REDACTED FOR FOIA

AUDIT OF AN EARLY DEFAULTED LOAN TO

[EX. 4]

AUDIT REPORT NO. 0-17

April 28, 2000

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

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US SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
Issue Date: April 28, 2000
Report Number: 0-17

To: Rodney W. Martin, District Director
San Antonio District Office

Robert G Seabrooks

From: Robert G. Seabrooks, Assistant Inspector General
for Auditing

Subject: Audit of an Early Defaulted Loan to
[Ex.4]

Attached is a copy of the subject audit report. The report contains one finding and two recommendations addressed to your office. Your comments and the comments of the lender have been synopsized and included in the report.

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

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

Attachment

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AUDIT OF AN
EARLY DEFAULTED LOAN TO
[Ex. 4]

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BACKGROUND

The Small Business Administration (SBA) is authorized under section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with Administration rules and regulations.

Heller First Capital Corporation (lender) processed an $855,000 loan (number [Ex. 4] (borrower) under Preferred Lender Program procedures. The purpose of the loan was in part to refinance a land note, construct a facility ([Ex. 4]), and purchase inventory, equipment, and machinery. Loan proceeds were disbursed between September 1996 and February 1997 with the loan placed in liquidation in July 1998.

AUDIT SCOPE AND OBJECTIVE

This report provides the conclusions of an audit conducted on an SBA guaranteed loan. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA guaranteed loans charged off or transferred to liquidation within 36 months of origination (early default).

The audit objective was to determine whether the early default was caused by lender or borrower non-compliance with SBA requirements. SBA and lender loan files were reviewed and district office and lender personnel were interviewed. The audit was accomplished between May and August 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

FINDING The Lender did not Adequately Determine the Borrower's Repayment Ability

The borrower defaulted because sufficient cash flow was not available to service business debts. We concluded that the borrower lacked repayment ability at the time of loan approval and that the lender did not perform a proper evaluation of the new business's projected income. As a result, the lender had not complied with SBA loan origination requirements and the Administration could lose as much as $635,981, before collateral liquidation, if the guarantee is purchased.

Loan considerations

SOP 50 10 3 and 50 11 state that the ability to repay a loan from the cash flow of the business is the most important consideration in the loan making process. When a historical cash flow is not available, as in the case of a new business, a realistic projection of future earnings is required. An evaluation of this projection must include testing of the

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projected income statement, or using a projected cash flow and income statement to determine expected gross and net profit margins for the new business. SOP 50 11 points out that most private lenders avoid making new business loans because of the inherent uncertainties of repayment. On the other hand, about one-third of SBA's loans are made to new businesses, even though losses are higher on these loans than on those to established businesses. The most common reason for new business failure is the inability to generate an adequate sales volume for viable operations.

Cash flow projection

The lender's evaluation of the borrower prepared cash flow projection and the lender's net income calculations for break-even, best case, and worst-case scenarios are shown in Appendix A. The lender's evaluation was incomplete and did not consider all relevant factors for determining reasonable cash flow and repayment ability. Specifically:

Sales volume forecasts The lender did not ensure that a required realistic projection of future earnings was utilized to underwrite this SBA loan. The lender used a [ex.4] forecast model to calculate the break-even cash flow projection for the business. However, the applicability of the [ex.4] model was not evaluated.

Fifteen months after the loan was approved, the borrower requested [ex.4] to provide an explanation as to why projected sales forecasts had not been meet. In an October 30, 1997 letter, [ex.4] told the borrower that their model was built using 1,200 actual [ex.4] sites with over 200 variables associated with each location (e.g. facility, demographic, lifestyle, traffic, etc.). The model's cash flow projection is based on a mature [ex.4] station. Site maturity is the result of several variables in the market place. Variables such as market growth and current competition must be considered if the model is to provide an accurate cash flow projection.

Texaco stated that their analysis of the business site showed that the current competitive environment was one of near saturation with over 40 competitors within a 3-mile radius. Also the census showed a population decline from 1980 to 1990 with a very slight increase (.3 percent) expected by 2002. Further, the small number of [ex.4] would increase the time needed to reach maturity. Had these factors been taken into consideration, [ex.4] stated that 3 years would be required for the business to reach maturity and realize the cash flow projected by the model.

If the lender had properly applied the [ex.4] model, it should have been evident that projected [ex.4] sales volume based on a mature business were overstated. The higher sales volume at the 3-year maturity point therefore was not realistic for the first and second year cash flow projections. Since the lender did not properly apply the model, cash flow and repayment ability were overstated.

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Ratio analysis The lender's evaluation did not include either a ratio analysis or a test of ratios against industry averages. According to SOP 50 11, a ratio analysis is vital for understanding and interpreting financial data of prospective borrowers. The SOP also states that pertinent ratios help determine if there is a reasonable assurance that the loan can be repaid. After a thorough review of the lender loan files and interviews with the lender, we determined that there was no evidence to show that such analysis had been performed.

The only document that we found that resembled a ratio analysis or projection was contained in the lender's evaluation of the loan. It was difficult to determine what the numbers in this document represent. There were no clear-cut projections by year or month that presented expected cash flow or analyzed the borrower's ability to repay the loan during the start-up phase of the business.

Therefore, we concluded that the lender approved the loan based on an incomplete cash flow projection. Accordingly, the lender did not comply with SBA loan origination requirements.

RECOMMENDATIONS

We recommend that the San Antonio District Office take the following actions:

1A. Process a request for denial of liability for loan number [ex. 4]

1B. Remind the lender of its obligations to comply with SBA regulations, policies, and procedures for originating loans by:

- obtaining the current market conditions present at the time of loan origination,
- reflecting the impact of those conditions upon the expected earnings of the business and the business' ability to repay loan, and
- considering the time required to achieve full business maturity in projecting earnings of start-up businesses.

District office action

The District Office forwarded a request for denial of liability to SBA Central Office. The District Office did not respond to recommendation 1B.

Evaluation of district office action

We reserve our evaluation of SBA actions until the Central Office makes a denial of liability determination. If a denial action is required, then the lender notification per recommendation 1B will be necessary.

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Lender comments

The lender did not agree with our audit conclusions. The failure of the business and subsequent default was attributed to the borrower's poor health and unexpected heart attack. The lender also stated "While the borrower struggled to repay the loan, there was no evidence of fraud or misrepresentation, nor any lack of commitment to the program or the community."

Evaluation of lender comments

The lender's comments do not accurately present the facts. Our discussions with the store manager ([Ex. 6]) disclosed that the borrower's [Ex. 6] [Ex. 6] ill health had very little to do with the failure of the business. The borrower's [Ex. 6] several days before the store closed, and five months after the borrower had contacted [Ex. 4] to question the legitimacy of the projected sales figures for a [Ex. 4] at that location. Therefore, the lender's assertion that the failure of the business and subsequent default was due to the borrower's unexpected poor health [Ex. 6] lacks merit. The business was failing prior to the borrower's [Ex. 6]

In our opinion, the lender's lack of evaluation of the borrower's projected income was the reason for the loan default. The lender had not satisfied SBA requirements to ensure that a realistic projection of future earnings was utilized prior to underwriting the SBA loan. Had such an evaluation been performed, it is unlikely that the loan would have been approved.

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Appendix A

Income Statement	Borrowers Cash flow FYE 12/31/93	%	Break-even FYE	%	Best Case FYE	%	Worst Case FYE	%	Projections	%
Sales	$1,544,905		$1,366,812		$1,892,590		$1,100,000		$0	
Cost of Goods Sold	883,721	57%	1,146,131	84%	1,514,072	80%	935,000	85%	0	#####
Gross Profit	661,184	43%	220,681	16%	378,518	20%	165,000	15%	0	#####
G & A Expense	149,069	10%	110,000	8%	160,000	8%	100,000	9%	0	#####
Officer's Salary	0	0%	0	0%	0	0%	0	0%	0	#####
Depreciation	0	0%	0	0%	0	0%	0	0%	0	#####
Rent Expense	0	0%	0	0%	0	0%	0	0%	0	#####
Operating Income	$512,115	33%	$110,681	8%	$218,518	12%	$65,000	6%	$0	#####
Interest Expense	87,004	6%	87,000	6%	87,000	5%	87,000	8%	$0	#####
Other Income	0	0%	1,435	0%	1,435	0%	1,024	0%	$0	#####
Other Expense	0	0%	0	0%	0	0%	0	0%	$0	#####
Net Income Before Taxes	$425,111	28%	$25,116	2%	$132,953	7%	($20,976)	-2%	$0	#####
Income Taxes	0	0%	0	0%	0	0%	0	0%	$0	#####
Net Income	$425,111	28%	$25,116	2%	$132,953	7%	($20,976)	-2%	$0	#####

Comments

Break-even analysis assumes that 70% of the [*] sales will be made or 860,739 at an average price of $1.10 and the [*] will be at $35,000 a month instead of $45,000, or a total of$420,000 for the year
Gross profit is 10% of [*], and 30% on [*]
Other income is a .02 rebate from [*]
The borrower presented a cash flow, which does not properly calculate CGS. It is shown here for informative purposes.

Net Worth Reconciliation				
Beginning Net Worth	0	96,848	0	0
Plus Net Income	425,111	25,116	132,953	(20,976)
Less Withdrawals				
Adjustments	328,263	121,964	132,953	(20,976)
Ending Net Worth	$96,848	$0	$0	$0

Comments

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Heller Financial, Inc.
900 Circle 75 Parkway, Suite 900
Atlanta, Georgia 30339
Telephone: (770) 980-6016
Facsimile: (770) 980-6215

Heller Financial

[ex. 6]
Deputy General Counsel

February 29, 2000

[ex. 6]
Small Business Administration
Office of Inspector General
4300 Amon Carter Blvd., Suite 116
Fort Worth, Texas 76155

Re: **Audit of an Early Defaulted Loan to [ex. 4]**

Dear [ex. 6]

This letter is in response to the audit of the early defaulted loan, [ex. 4]
We disagree with the results of your audit.

[ex. 4] was a SBA 7(a) loan to an underserved market, to a borrower with good management experience who was to construct and operate what was to be one of the nicest branded [ex. 4] in the area. The Borrower had successfully owned and operated a [ex. 4] for 3 years prior to our transaction, in addition to previous management experience in other industries.

While there is no question the borrower was struggling financially, it is clear that the business failed, actually closed, because of the borrower's poor health and [ex. 6] [ex. 6] It is true, we relied heavily on [ex. 4] projections. [ex. 4] was experienced in the industry and we thought the brand and franchise would bring added value. At the time, [ex. 4] was considered a very reliable source of information who also had a vested interest in the success of the location. [ex. 4] would make no money from a failed store.

This store was, and is, one of the nicest in the area. Again, this is an underserved market and oftentimes, newly constructed, branded franchises bring not only value to the location but revitalization to the area. The borrower put substantial personal cash into the deal and was committed. Who knows for sure what might have happened had the borrower's health been better.

While the borrower struggled to repay the loan, there was no evidence of fraud or misrepresentation, nor any lack of commitment to the program or the community. Sometimes loans fail and in hindsight, with full clarity of vision, it is easy to say there was not sufficient cash flow. However, at the time we made the loan, we thought this was a prudent loan within the SBA guidelines and more importantly, was good for the community and the underserved market.

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Heller Financial

As we have stated on numerous occasions, we value our relationship with the SBA and each district we do business. We feel this loan was adequately underwritten but we will work with the local office as appropriate.

Cordially,
HELLER FINANCIAL, INC.

[Ex. 6]

Deputy General Counsel

[Ex. 6]

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