



U.S. Small Business Administration
Office Inspector General

Memorandum

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

Date: December 2, 2009

15/ original signed
From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Notice of Finding and Recommendation on Recovery Act Loans Involving Change of Ownership Transactions
ROM-10-03

The OIG is conducting an audit of 7(a) loans disbursed pursuant to the American Recovery and Reinvestment Act of 2009 (Recovery Act) to determine if the loans made under the Act were originated and closed in compliance with SBA's policies and procedures and to identify any evidence of suspicious activity. This is the first in a series of finding notices related to our ongoing audit that provide the Agency with early notification of findings and recommendations related to material deficiencies in Recovery Act loans and with the loan approval process. This Notice of Finding and Recommendation (NFR) identifies issues with SBA's approval of Recovery Act loans involving change of ownership transactions. We made three recommendations to the Associate Administrator for Capital Access to: (1) provide training to loan officers on the calculation of goodwill and application of change of ownership requirements to loans involving the refinancing of seller debt; (2) measure the effectiveness of the loan officer training through a Quality Assurance Review process; and (3) establish a process for granting policy waivers approved by the Associate Administrator for Capital Access or higher official that provides the necessary independence and is supported by risk-based justifications.

On November 6, 2009, we provided a draft of this NFR to SBA for comment. On November 20, 2009, SBA submitted its formal comments, which are contained in their entirety in Appendix II. Management disagreed that there were deficiencies in the three loans involving the proper calculation of goodwill discussed in the NFR, but did not specifically address the asset valuation deficiencies identified in these loans. Management did agree with our finding for the one loan that was not eligible for an SBA guaranty because it did not result in the borrower owning

100 percent of the business. SBA also questioned the statistical validity of projecting the findings to the population of change of ownership transactions. SBA agreed to provide training to loan officers on change of ownership transactions, debt refinancing, and goodwill and also agreed to review these types of transactions in their quality assurance reviews. However, SBA did not agree that policy waivers for change of ownership transactions need to be approved by the Associate Administrator for Capital Access as they are loan policy issues that fall under the responsibility of the Office of Financial Assistance. Nevertheless, SBA agreed to review the change of ownership policy waiver process in order to identify possible areas for strengthening.

We continue to support our finding that SBA did not properly calculate the amount of goodwill funded by three loans in our sample, and will meet with the Agency and work to resolve any differences in correctly calculating goodwill. With regard to the statistical validity of our projections, it is important to note that our findings were not projected to the population of change of ownership transactions as stated in SBA's comments. Rather, we projected our results to the population of SBA-approved 7(a) Recovery Act loans disbursed as of May 31, 2009, from which our sample of 30 SBA-approved loans was derived. As a result, we are 90 percent confident that SBA inappropriately approved at least \$6.6 million in SBA loans between February 17, 2009 and May 31, 2009. Our projection was performed by a statistical consultant and is statistically valid.

SBA's plans to provide training on change of ownership transactions, debt refinancing, and goodwill and to monitor these areas through its quality assurance process are responsive to recommendations 1 and 2. While SBA agreed to review its change of ownership policy waiver process, it did not provide any specifics on how the process would be strengthened. We continue to support our position that allowing the Director of the Office of Financial Assistance to approve such waivers places him in a conflicted position of fostering lender relationships and assessing risk of loss on loans. We have repeatedly expressed our concern with lender oversight functions being organizationally placed within an office whose mission is to increase small business access to capital through expanding lender participation.¹ Also, we believe the current change of ownership waiver process presents a similar conflict of interest issue. We will seek a management decision for this recommendation through the audit resolution process.

¹ OIG Report 9-08, *Audit of the Liquidation Process at the National Guaranty Purchase Center*, January 30, 2009; and OIG Report 9-16, *The Small Business Administration's Fiscal Year 2008 Improper Payment Rate for the 7(a) Guaranty Loan Program*, July 10, 2009.

We appreciate the courtesies and cooperation of the Office of Capital Access. If you have any questions concerning this NFR, please call me at 202-205- or Debra Mayer, Director, Recovery Oversight Group, at 202-205- [FOIA ex. 2]

[FOIA ex. 2]

Attachment

**U.S. Small Business Administration
Office of Inspector General**

Notice of Finding and Recommendation

Audit Location/Division	<u>Office of Capital Access</u>
Date	<u>December 2, 2009</u>
Description of Issue	<u>SBA did not adequately review and approve Recovery Act loans involving change of ownership transactions and the financing of goodwill.</u>

BACKGROUND:

The purpose of this Notice of Finding and Recommendation (NFR) is to advise you of an issue that was identified during our ongoing audit of 7(a) loans disbursed under the American Recovery and Reinvestment Act of 2009 (Recovery Act). As part of this audit, we reviewed 30 SBA approved loans, of which 9 involved “change of ownership” transactions.

CONDITION:

We identified deficiencies in SBA’s approval of four of the nine Recovery Act loans in our sample that funded change of ownership transactions. These four loans totaled approximately \$2.1 million. One loan was not eligible for an SBA guaranty because it did not result in the borrower owning 100 percent of the business, as required under Standard Operating Procedure (SOP) 50 10 5(a). Eligibility for the other three loans was questionable due to the excessive amount of goodwill financed in each transaction. We found that SBA did not properly calculate the amount of goodwill funded by these three loans. In performing the calculations correctly, we found that these loans included goodwill of 80 to 86 percent of the loan amounts and up to \$657,000, significantly exceeding SBA’s goodwill limitations. Due to its miscalculations, SBA was not aware that it approved two loans which had exceeded the goodwill limitations. For the third loan, SBA provided an official waiver to the goodwill policy, but calculated the amount of goodwill to be 65 percent, or \$522,587, when it was actually 82 percent, or \$657,000. Furthermore, SBA provided this waiver without the information required to make an informed, risk-based decision.

CRITERIA:

SBA SOP 50 10 5(a) requires a loan involving the refinancing of seller debt to be treated as a change of ownership transaction. The transaction is not eligible for an SBA guaranty if the borrower will not own 100 percent of the business it is purchasing.

SBA SOP 50 10 5(a) states that under a change of ownership transaction, the lender may finance a limited amount of goodwill, but that 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.

SBA SOP 50 10 5(a) states that if the valuation of fixed assets is greater than their depreciated value, an independent appraisal must be obtained to support the higher valuation.

SBA Information Notice 5000-1096 provided additional guidance on SBA's policy related to the financing of goodwill. The notice gave lenders the option to submit loans that exceeded goodwill limitations to SBA for loan approval consideration. The notice, however, required lenders to submit certain documentation with their requests to SBA, including:

- A detailed explanation of the circumstances that prevented the seller and/or buyer from meeting the SOP requirements for financing the balance of goodwill;
- A business valuation, as required in SOP 50 10 5(a);
- Any appraisals used to establish the value of real estate and/or equipment;
- The name and address of any broker involved in the transaction and the fee charged for their services; and
- Any other information needed to process the application.

The notice also defined goodwill for change of ownership transactions structured as asset purchases as the selling price minus the sum of the book value of all assets being purchased.

CAUSES:

SBA treated one loan as a traditional debt refinance rather than a change of ownership transaction, as required when a lender is refinancing seller debt. Had SBA evaluated this loan as a change of ownership, the analysis would have shown that the transaction did not result in the borrower owning 100 percent of the business, in violation of SOP 50 10 5(a).

For the other three loans, SBA did not properly calculate the amount of goodwill included in the change of ownership transactions which were structured as asset purchases. Specifically, SBA overstated the value of assets being purchased in the transactions because it did not adjust the assets to their book value, as required, and accepted the inflated values provided in the purchase agreements or seller asset lists.

Furthermore, a waiver provided by the Director of SBA's Office of Financial Assistance (OFA) for one of these loans was based on incomplete and inaccurate information provided by the SBA loan processing center, which prevented the Director from making an informed, risk-based decision. The center did not provide complete or accurate information on the amount of goodwill being financed and the payment of an excessive broker fee from working capital loan proceeds. Lastly, because the Director of OFA is

responsible for lender relations, approving the waiver placed him in a conflicted position of fostering lender relationships and assessing risk of loss on the loan.

EFFECT:

Based on SBA's approval of these four loans valued at \$2.1 million, we project that SBA inappropriately approved at least \$6.6 million in SBA loans between February 17, 2009 and May 31, 2009. These approvals will (1) increase the risk of loss to SBA if these loans default, and (2) reduce the availability of SBA loans to other lenders and eligible borrowers.

RECOMMENDATIONS:

We recommend that the Associate Administrator for Capital Access:

1. Provide training to loan officers on (1) the calculation of goodwill and the importance of adjusting assets to their book values or appraised values in performing their calculations, and (2) applying change of ownership requirements to loans involving the refinancing of seller debt.
2. Measure the effectiveness of the loan officer training through a Quality Assurance Review process.
3. Establish a process for granting policy waivers approved by the Associate Administrator for Capital Access or higher official that provides the necessary independence and is supported by risk-based justifications.

**APPENDIX I. INELIGIBLE LOANS INVOLVING CHANGE OF OWNERSHIP
TRANSACTIONS**

Loan Number	Loan Name	Loan Amount
[FOIA ex.2]	[FOIA ex.4]	\$600,000
		\$293,300
		\$363,000
		\$800,000
Total		\$2,056,300

APPENDIX II. AGENCY COMMENTS



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

DATE: November 16, 2009
TO: Debra S. Ritt
Assistant Inspector General for Auditing
FROM: Eric R. Zarnikow [FOIA ex. 6]
Associate Administrator for Capital Access
SUBJECT: Draft Notice of Finding and Recommendation on Recovery Act Loans
Involving Change of Ownership Transactions, Project No. 9512A

Thank you for the opportunity to comment on the Draft Notice of Finding and Recommendation on Recovery Act Loans Involving Change of Ownership Transactions.

We appreciate that the Office of the Inspector General has given us a quick response and feedback on the Recovery Act loans involving change of ownership. OCA partially agrees with OIG's findings included in the report. In three of the four cases outlined in your notice, OCA disagrees with OIG's conclusions that an improper decision was made.

Although the office agrees with the recommendations regarding staff training and quality assurance we disagree with the recommendation regarding the need to establish a process for granting policy waivers outside of the current standard operating procedure.

In reviewing the Draft Report OCA does not agree with the determination that there were deficiencies in SBA's approval of four of the nine Recovery Act loans in your sample that funded change of ownership transactions. A review of the loans processed by the center indicates that only one of the four loans was processed incorrectly. We would welcome the opportunity to discuss the differences in analysis of the remaining cases in your sample.

At the same time, OCA does not know, or at least the report does not address, the statistical validity of projecting these findings to the population of change of ownership transactions.

That said, OIG identified some issues that OCA believes should be addressed. The center will continue to provide training on these important areas of lending, and will monitor them through its quality assurance process.

- Updated training will be conducted in the 7(a) processing centers on change of ownership transactions, debt refinancing and goodwill.

- Review of these types of transactions will be included in OCA's quality assurance plan and additional training provided, as appropriate.

OCA does not agree that policy waivers for change of ownership transactions need to be approved by the AA/CA. It is appropriate for the D/OFA to make these determinations as they are issues of loan policy and therefore fall under the responsibility of the Office of Financial Assistance. However, OCA will review the change of ownership policy waiver process in order to identify possible ways to strengthen the process.