

AUDIT OF
LOS ANGELES DISTRICT OFFICE 7(a) LOANS
GLENDALE, CALIFORNIA
AUDIT REPORT NO. 8-8-F-002-028
September 30, 1998

This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.



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

AUDIT REPORT
Issue Date: September 30, 1998
Number: 8-8-F-002-028

Date: September 30, 1998

To: Arnold Rosenthal, Associate Administrator,
Office of Borrower and Lender Servicing

Alberto Alvarado, District Director
Los Angeles District Office

Richard Taylor, Director
Preferred Lender Program (PLP) Loan Processing Center

Peter L. McClintock

From: Peter L. McClintock, Assistant Inspector General
for Auditing

Subject: Audit of Los Angeles District Office 7(a) Loans

Attached is a copy of the subject audit report. The report contains two findings with eight recommendations for the Associate Administrator, Office of Borrower and Lender Servicing; District Director, Los Angeles District Office; and the Director, PLP Loan Processing Center.

The recommendations in this report are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up. Please provide your management response to the recommendations within 30 days from the date of this report, using the attached SBA Forms 1824, Recommendation Action Sheet..

Any questions or discussions of the issues contained in this report should be directed to Garry Duncan at 202-205-7732.

Attachment

cc: Acting Associate Administrator for Financial Assistance

**AUDIT OF 7 (a) LOAN PROCESSING
LOS ANGELES DISTRICT OFFICE
GLENDALE, CALIFORNIA**

TABLE OF CONTENTS

	Page
SUMMARY	i
INTRODUCTION	
A. Background	1
B. Audit Objective and Scope	1
RESULTS OF AUDIT	
Findings and Recommendations	
1. SBA 7(a) Guaranteed Loans were not always Processed, Disbursed, and Used in Accordance with SBA Requirements	2
2. Canceled Loans were not Reported to SBA	9
Other Matters	
Lender Non-compliance with SBA Policies and Procedures	10
Borrower Misrepresentations	10
APPENDICIES	
A- Schedule of Loans Reviewed and their Status	
B- SBA Procedures Reviewed and the Related Loans with Discrepancies	
C- SBA Management Response	
D- Audit Report Distribution	

SUMMARY

The audit was part of a nationwide review to determine whether 7(a) loans were processed, disbursed, and used in accordance with Small Business Administration (SBA) requirements. The Los Angeles District Office was assigned 1,908 loans valued at \$662.1 million from March 1, 1996 to June 30, 1997. The sample loans, made to small business concerns within the state of California, were processed by the District Office and the Preferred Lender Program Loan Processing Center. We selected a random sample of 30 loans valued at \$10 million for review.

SBA procedures for lenders and SBA loan officers are intended to reduce risks and assure that only eligible loans are guaranteed. Failure to follow these procedures increases the chance that ineligible or risky loans will be approved. We reviewed lenders' compliance with 22 such procedures. We determined that lenders did not follow at least 1 of the 22 SBA procedures for 11 of the 30 loans reviewed.

The noncompliance with procedures consisted of the following:

- The proceeds for two loans totaling \$270,000 were used either for an ineligible purpose or were not used in accordance with the terms of the loan agreement.
- Lenders did not verify equity injections totaling \$233,400 for two loans valued at \$422,000.
- Financial information was not verified with Internal Revenue Service prior to disbursing six loans valued at about \$1.2 million.
- The borrower for a [FOIA Ex.4] loan showed financial statement income that exceeded his average tax return income by 275 percent. The borrower also lacked loan repayment ability and had a poor credit history.
- Available collateral was not taken to secure one loan.
- Compensation agreements were not prepared for two loans totaling approximately \$1.3 million, and the borrowers were charged prohibited fees totaling \$15,600.

In addition, two loans totaling \$700,000 were canceled, but the lenders did not notify SBA of the cancellations for at least 8 months.

During the audit, we notified the District Director that a participant in the Preferred Lender Program had not followed SBA's lending policies and procedures in processing three PLP loans reviewed. When we brought this to the District Director's attention, he immediately issued a warning to the lender.

As of August 31, 1998, 24 of the 30 sampled loans were current, 1 was past due, 2 were paid in full, and 3 were canceled, but SBA had not canceled one of the loans. Lender responses regarding the loans indicated the deficiencies were due to loan officers choosing to ignore SBA policy and unintentional loan officer errors.

We made eight recommendations to the Associate Administrator, Office of Borrower and Lender Servicing; the District Director, Los Angeles District Office; and the Director,

Preferred Lender Program Loan Processing Center, all of whom agreed with the report and recommendations.

The findings in this report are the conclusions of the OIG's Auditing Division based on testing of the auditee's operations. The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for follow-up and resolution.

INTRODUCTION

A. BACKGROUND

Audits of the SBA LowDoc Loan Program (a subsection of the 7(a) Loan Program) in 1996 and 1997 showed that lenders and SBA district offices were not always processing loans in compliance with existing policies and procedures. At the request of SBA's Office of Financial Assistance, we initiated an audit of the 7(a) Loan Program to determine if a similar level of non-compliance exists. Our evaluation will be presented in a summary report combining the results of eight individual audits. This report presents the audit results for one site.

Section 7(a) of the Small Business Act of 1958, as amended, authorizes SBA to provide financial assistance to small businesses. SBA provides this financial assistance primarily by guaranteeing loans made by participating lenders to small businesses. To obtain the SBA guarantee, a lender must have continuing ability to evaluate, close, service, and liquidate loans in accordance with SBA requirements. A Loan Guaranty Agreement between SBA and the lender requires the lender to abide by SBA regulations and procedures and allows the lender to request SBA purchase of defaulted loans.

Generally, SBA regulations and procedures require both the lender and SBA to review the borrower's eligibility, repayment ability, management qualifications, character, creditworthiness, and adequacy of collateral for loans submitted under regular procedures. The most active and expert lenders qualify for SBA's Certified Lender Program (CLP) and Preferred Lender Program (PLP), respectively. Under CLP procedures, SBA utilizes the credit presentation of the lender and makes a credit and eligibility determination. Under PLP procedures, the Sacramento PLP Loan Processing Center reviews loan applications solely for eligibility.

B. AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine whether 7(a) loans (excluding special programs with modified requirements such as LowDoc) were processed and proceeds disbursed and used in accordance with SBA requirements. The audit was based on a statistical sample of 30 loans valued at \$10 million out of a population of 1,908 loans for \$662.1 million made to small businesses in the state of California and assigned to the Los Angeles District Office between March 1, 1996, and June 30, 1997.

The auditors reviewed compliance with 22 procedures established by SBA to reduce risks associated with loan making and to assure that only eligible loans are guaranteed (see Appendix B). To make these determinations, the auditors reviewed lender and/or SBA file documentation for each loan in the sample; interviewed borrower, lender, and SBA district office personnel; and visited businesses to review records. Field work was performed from January through April 1998. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

FINDING 1 SBA 7(a) Guaranteed Loans were not Always Processed, Disbursed, and Used in Accordance with SBA Requirements

SBA procedures for lenders and SBA loan officers are intended to reduce risks and assure that only eligible loans are approved. The chance that risky or ineligible loans will be approved is increased when these procedures are not followed. In our sample, at least one processing or disbursing deficiency was identified for 11 of the 30 loans reviewed. Noncompliance with established procedures resulted in SBA inappropriately providing \$196,000 in guarantees for three loans (*sample numbers 14, 18, and 22*). Corrective actions are necessary to protect guarantees totaling \$433,750 for four other loans (*sample numbers 5, 8, 15, and 17*). Borrowers for two additional loans (*sample numbers 23 and 30*) were charged fees totaling \$15,600 which were not permitted by regulation and should be refunded. No action is required to protect the guarantees for the remaining two loans (*sample numbers 6 and 27*) since SBA's requirements were complied with after the loans had been disbursed.

Loan Proceeds were used for an Ineligible Purpose

SBA approved a guarantee for a loan processed by a PLP lender where the proceeds were disbursed and used for an ineligible purpose. The loan for [FOIA Ex. 4] (*sample number 14*) was approved in [FOIA Ex. 4] for working capital. The loan proceeds were disbursed to the PLP lender and used to pay down a line of credit the borrower had with the lender. The use of proceeds could be perceived as involving a conflict of interest. The lender should have processed the loan under regular procedures and provided a full explanation of the debt to SBA. Because the loan was processed under PLP procedures, SBA would not have been aware the loan proceeds would be used to reduce the line of credit and to transfer the PLP lender's risk of loss to SBA. Since the lender did not process the loan under regular procedures, SBA should rescind the [FOIA Ex. 5] guarantee. As of August 31, 1998, the loan was current.

According to Title 13 Code of Federal Regulations (CFR) Section 120.452, a lender may not make a PLP loan that reduces its existing credit exposure for any borrower. In addition, Section 120.140 requires a lender to process the loan under regular procedures and to provide a full explanation to SBA that the loan will repay or refinance debt owed to the lender and would reduce the lender's exposure to a loss. Section 120.140 also prohibits a lender from engaging in transactions which could result in a real or apparent conflict of interest.

Loan Proceeds were not used for An Approved Purpose

The proceeds of a [FOIA Ex. 4] loan (*sample number 22*) were not used for the purpose approved by SBA. Any deviation from the purpose identified in the loan agreement requires SBA approval. The loan was approved in [FOIA Ex. 4] to purchase real estate for the expansion of a business.

The loan agreement required the lender to obtain satisfactory evidence that the borrower was duly licensed before making the first disbursement. The loan agreement also stated that this provision could not be waived without the prior consent of SBA. The lender disbursed the loan proceeds without proof that the borrower had obtained the required business license for the location purchased. According to the Los Angeles County Department of Licensing, the borrower did not apply for the

required license. The proceeds were used to purchase real estate to rent. SBA was not aware that the terms of the loan agreement were violated, and the funds had not been used to expand the business, until our audit. The SBA guarantee of [FOIA Ex. 5] should be rescinded.

Based on discussions with SBA personnel during the audit, the District Director reprimanded the lender. The lender consequently obtained a letter from the borrower stating that the loan would be paid in full. The loan was repaid May 27, 1998.

Equity Injections were not Verified Prior to Disbursement

Lenders did not ensure that required equity injections were made for two loans totaling \$422,000. By not complying with the loan requirements, lenders increased the risk that borrowers may not remain committed to the business or the business may not have sufficient cash flow to sustain operations.

A loan for [FOIA Ex. 4] (*sample number 15*) for the purchase of real property for an existing business was approved in [FOIA Ex. 4]. The loan agreement required an equity injection of \$135,000 in cash prior to the first disbursement. The lender's loan file contained evidence that only \$51,600 (38 percent of the required amount) was injected prior to disbursement of the loan proceeds. During our visit to the business, the borrower could not provide acceptable proof that the remaining \$83,400 had been injected. Either the remaining injection should be made or the guarantee should be reduced to reflect the lack of the required equity injection. As of August 31, 1998, this loan was current.

A loan (*sample number 27*) was approved in [FOIA Ex. 4] to provide working capital of [FOIA Ex. 4]. The loan agreement required the lender to have evidence that the borrower injected at least \$150,000 into the business. The lender did not obtain evidence that the borrower had injected the required equity until April 1998, when we requested proof of the equity injection. The lender provided a letter from the borrower's accounting firm dated 15 months after the loan proceeds were disbursed stating the borrower had injected \$112,500 into the business. The letter was not adequate evidence and did not indicate when the injection was made. During our site visit to the borrower, we were able to verify that the required injection had been made. As of August 31, 1998, the loan was current.

Financial Information was not Verified Prior to Disbursement

For 6 loans totaling \$1.2 million, lenders did not verify business or borrower financial information prior to disbursement as required by the loan agreements. SBA Policy Notice 9000-941 requires lenders to obtain Internal Revenue Service (IRS) verification of the financial information of the small business concern and for a business being purchased prior to disbursing the loan proceeds. This requirement ensures the financial information, submitted by small businesses and used by lenders and SBA to make loan decisions, is credible.

A loan for [FOIA Ex. 4] (*sample number 5*) was approved for the purchase of business equipment, inventory, and working capital in [FOIA Ex. 4]. As required, the lender verified the tax returns for 1993 and 1994. The 1995 tax return was not available at the time the other returns were verified because an extension to file the return had been granted. The business was a sole proprietorship and even if an additional extension of time to file the tax return had been granted, it should have been filed no later than October 15, 1996. The lender, therefore, had time to verify the 1995 tax return before the loan proceeds were disbursed in January 1997. During the audit the lender stated that a request for verification of the 1995 tax return would be resubmitted. SBA should either

verify that the 1995 tax return in the loan application agrees with IRS validated data or rescind the guarantee of [FOIA Ex. 5]. As of August 31, 1998, the loan was delinquent.

A [FOIA Ex. 4] loan (*sample number 6*) was approved in [FOIA Ex. 4] to pay a specific vendor, to provide working capital, and to pay loan fees. The loan proceeds were disbursed before the tax verifications were received for 1992 through 1994. There was, however, no difference between the financial information submitted by the borrower and the IRS verification. As of August 31, 1998, the loan was current.

A [FOIA Ex. 4] loan (*sample number 8*) was approved in [FOIA Ex. 4] for the purchase of an existing business and for working capital. The lender did not verify the seller's financial information because the seller had not filed his 1995 tax return. After the loan was disbursed, the lender could not obtain an IRS tax verification because the seller could not be located. Since the seller only owned the business for one year, verification of the accuracy of the seller's financial information is an important element of the credit decision. The business was a sole proprietorship and the 1995 tax return should have been filed no later than October 15, 1996, if the taxpayer had been granted an additional extension of time to file the return. Since the loan was not disbursed until January 1997, the lender would have had time to obtain a verification. We compared the borrower's tax return for 1997 with the seller's reported gross sales for 1995 and found a significant difference. The borrower's tax return for 1997 showed [FOIA Ex. 4] in gross sales, which were about 59 per cent of the seller's reported gross sales of [FOIA Ex. 4] for 1995. The decrease in gross sales of 41 percent in a 2-year period may be an indication that financial information submitted by the seller was inaccurate. Since the lender did not verify the financial information before disbursement and the seller cannot be located to authorize IRS verification, the loan guarantee of [FOIA Ex. 5] should be rescinded. As of August 31, 1998, the loan was current.

A loan for [FOIA Ex. 4] (*sample number 14*) was approved for working capital in [FOIA Ex. 4]. The lender claimed it had complied with the IRS verification requirement for 1993 through 1995, but could not provide any evidence that the verifications had been requested. The lender agreed to resubmit the request for tax verifications.

A loan for [FOIA Ex. 4] (*sample number 17*) was approved in [FOIA Ex. 4] for the acquisition and refinancing of commercial properties used by an existing business. The loan files did not contain an IRS tax verification and the lender could not explain why its former loan officer had not requested the verification. We asked the lender to obtain the tax verification. SBA should either verify that the tax returns in the loan application agree with IRS validated data or rescind the guarantee of [FOIA Ex. 5]. As of August 31, 1998, the loan was current.

A [Ex. 4] loan (*sample number 18*) for working capital was approved in [Ex. 4]. The lender disbursed the loan proceeds prior to receiving tax verifications for 1993 through 1995. The verifications showed discrepancies between the financial information provided by the borrower and the information reported on the tax returns. The [Ex. 4] guarantee for this loan should be rescinded. As of August 31, 1998, the loan was current.

Borrower Provided Inaccurate Information, Lacked Repayment Ability, and was not Creditworthy

One borrower who received a [EX. 4] (*sample number 18*) provided inaccurate information to

the lender. In addition, the lender did not adequately evaluate the borrower's repayment ability or creditworthiness. The loan was approved by SBA on [FOIA EX. 4], and loan proceeds were disbursed on [FOIA EX. 4]. As mentioned in the paragraph above, the loan guarantee in the amount of [EX. 5] should be rescinded.

- **Inaccurate Information** The lender reported the borrower had practiced law in the area for 20 years. The borrower's tax returns for 1993 and 1994, which were verified with IRS transcripts, showed no income from his law practice, nor did the lender's loan file contain any historical income to support the claim of being in business for 20 years. Further, the borrower's copy of his 1995 tax return (which had not been filed with IRS at the time of loan approval) did not show any business income. For 1996, the borrower showed a financial statement with net income of [EX. 4&6]. This was 275 percent greater than the previous 3 years average non-business income reported on the tax returns. The tax returns showed income of [EX. 4&6] (1993), [EX. 4&6] (1994), and [EX. 4&6]. The lender's verification of the borrower's tax return for 1996 showed gross revenues of [EX. 4&6] and net income of only [EX. 4&6]. All attempts to contact the borrower were unsuccessful. The borrower would not return numerous telephone calls, and an auditor was denied access to the borrower's office. Based on the discrepancies discussed above and the borrower's failure to meet with us, we have referred this loan to the Investigations Division. [4, 6, & 7(A), (B), & (C)]
- **Repayment Ability** The best evidence of repayment ability for an ongoing business is sufficient cash flow from prior operations. Instead of using historical financial information to project cash flow, the lender used interim financial data, which was inaccurate, to show cash flow was sufficient to service the debt. The 1996 income statement showed gross revenues of [EX. 4] and net income of [EX. 4]. Gross revenues and net income on the verified 1996 tax return were only 54 percent and 14 per cent, respectively, of figures on the financial statements. Based on the tax return information, the borrower lacked the ability to repay the loan. SOP 50 10 3, Chapter 2, paragraph 13 states the ability to repay the loan from cash flow of the business is the most important consideration in the loan making process.
- **Creditworthiness** The lender did not report to SBA that its borrower had a bad credit history with several tax liens and judgments. The borrower's credit report showed 11 tax liens (including two Federal tax liens) and 3 civil judgments totaling \$28,152 for 1991 through 1996. The credit report and lender's loan file indicated the borrower was unlikely to conform to the terms of the loan agreement and was not eligible for an SBA guaranteed loan. The lender informed SBA and the auditors that the borrower had cleared the liens and judgments. We could not determine if the liens and judgments had been cleared because the lender did not obtain proof from the borrower and the borrower refused to meet with us. According to 13 CFR 120.150, loans must be so sound as to reasonably assure repayment, and applicants must be creditworthy, including character, reputation, and credit history. Repeated failure to pay taxes indicates a less than creditworthy character.

Available Collateral was not used to Secure Loan

One lender (*sample number 18*) did not require adequate collateral to secure a [EX. 4] loan although the borrower reported two worthwhile assets - \$195,000 equity in a [EX.4] residence and \$65,000 equity in a rental property. SOP 50 10 3, paragraph 16.a. states that to the extent worthwhile

assets are available from the applicant, adequate collateral is required. The lender informed us it did not use either of the assets as collateral for the loan because the lender's past experience with the borrower indicated he was a good credit risk. Since we are recommending rescission of the guarantee for this loan, no action on obtaining additional collateral is needed.

Prohibited Fees were Paid and Compensation Agreements were not Prepared

Agents for two lenders charged one borrower a broker fee and another borrower a loan referral fee. Procedures to regulate fees charged borrowers are in 13 CFR 103.5. Applicants, agents, or packagers must execute a compensation agreement and provide a copy to SBA. The compensation agreement provides that the agent or packager will not charge an amount deemed by SBA to be unreasonable. The agreement also provides for a refund to the borrower of any sum in excess of the amount deemed reasonable. The types of fees a lender or an associate may not collect from the borrower or share with third parties are set forth in 13 CFR 120.222. This section specifically prohibits agents or lenders from charging an applicant any commitment, bonus, broker, commission, referral or similar fees.

[FOIA EX. 4] loan (*sample number 23*) was approved to purchase real property and to provide working capital. The required compensation agreement or report to SBA was not prepared although the borrower was required to pay a broker about one percent of the loan amount. The borrower stated he paid the broker [EX. 4] for the loan. The broker stated both the lender and the borrower paid him a one per cent fee. Since the compensation agreement was not prepared and submitted, SBA was unaware that a broker fee was paid. As of August 31, 1998, the loan was current.

[FOIA EX. 4] (*sample number 30*) was approved in [EX. 4] for building improvements, repayment of three debts, and related costs. A compensation agreement was not prepared and submitted to SBA showing that the borrower was charged a loan referral fee of \$11,600. The borrower confirmed he paid the fee. If the compensation agreement had been properly prepared and submitted, SBA would have been aware of the referral fee paid and could have taken appropriate action. As of August 31, 1998, the loan was current.

Relationship of Loan Deficiencies to SBA Oversight

All of the loans with deficiencies were originated when SBA had limited or no oversight of the lender's loan processing and disbursing. For certain loan processing and disbursing actions, an SBA district office would normally be unaware of how and when the actions were done because no documentation of the actions were required to be submitted to SBA. These actions include, but are not limited to, equity injections, IRS verifications, and use of loan proceeds. District offices are unaware of almost all actions for loans processed under PLP procedures.

All deficiencies identified were processing or disbursing actions not normally reviewed by or reported to SBA under existing procedures. Therefore, the deficiencies generally would not be identified by SBA until after the loan defaulted and the lender requested that the guarantee be honored.

Reasons for lender deficiencies

Because lenders were responsible for all the deficiencies identified, we determined why the deficiencies occurred. Lenders provided the following reasons:

Loan officer chose to use other than SBA policy	10 deficiencies
Loan officer made an unintentional error	10 deficiencies

These issues will be further addressed in a summary audit report on the 7 (a) Loan Program because actions to minimize SBA's risk must be implemented Agency-wide.

Recommendations

We recommend that the Office of Borrower and Lender Servicing take the following actions:

- 1.A. Direct the Fresno Servicing Center to write a letter to the lenders concerning the deficiencies found in loan origination for samples numbers 8, 14, and 18 and request the lenders to release SBA from its guarantee.

We recommend that the Los Angeles District Office Director take the following actions:

- 1.B. Rescind the guarantee for sample number 22. (Based on the actions taken by the District Director after we brought the ineligible use of proceeds to his attention, the loan has been paid in full.)
- 1.C. Require the remaining equity injection of \$83,400 for sample number 15 be made or notify the lender that SBA may deny liability in whole or part if requested to purchase the guarantee.

- 1.E. Require the lenders' agents to refund the referral and broker fees charged borrowers for sample numbers 23 and 30 and advise the lenders and their associates to refrain from charging or collecting commission, broker, referral, or similar fees from borrowers.
- 1.F. Re-emphasize to lenders their responsibility to comply with SBA loan requirements, including ensuring
- loans are for eligible purposes,
 - loan proceeds are used for authorized purposes,
 - SBA approval is obtained for any loan agreement modifications,
 - required cash and equity injections are made and properly documented,
 - financial data are verified with the IRS prior to disbursement of loan proceeds,
 - borrowers are creditworthy and eligible for loans,
 - borrowers have evidence of repayment ability,
 - potential fraud is reported to SBA,
 - loans are adequately secured,
 - joint payee checks are used,
 - compensations agreements are completed and sent to SBA, and
 - borrowers are not charged commission, broker, referral and similar fees.

SBA Management's Response

The Deputy Associate Administrator, Office of Borrower and Lender Servicing, verbally stated he would instruct the Fresno Servicing Center to write a letter to the lenders for sample numbers 8, 18, and 14 informing them of the deficiencies concerning origination and requesting the lenders to release SBA from the guarantee. The letter will also inform the lenders that if they do not release SBA from its guarantee, SBA may deny liability, in whole or in part, if purchase is requested.

The District Director agreed with the finding and stated that the following actions were being taken to implement the recommendations. The District Office will require the borrower to make the remaining equity injection for sample number 15 and notify the lender that SBA may deny liability, in whole or in part, if purchase is requested, because the lender failed to require evidence that the equity was injected. Lenders for sample numbers 5 and 17 will be notified that SBA may deny liability in whole or in part, if purchase is requested, unless the lenders obtain IRS verifications and the data agrees with borrower submitted financial information. Lenders for sample numbers 23 and 30 will be requested to return disallowed fees to the borrowers. The lenders and their associates will be advised to refrain from collecting disallowed fees. To reduce risk and to ensure that only eligible loans are made, the District Office will re-emphasize to lenders their responsibility to comply with SBA requirements.

Evaluation Management's Response

The actions taken or planned to be taken by the Office of Borrower and Lender Service and the District Director meet the intent of the recommendations.

FINDING 2 Canceled Loans were not Reported to SBA

Two loans totaling \$700,000 were canceled by the lenders without informing SBA. If the lenders had promptly notified SBA of the cancellations, loan guarantees totaling \$530,000 could have been made available to other lenders and small business entities.

A loan for [FOIA Ex. 4] (*sample number 16*) was approved in [FOIA Ex. 4] to purchase a business and provide working capital. After learning the business had an outstanding lawsuit, the borrower canceled the loan in mid-1997. The lender refunded the borrower's fees in December 1997. At our request the lender informed SBA, in writing, of the loan cancellation in February 1998, some 8 months after the borrower canceled the loan. SBA canceled this loan after receiving the lender's written notification. The lender's failure to report the cancellation resulted in \$450,000 in SBA guarantee authority being temporarily unavailable to guarantee loans for other borrowers.

A loan (*sample number 31*) was approved in [FOIA Ex. 4] for new construction and working capital. The loan agreement was never executed because the borrower could not be located and was reported missing. At the request of the borrower's son, the lender canceled the loan in May 1997, but did not inform SBA of the cancellation until our audit, more than 8 months later. As of July 10, 1998, SBA had not canceled the loan. As a result, \$80,000 in SBA guarantee authority was unnecessarily obligated which could have been used to guarantee other loans.

Recommendations

We recommend that the PLP Loan Processing Center Director take the following action:

2.A. Cancel the guarantee authority for sample number 31.

We recommend that the Los Angeles District Director take the following action:

2.B. Re-emphasize to lenders their responsibility to comply with the requirement to notify SBA promptly whenever a change in the loan status warrants withholding or not making a disbursement.

SBA Management's Response

The Center Director stated that the guarantee authority for sample number 31 has been cancelled.

The District Director did not directly respond to the recommendation to re-emphasize to lenders to notify SBA promptly when changes in loan status warrants withholding or not making disbursement. The District Director did indicate, however, that future training would stress the items noted in the audit report to ensure compliance.

Evaluation Management's Response

The PLP Loan Processing Center implemented the recommendation. The District Director's response satisfies the recommendation because the items noted in the report will be included in future lender training.

Other Matters

Lender Non-compliance with SBA Policies and Procedures

During the audit, we reviewed three loans (sample numbers 8, 18, and 22) processed by the same PLP lender. The lender violated SBA policies and procedures in processing each of the loans. The lender did not--

- verify seller financial information,
- verify borrower tax return information prior to loan disbursement,
- prohibit a borrower from violating the loan agreement,
- determine a borrower's creditworthiness and ability to repay the loan, or
- adequately secure a loan.

We brought the discrepancies to the attention of the Los Angeles District Director and his staff during the audit. As a result, the District Director wrote a stern warning letter that directed the lender to correct the systemic problems found during the audit. The lender reported it immediately reviewed its loan operations and **took** action to correct the problems identified.

We provided the information on this lender to the staff of the Acting Associate Administrator for Financial Assistance for consideration in scheduling and conducting a PLP review of the lender.

Borrower Misrepresentations

The auditors requested criminal history reviews for the principals of each loan identified as a borrower. The results of the criminal history checks showed that four borrowers did not state they had a criminal history, when in fact they did. Their histories, however, did not contain offenses that were serious enough to preclude financial assistance from SBA.

Schedule of Loans Reviewed and Their Status as of August 31, 1998

SAMPLE NUMBER	LOAN NUMBER	BORROWER	GUARANTY (%)	LOAN AMOUNT	LENDER LOAN STATUS	TYPE
1	[FOIA Exemptions 4, 6, and 7(A)(B)&(C)			Current	CLP
2					Current	PLP
3					-----	----
4					Current	CLP
5					Past Due	REGULAR
6					Current	CLP
7					Current	REGULAR
8					Current	PLP
9					Current	PLP
10					-----	----
11					Current	PLP
12					Current	PLP
13					Current	PLP
14					Current	PLP
15					Current	REGULAR
16					Canceled	PLP
17					Current	REGULAR
18					Current	PLP
19					Paid in Full	REGULAR
20					Canceled	CLP
21					Current	PLP
22					Paid in Full	PLP
23					Current	PLP
24					-----	----
25					Current	PLP
26					Current	REGULAR
27					Current	CLP
28					Current	PLP
29					Current	PLP
30					Current	REGULAR
31					Canceled	PLP
32					Current	PLP
33					Current	PLP

Schedule of Procedures Reviewed and the Related Loans with Discrepancies

Procedures Reviewed	Loans with Discrepancies
1) Inadequate evidence of repayment ability	[#18]
2) No repayment ability calculation documented	
3) Lack of character/creditworthiness (including lack of credit reports)	[#18]
4) Conflict of interest	
5) Alternative sources of funds availability	
6) Size standards	
7) Ineligible loan purpose or ineligible use of proceeds	[#14]
8) Unallowed business type	
9) IRS verification not done	[##'s 5, 8,14, &17]
10) IRS verification done after disbursement of loan	[##'s 6 & 18]
11) False/inaccurate financial information provided	[# 18]
12) 1050 Settlement sheet signed in blank	
13) 1050 Settlement sheet not prepared	
14) Disbursements not made per loan authorization requirements	
15) Joint payee checks not used	
16) Use of proceeds not verified or not used in accordance with ALA	[#22]
17) Required equity injections not verified	[##'s15 & 27]
18) Adverse change not reported	
19) All available and needed collateral not used	[#18]
20) Disbursements not per the required time frame	
21) Required standby agreement not obtained	
22) Unallowable fees charged borrowers	[##'s 25 & 30]



U. S. SMALL BUSINESS ADMINISTRATION
LOS ANGELES DISTRICT OFFICE
330 N. BRAND
GLENDALE, CALIFORNIA 91203-2308

APPENDIX C
(1 of 2)

Date: September 28, 1998
To: Peter J. McClintock
Assistant Inspector General For Auditing
Office of Inspector General
From: Alberto G. Alvarado
District Director
Subject: Audit of Los Angeles District Office 7(a) Loans
Draft Audit Report No. 8-8-F-002

Thank you for the opportunity to comment on the findings and recommendations contained in your draft audit report received in this office on August 28, 1998. We believe that the Agency's policies and procedures must be observed and with your assistance we will continue to do everything possible to maintain a portfolio that is of the highest quality.

In that regard I should note that, as we have done historically, our lender training will emphasize the importance and necessity that eligibility issues be addressed and that only eligible loans be made. We will reiterate, as we have done in the past, and train our lending partners on the necessity for compliance with the terms and conditions of the Loan Authorization and the necessity that financial data be verified prior to disbursement. As you are aware we presently conduct numerous lender training sessions each year (over 18 this year) to keep lenders apprised of SBA's policies and procedures while also informing them of the potential consequences of their failure to comply.

In our future training we will stress the items noted in the audit to ensure compliance. In addition, we will continue our ongoing practice of conducting regular training for our Loan Specialists and Attorneys on eligibility issues, financial requirements, fraud issues, and general SBA regulations, guidelines, policies, and procedures.

With regard to the specific recommendations of the draft audit report, noted on page 7, the Los Angeles District Office is in the process of doing the following:

- Requiring that the remaining equity injection be made on item number 15 [Ex 4] while informing the lender that SBA may deny liability in whole or in part, if purchase is requested, based upon the lender's failure to require evidence that the equity was injected.
- Notifying the lenders for sample number 5 [Ex 4] and sample number 17 [Ex 4]

EX. 4 § 5] that SBA may deny liability in whole or in part, if purchase is requested, unless IRS verifications are obtained and the data agrees with the financial information submitted by the borrowers.

(Parenthetically, we note that the lack of IRS verification by subject participants is the primary discrepancy noted in the audit. The Los Angeles District Office will therefore stress this subject in future lender and Loan Specialist training and would suggest the FLP Center do likewise.)

- Requiring that the lenders return disallowed fees to the borrowers in samples 23 [EX 4

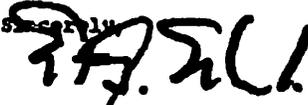
J and 30 [EX 4

] It may be difficult legally for SBA to require a Broker to return a fee since we have no contractual relationship with the Broker and the Broker is not subject to SBA jurisdiction. The Los Angeles District Office will, however, advise the lenders and their associates to refrain from collecting commission, broker, referral, or similar fees from borrowers.

As mentioned above, we will re-emphasize to lenders their responsibility to comply with SBA loan requirements in order to reduce risk, ensure that only eligible loans are made, and to maintain the integrity of the Agency's programs. As the highest lending volume office in the country, we feel that the relatively few deficiencies (2.4% or 16 out of 660 procedures reviewed) noted in the audit reflect well on this office which, according to your report, was assigned 1,908 loans valued at \$662.1 million from March 1, 1996 to June 30, 1997. Nevertheless, we also recognize the need for continuing vigilance and improvement and trust that other Agency units charged with overseeing, especially FLP submissions, which comprised 18 of the 30 or 60% of the loans reviewed, will do likewise.

If you have any questions or comments or if you need additional information, please do not hesitate to contact me at (818) 552-3201. Once again, thank you for your assistance in allowing us to maintain the highest integrity in our loan programs.

Sincerely,


Alberto S. Alvarado
District Director

cc: Associate Deputy Administrator for Capital Access
Associate Administrator for Field Operations

**OFFICE OF INSPECTOR GENERAL
AUDIT REPORT DISTRIBUTION**

<u>Recipient</u>	<u>Number of Copies</u>
Administrator	1
Deputy Administrator	1
General Counsel	2
Associate Administrator for Field Operations	1
Associate Administrator for Financial Assistance	1
Deputy Associate Administrator for Financial Assistance	1
Associate Deputy Administrator for Management & Administration	1
Financial Administrative Staff	1
Attention: Jeff Brown	
District Director, Los Angeles District Office	1
Director, Preferred Lender Program Processing Center	1
General Accounting Office	1