to CDCs on this matter.