



September 2013

SMALL BUSINESS ADMINISTRATION

Review of 7(a) Guaranteed Loans to Select Franchisees

GAO Highlights

Highlights of [GAO-13-759](#), a report to congressional requesters

Why GAO Did This Study

From fiscal years 2003 to 2012, SBA guaranteed franchise loans under its 7(a) program totaling around \$10.6 billion. SBA made guarantee payments on approximately 28 percent of these franchise loans, representing about \$1.5 billion, according to SBA. GAO was asked to examine SBA-guaranteed loans to franchisees, and to investigate an allegation that a loan agent provided exaggerated revenue projections to franchisees of the same franchise organization to help them qualify for SBA loans.

This report describes (1) the magnitude of SBA-guaranteed loans to franchisees of the franchise organization, and (2) the results of GAO's investigation into the allegation, and aspects of SBA's oversight of its 7(a) loan program with respect to loans made to franchisees of the franchise organization.

GAO examined SBA's loan data and files of loans made to franchisees. GAO used the franchise organization's revenue data to compare to revenue projections in SBA applications, as well as revenue reported in the organization's disclosure documents. As part of the investigative work, GAO interviewed the franchisor, loan agents, and select borrowers to better understand the franchising experience.

GAO is not making any recommendations. In their comments, representatives of the franchise organization state that GAO's comparison of average revenue in the disclosure document and the first-year average revenue calculation is potentially misleading and inaccurate. GAO disagrees, as discussed in more detail in this report.

View [GAO-13-759](#). For more information, contact Stephen M. Lord at (202) 512-6722 or lords@gao.gov or Wayne A. McElrath at (202) 512-6722 or mcelrathw@gao.gov.

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What GAO Found

Analysis of guaranteed loans to franchisees of a select franchise organization reviewed by GAO, approved from January 1, 2000, to December 31, 2011, showed the Small Business Administration (SBA) approved a total of about \$38.4 million for 170 loans made by 54 lenders. SBA's guaranteed portion on these loans was approximately \$28.8 million. Of the total population of 170 loans, 74 loans defaulted, 55 of which (74 percent) originated from four lenders that had the highest loan volume and default rates on loans to the franchisees. SBA made guarantee payments of around \$11 million on the defaulted loans to franchisees, including about \$8.5 million in guarantee payments on the 55 defaulted loans from these four lenders. Of the 88 loans reviewed from the four lenders, 55 (63 percent) defaulted. In comparison, 19 of the 82 loans (23 percent) that originated at the other 50 lenders to the franchisees defaulted. As part of GAO's investigative work, GAO interviewed the owners of 22 franchisees of the franchise organization in GAO's review, of which 16 defaulted on their loans and 10 filed for bankruptcy protection. Interviewed franchisees noted difficulties meeting anticipated revenue estimates and limited access to information that would aid in business planning.

GAO was unable to conclusively determine whether the loan agent referred to GAO for investigation intentionally provided exaggerated revenue projections to franchisees to help them qualify for SBA loans, and SBA has taken initial steps to enhance program oversight. The loan agent stated that she obtained the revenue projections from her employer and former clients, one of which she identified. She then provided these revenue projections to clients. The employer and former client she identified denied providing the revenue projections to the loan agent. SBA's Office of Credit Risk Management debarred the loan agent and her employer for encouraging false statements, among other things, making them ineligible to work with the federal government for a period of 3 years beginning in January 2012. According to GAO's analysis, the first-year projected revenues on loan applications involving the loan agent or her employer were, on average, more than twice the amount of actual first-year revenue for 19 of the 24 franchisees reviewed. Potential franchisees should include first-year revenue estimates in their SBA loan applications. However, this information is not necessarily available to potential franchisees in the franchise organization's disclosure document, which provides information about the organization's financial performance representations and franchisees' estimated initial investment, among other things. Further, federal regulations do not require franchise organizations to provide actual first-year average revenues for start-up businesses in their disclosure document. Thus, potential franchisees may have to conduct due diligence to identify this information from other sources, if available. GAO also identified discrepancies and other issues in SBA's franchise loan data with respect to fields used for risk-based oversight of its loans portfolio, such as default status, number of loans, and loan agent information. SBA has taken, or is considering steps, to address these issues and enhance oversight of loan agents. For instance, SBA is working with a third-party vendor to replace SBA's current franchise codes with publicly available identifiers used in the franchise industry. At the time of GAO's review, it was too early in the process to assess the effectiveness of these actions.

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Abbreviations

BCP	Bureau of Consumer Protection
FDD	Financial Disclosure Document
FTA	fiscal and transfer agent
LAS	Loan Accounting System
NMLS	Nationwide Mortgage Licensing System and Registry
OIG	Office of Inspector General
PACER	Public Access to Court Electronic Records
PLP	Preferred Lenders Program
SBA	Small Business Administration

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September 10, 2013

The Honorable Mary L. Landrieu
Chairwoman
Committee on Small Business and Entrepreneurship
United States Senate

The Honorable Tom Coburn, M.D.
Ranking Member
Committee on Homeland Security
and Governmental Affairs
United States Senate

The Honorable Carl Levin
Chairman
Permanent Subcommittee on Investigations
Committee on Homeland Security
and Governmental Affairs
United States Senate

From fiscal years 2003 to 2012, the Small Business Administration (SBA) guaranteed 32,323 franchise loans under its 7(a) program—a lending program intended to assist small-business borrowers, including franchisees—totaling around \$10.6 billion. SBA made payments to honor its guaranty on approximately 28 percent of these franchise loans, representing about \$1.5 billion, according to SBA.¹ The 7(a) program is the primary lending program of SBA and guarantees as much as 75 or 85 percent of an outstanding commercial loan balance, depending on the size of the loan.² Proceeds from 7(a) loans may be used to establish a

¹According to SBA officials, this figure does not include loan recoveries, and, therefore, losses may be less. In addition, officials said the figure reflected loans that lenders self-identified as SBA-guaranteed franchise loans. Thus, the officials noted the number may not reflect all franchise loans guaranteed by SBA.

²SBA's 7(a) loan program is authorized under Section 7(a) of the Small Business Act (15 U.S.C. § 636(a)), which authorized SBA to provide business loans and loan guarantees to U.S. small businesses. SBA can guarantee as much as 85 percent of loans up to \$150,000 and 75 percent of loans of more than \$150,000. In addition, SBA also offers SBA Express loans up to \$350,000 with a maximum guarantee of 50 percent. The SBA Express program allows lenders to use, to the extent possible, their respective loan analyses, procedures, and documentation. SBA Express loans can be used as a revolving line of credit, as well as a term loan.

new business or to assist in the operation, acquisition, or expansion of an existing business, among other uses. The 7(a) program involves SBA, commercial lenders, borrowers, and in some cases, loan preparers or other agents, who are private entities that offer SBA loan application services for a fee. Default on an SBA loan may result in taxpayer loss, as well as potential personal hardship for the borrower, such as financial distress or bankruptcy. As part of its oversight efforts, SBA generally conducts reviews of all 7(a) lenders with SBA-guaranteed loan portfolios of \$10 million or more on a 12- to 24-month cycle. SBA can conduct additional reviews of the lenders if it identifies specific performance concerns.

We have previously reported on SBA's oversight of the 7(a) program, in particular SBA's assessments of lenders' practices for determining whether borrowers were unable to obtain credit at reasonable terms in the conventional lending market and the agency's use of the lender risk-rating system for oversight and predicting lender performance.³ We reported that SBA's 7(a) program had some program weaknesses, such as limited guidance on how lenders should document that borrowers could not obtain credit elsewhere. We made several recommendations, including one that SBA issue more detailed guidance to lenders on how to document their compliance with the credit elsewhere requirement. SBA generally agreed and has taken some action in response, such as revising its guidance to lenders on how to document their determination that borrowers could not obtain credit elsewhere.

You asked that we examine SBA-guaranteed loans to franchisees, and to investigate an allegation that a loan agent provided exaggerated revenue projections to franchisees of the same franchise organization to help them qualify for SBA loans. This report describes (1) the magnitude of SBA-guaranteed loans to franchisees of the franchise organization, and (2) the results of our investigation into the allegation, and aspects of SBA's oversight of its 7(a) loan program with respect to loans made to franchisees of the franchise organization. Any mention of franchisees throughout this report refers to borrowers obtaining SBA-guaranteed

³GAO, *Small Business Administration: Actions Needed to Improve the Usefulness of the Agency's Lender Risk Rating System*, [GAO-10-53](#) (Washington, D.C.: Nov. 6, 2009) and *Small Business Administration: Additional Guidance on Documenting Credit Elsewhere Decisions Could Improve 7(a) Program Oversight*, [GAO-09-228](#) (Washington, D.C.: Feb. 12, 2009).

loans to open or acquire one specific franchise. Reference to the franchise organization refers to the overall franchise and its management.

To conduct our audit work, we examined data for all SBA-guaranteed loans to franchisees of the select franchise organization approved from January 1, 2000, to December 31, 2011, in order to assess loan volume, default rates, and the amount of SBA's guarantee payments made for 170 loans to franchisees from 54 lenders. We selected this date range in order to obtain a broad understanding of SBA-guaranteed loans to franchisees during different economic conditions and from multiple lenders. The original dataset we received from SBA included 184 loans to franchisees; however, 16 of these indicated that the lender canceled the guarantee on the loan and 2 were outside the scope of our review.⁴ We therefore excluded these loans from our analysis. From these data, we selected four lenders with the highest loan volume and default rates. Three of these four lenders are preferred lenders, which mean they have delegated authority to make lending decisions on behalf of SBA.⁵ We also reviewed 88 SBA loan packages for these four lenders in order to examine characteristics of individual loans, such as the extent to which the franchisees' projected first-year revenues differed from actual first-year revenues, as well as to assess the accuracy of certain data fields in the SBA franchise loan data. These loan packages included all loan packages for these lenders during this time period. We assessed the reliability of the SBA loan data by comparing it to information in loan files for the four lenders and interviewing knowledgeable agency officials. We found discrepancies between data in SBA's loan database and information in the loan files we reviewed, as discussed later in this report, but we determined that the SBA loan data were sufficiently reliable for reviewing loans to franchisees.

⁴We identified two SBA-guaranteed loans that fell outside the scope of our review, including one loan approved for a different franchise organization and another loan that was not originated by one of the four lenders. The number of loans we received in the original dataset that were relevant to our review, excluding these two loans and the 16 canceled loans, was 166 loans. However, during our review of the loans from the four lenders to the franchise organization, we identified four loans that were not in the dataset we received from SBA. Thus, in all, we reviewed 170 loans from the four lenders to the franchise organization.

⁵Prior to March 2011, the four lenders had delegated authority.

We analyzed revenue data that we obtained from the franchise organization to calculate actual first-year revenue of franchisees, when possible. We compared these calculations with the projected revenues in SBA loan applications for select franchisees. We also calculated average revenues for a broader population of franchisees, and compared it to average revenues reported in the franchise organization's disclosure documents. We identified several issues with the accuracy and completeness of the franchise organization's revenue data, including missing, duplicate, and nonsequential revenue data. For purposes of data reliability, we excluded these businesses from our calculations. However, after assessing the reliability of the revenue data, we determined that they were sufficiently reliable for purposes of our analysis.

We also interviewed SBA officials about their activities related to oversight of the four lenders to the franchise organization, efforts to track and monitor loan agents, and assistance provided to potential franchisees during the loan application process. In addition, we examined SBA's policies and procedures for overseeing lenders in the 7(a) program. We also reviewed reports by SBA's Office of Inspector General (OIG) and other related documents.⁶

To conduct our investigative work, we reviewed an allegation that a loan agent intentionally exaggerated first-year revenue projections on SBA loan applications in order to ensure that potential franchisees would qualify for SBA-guaranteed loans. We interviewed the owner of the franchise organization, the loan agent who was the subject of the allegation, her employer, eight former franchisees that were referred to us during the course of the investigation, and a bank officer who reviewed loans related to the allegation. To better understand the franchisees' experience with the 7(a) program, we interviewed 14 additional franchisees of the select franchise organization. We selected these franchisees on the basis of a range of factors, including whether they used a loan agent, geographic dispersion, and performance status of the

⁶Small Business Administration, Office of Inspector General, *The SBA's Portfolio Risk Management Program Can Be Strengthened*, Report No. 13-17 (July 2, 2013); *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in Fiscal Year 2013*, Report No. 13-02 (Oct. 15, 2012); *Addressing Performance Problems of High-Risk Lenders Remains a Challenge for the Small Business Administration*, Report No. 12-20R (Sept. 28, 2012); Report No.11-16 (July 13, 2011); and *Material Deficiencies Identified in Early-Defaulted and Early-Problem Recovery Act Loans*, Report No. ROM 10-19 (Sept. 24, 2010).

loan. The 14 franchisees received 19 SBA-guaranteed loans from one of the four lenders included in our review. In addition, on the basis of the 88 loan packages we reviewed for the four lenders, we identified 24 franchisees that used the loan agent connected to the allegation or her employer, 19 of whom had data available to compare the first-year revenue projections on SBA loan applications with the franchisees' actual first-year revenue. We are unable to generalize our findings from these interviews and analysis to other franchisees, loan agents, franchise organizations, or borrowers in the 7(a) program. Our intent was not to identify potential fraud or abuse for all franchise loans of the franchise organization, or the 7(a) loan program as a whole.

We conducted this performance audit from March 2012 to September 2013, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our related investigative work in accordance with the standards prescribed by the Council of the Inspectors General on Integrity and Efficiency. For a more detailed description of our scope and methodology, see appendix I.

Background

SBA's 7(a) loan program is intended to help businesses obtain credit that they are unable to secure in the conventional lending market. Under the 7(a) program, SBA guarantees loans made by commercial lenders. Borrowers may use 7(a) loan proceeds to establish a new business, expand an existing business, or purchase an existing one, including a franchised business. Loan proceeds can be used to buy equipment, finance working capital, purchase or renovate a building, and pay for other expenses. Currently, the maximum loan amount for a 7(a) loan is \$5 million. The average 7(a) loan for fiscal year 2012 was \$337,730. Loan maturities vary based on the borrower's ability to repay and the intended use of loan proceeds.⁷

⁷The maximum loan maturity for real estate and equipment is 25 years, and loans for capital and inventory can have a maturity of up to 10 years.

To qualify for a 7(a) loan, the applicant must be deemed creditworthy, have demonstrated an inability to obtain credit elsewhere on reasonable terms from nonfederal sources, and be able to reasonably ensure repayment. Lenders are required to consider these factors for each applicant. In addition, lenders are required to report any fees paid to loan agents, and other agents who assist the borrower during the loan origination process, using the “Fee Disclosure Form and Compensation Agreement” (Form 159).⁸ In general, examples of loan agents include: (1) loan packagers, who are agents compensated by loan applicants or lenders to prepare loan applications; (2) referral agents, who refer loan applicants to lenders or vice versa, and may be compensated by either party; and (3) lender service providers, who carry out lender functions in originating, disbursing, servicing, or liquidating SBA loans in return for compensation from lenders.

SBA’s Preferred Lenders Program (PLP) is part of SBA’s effort to provide streamlined financial assistance to the small-business community, including franchisees. Under this program, SBA delegates the final credit decision, as well as most servicing and liquidation authority and responsibility, to a group of preferred lenders. SBA relies on these lenders to ensure that borrowers meet the program’s eligibility requirements. SBA considers potential preferred lenders on the basis of their performance records with SBA, and they must have demonstrated a proficiency in processing and servicing SBA-guaranteed loans. In fiscal year 2011, SBA had 3,537 active lenders in the 7(a) program, 545 of which had preferred lender status.

SBA’s Office of Credit Risk Management conducts on-site reviews of certain lenders through a risk-based review process. On-site reviews are generally to be conducted on all 7(a) lenders with outstanding balances of \$10 million or more on the SBA-guaranteed portions of their loan portfolios. SBA’s risk-based review process is to consider factors such as portfolio performance, SBA management and operations, credit administration practices for both performing and nonperforming loans, and compliance with SBA requirements. According to SBA’s procedures for conducting on-site risk-based lender reviews, SBA can assess a lender as (1) acceptable, which means the lender is managing a

⁸Lender service providers identify and disclose their fees in a Lender Service Provider Agreement, which they submit to SBA for review.

satisfactory SBA loan program using prudent lending practices and representing limited financial risk to SBA; (2) acceptable with corrective actions required, indicating the lender may have weaknesses, but it is reasonably expected that the lender can address the issues during the normal course of operations; (3) marginally acceptable with corrective actions required, meaning the lender demonstrates serious deficiencies and demonstrates an inadequate degree of understanding and management of the SBA loan program; and (4) less than acceptable with corrective actions required, which means the lender is operating an SBA loan program with serious deficiencies or represents significant financial risk to SBA.

When a borrower with an SBA-guaranteed loan defaults, the lender has the option of submitting a purchase request to SBA to honor the guaranteed portion of the loan. Effective November 15, 2010, SBA defined an early defaulted loan as one in which the borrower defaulted within 18 months of *initial* disbursement.⁹ Prior to that date, early defaulted loans were those that defaulted within 18 months of *final* disbursement. Early defaulted loans may indicate potential deficiencies in the originating, closing, and servicing of loans. According to SBA's procedures, the agency must review guaranty purchase requests for early defaulted loans with a higher degree of scrutiny than other defaulted loans.

A franchise is a business model that involves one business owner (the franchise organization) licensing trademarks and methods to another (the franchisee). The franchisee pays the franchise organization a fee. As an aid to potential franchisees considering opening or purchasing a franchise, franchise organizations are required by law to provide certain information about their franchise organization in their Financial Disclosure Document (FDD).¹⁰ The disclosure document provides information about the organization, such as financial performance representations, the initial franchise fees, franchisees' estimated initial investment, and the franchisor's litigation history, among other information. The financial

⁹In addition, according to the Standard Operating Procedures 50-51-3, when the final disbursement occurs more than 6 months after the initial disbursement, the 18-month period commences from the date of final disbursement. Loan disbursements can be made over time as long as all loan proceeds are disbursed within 24 months after the date of the loan approval.

¹⁰16 C.F.R. § 436.2. This regulation was issued by the Federal Trade Commission.

performance representations in the FDD, which can include average revenue figures and other earnings statements, are optional and can vary by franchise organization. Current regulations stipulate that the financial performance representation must have a reasonable basis and substantiation at the time it was made.¹¹ Potential borrowers have the option to request additional information from the franchise organization regarding the financial representations made in the FDD. In addition, franchise organizations may provide the names and contact information of current and former franchisees in the FDD.

Defaulted Loans to Franchisees of the Franchise Organization Resulted in \$11 Million in Guarantee Payments, and Four Lenders Accounted for about 74 Percent of Defaulted Loans

Our analysis of SBA-guaranteed loans to franchisees of the franchise organization approved from January 1, 2000, to December 31, 2011, showed that SBA approved a total of about \$38.4 million for 170 loans made by 54 lenders. SBA's guaranteed portion on these loans amounted to around \$28.8 million. Of the total population of 170 loans, we identified 74 defaulted loans, 55 of which (74 percent) were originated by four lenders. Three of these four lenders are preferred lenders that have delegated authority to make lending decisions on behalf of SBA.¹² SBA made guarantee payments of around \$11 million on the defaulted loans, including about \$8.5 million in guarantee payments on the 55 defaulted loans from these four lenders.¹³ Figure 1 illustrates the dollar value of SBA guarantee payments for loans from the four lenders. In addition, figure 1 shows that loans originating with Lender A and Lender B comprised about 64 percent of the \$11 million in guarantee payments disbursed by SBA for loans to the franchisees of the franchise organization.¹⁴

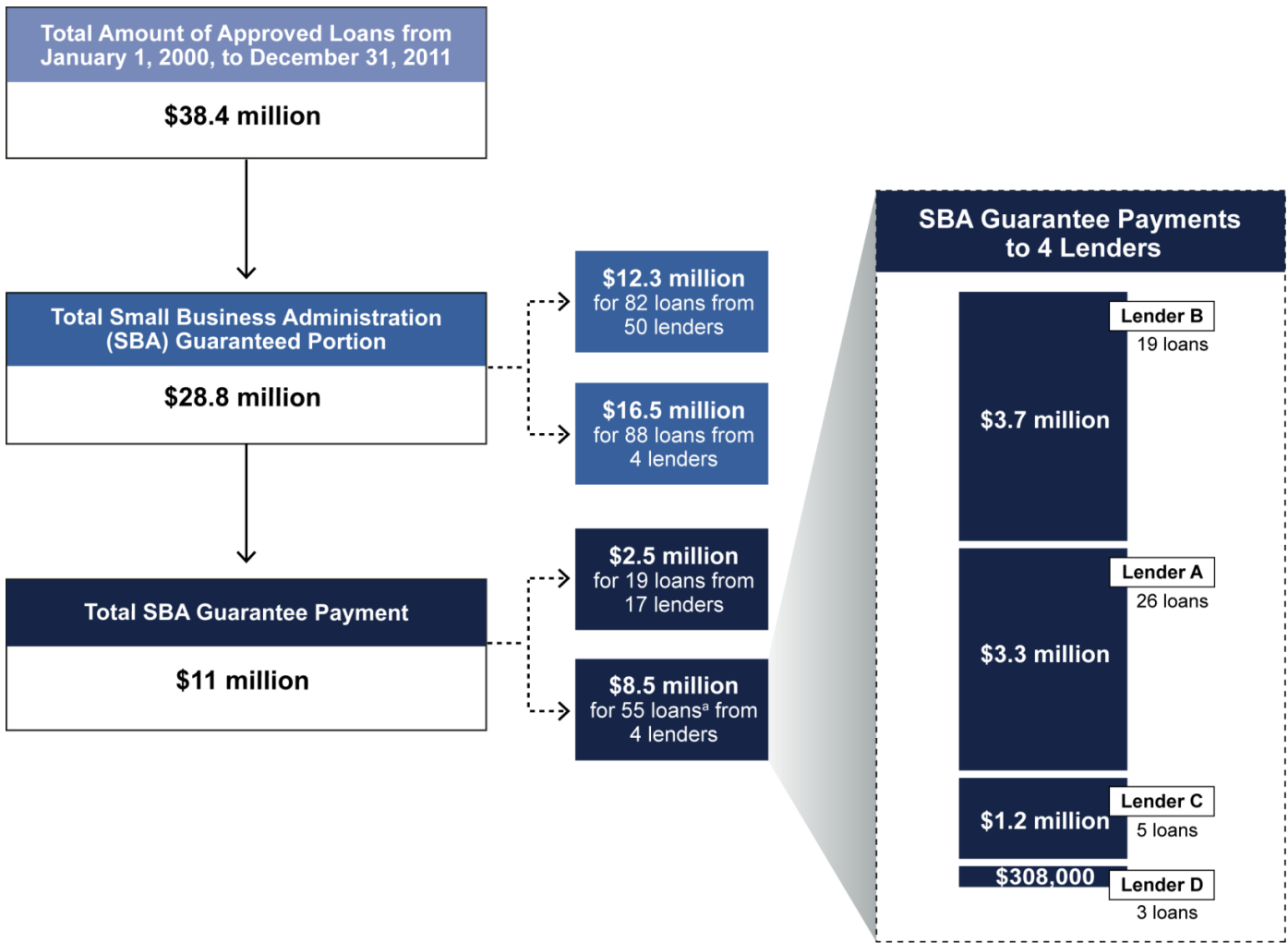
¹¹16 C.F.R. § 436.5.

¹²Prior to March 2011, the four lenders had delegated authority.

¹³We identified 55 defaulted loans for the four lenders to franchisees; however, SBA made guarantee payments for 53 of these defaulted loans. The average approved dollar amount of 7(a) loans from these four preferred lenders to franchisees, excluding SBA Express loans, was approximately \$326,000. We excluded SBA Express loans from this calculation because the approved loan amount for the 22 of the 23 loans of this type for the four lenders was no more than \$30,000, and often these loan proceeds were not disbursed.

¹⁴All dollar figures are presented in nominal dollars and have not been adjusted for inflation.

Figure 1: Small Business Administration (SBA) Paid \$11 Million in Guarantee Payments for Loans from Franchisees of the Franchise Organization (Approved from Jan. 1, 2000, to Dec. 31, 2011)



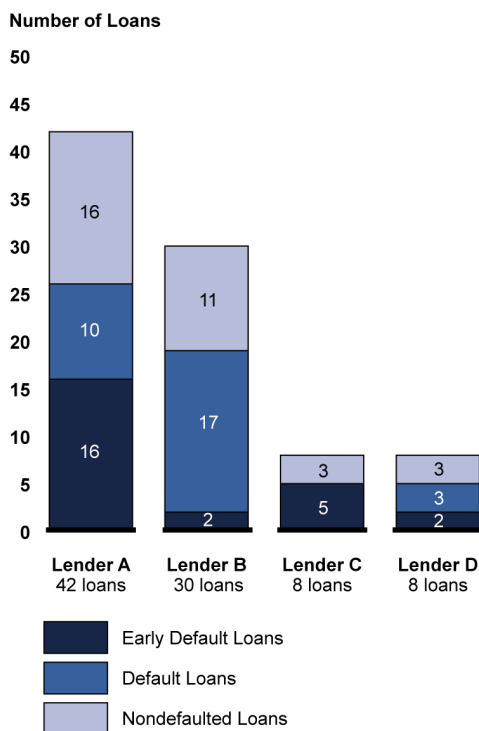
Source: GAO analysis of SBA data.

Notes: Data are from SBA's loan data and loan files for the four lenders.

^aWe identified 55 defaulted loans for the four lenders to franchisees from SBA data and loan files provided by SBA; however, SBA made guarantee payments for 53 of these defaulted loans.

Of the 88 loans we reviewed from the four lenders, 55 (about 63 percent) defaulted.¹⁵ In comparison, 19 of the 82 loans (23 percent) that originated at the other 50 lenders to the franchisees defaulted. As shown in figure 2, two lenders—Lender A and Lender B—represented about 82 percent of the defaulted SBA-guaranteed loans to franchisees from the four lenders (45 of the 55 defaulted loans), and over half of the total defaulted SBA-guaranteed loans to franchisees from all the lenders (45 of the 74 defaulted loans).

Figure 2: Two Lenders Accounted for over Half of All Defaulted Loans to Franchisees from the Four Lenders Approved from January 1, 2000, to December 31, 2011



Source: GAO analysis of SBA data.

Note: Data are from SBA's loan data and loan files for the four lenders.

¹⁵We identified 63 franchisees who received at least one loan from one of the four lenders. Overall, at least 31 of the 63 franchisees filed for bankruptcy. Some of these franchisees received more than 1 of the 88 SBA-guaranteed loans we reviewed from the four lenders. In addition, some franchisees received loans that were approved and defaulted during the financial crises from 2007 to 2009.

SBA oversees preferred lenders, in part, through its risk-based review process. SBA conducted such reviews on these four lenders, and found in 16 of 17 reviews conducted that the lenders' management of their SBA loan programs was either acceptable or acceptable with corrective actions required. One of the five reviews for one lender, Lender A, determined the lender's management was marginally acceptable with corrective actions required, including improvements to the lender's policies, procedures, and controls for demonstrating certain underwriting decisions.¹⁶ In September 2012, SBA OIG issued a report noting that during SBA's onsite reviews, the agency did not always recognize the significance of lender weaknesses for 8 of the 16 sampled lenders and it did not require lenders to correct performance problems that could have exposed SBA to unacceptable levels of financial risks.¹⁷ SBA OIG made six recommendations in the report, including proposals that SBA develop and implement a process for assessing lender weaknesses in terms of their risk to the agency, and that SBA tailor the scope of on-site reviews of lenders to identify and address the weaknesses underlying lender ratings. SBA agreed with the recommendations and the report noted it has taken steps to address concerns in the lender oversight process. For additional details on SBA's risk-based review of the four lenders, see appendix II.

In addition, as part of our investigative work, we interviewed the owners of 22 franchisees of the franchise organization to obtain background information on the SBA loan process and efforts to start their businesses.¹⁸ One franchisee we interviewed obtained an SBA-guaranteed loan that defaulted within 9 months of final disbursement, making it an early defaulted loan. The franchisee highlighted challenges related to insufficient working capital and unexpected expenses. The

¹⁶The period SBA conducted the risk-based reviews varied by lender, as described in more detail in app. II.

¹⁷Small Business Administration, Office of Inspector General, *Addressing Performance Problems of High-Risk Lenders Remains a Challenge for the Small Business Administration*, Report No. 12-20R (Sept. 28, 2012).

¹⁸We selected 14 franchisees who received 19 SBA-guaranteed loans to provide anecdotal information about the process of obtaining an SBA loan. As part of our review of the allegation, we interviewed 8 additional franchisees for a total of 22 franchisees. For additional details on our selection process, see app. I.

franchisee ultimately filed for bankruptcy in March 2010.¹⁹ In addition, franchisees we interviewed noted difficulties meeting anticipated revenue estimates, as well as limited access to information that would aid in business planning. While some of the franchisees we interviewed who had not defaulted on their loan expressed similar challenges faced by those with defaulted loans, one of the franchisees with a nondefaulted loan told us he maintained excess capital in order to withstand slow periods, and he highlighted previous business experience. The experiences described in our interviews with the 22 franchisees are not generalizable to the broader population of franchisees, other franchise organizations, or 7(a) borrowers in general, but they provide additional background and highlight some of the difficulties experienced by these franchisees.²⁰

Alleged Loan Agent Fraud Could Not Be Conclusively Determined, and SBA Has Taken Initial Steps to Enhance Oversight of Loan Agents and Improve Loan Data Quality

We were unable to conclusively determine whether the loan agent referred to us for investigation intentionally provided exaggerated revenue projections to franchisees to help them qualify for SBA loans; however, we found that first-year projected revenues on loan applications involving the agent or her employer were, on average, more than twice the amount of actual revenue for 19 of the 24 franchisees we reviewed in the first year of operations. Our review of the allegation included obtaining information on SBA's efforts to track and monitor loan agent involvement during the loan origination process. SBA has taken some steps to enhance oversight of loan agents and to improve the completeness and accuracy of data in its franchise loan portfolio.

Results of Investigation of Alleged Fraud Were Inconclusive

As part of our investigative work, we examined an allegation that a specific loan agent provided exaggerated revenue projections to some franchisees of the franchise organization in our review to assist them in qualifying for SBA-guaranteed loans. Potential franchisees and lenders

¹⁹Of the 22 franchisees we interviewed, 16 defaulted on their loans and 10 filed for bankruptcy protection.

²⁰The difficulties some of these franchisees faced may have been attributable to the economic downturn, given that the default dates for 12 of the 16 loans occurred from 2008 through 2010.

may choose to employ loan agents to assist in the preparation of SBA loan applications. In an interview in February 2012, the loan agent told us she obtained the revenue projections from her employer and former clients, one of which she identified. The loan agent told us she provided these revenue projections to clients. The employer and former client she identified denied providing the revenue projections to the loan agent. SBA's Office of Credit Risk Management debarred both the loan agent and her employer, and they are ineligible to work with the federal government for a period of 3 years beginning in January 2012. SBA debarred the loan agent on the basis of evidence supporting other grounds, including charging impermissible contingency fees, encouraging 7(a) loan applicants to violate SBA requirements by inflating working capital requests, and directing prospective borrowers not to disclose fees. In addition, the loan agent's employer was debarred for impermissible contingency fees and encouraging false statements in connection with the 7(a) program. On the basis of interviews with the loan agent, her employer, eight former franchisees, and a bank officer for the loans, and our associated audit work we could not conclusively determine whether the loan agent intentionally provided misleading first-year revenue projections to SBA loan applicants of the franchise organization.

Projected and Actual Revenue Differed, and Franchisees Should Exercise Due Diligence in Obtaining Accurate First-Year Revenue Projections

To better understand the role of loan agents and the preparation of SBA loan applications, we interviewed three loan agents who were not the subject of the allegation we received. These three loan agents stated that they did not provide clients with revenue projections, and one of them said it would be improper to do so. The Federal Trade Commission's Bureau of Consumer Protection (BCP) *Buying a Franchise: A Consumer Guide* encourages franchisees to conduct due diligence on any earning representations, including potential earning claims that the loan agent or other individuals may provide.

During our review of the 88 loans files, we identified 6 loan agents, including the subject of the allegation, who assisted franchisees in preparing SBA loan applications. For SBA loans involving these loan agents, to the extent possible, we assessed the accuracy of franchisees' first-year revenue projections on their SBA loan applications by comparing those figures to their actual first-year revenues using the franchise organization's revenue data. First-year revenue projections on SBA applications that involved the loan agent we reviewed as part of our investigation were, on average, higher than the franchisees' actual first-year revenue. The magnitude of this difference was also higher than what we found for other loan agents; however, the number of loans involving

loan agents with available data to make this calculation was limited and the results are not statistically significant or generalizable to other SBA loan applications.

Of the 88 SBA-guaranteed loans from the four lenders, we identified 24 franchisees with loans that indicated the loan agent referred to in the allegation, or her employer, assisted the franchisee in preparing the SBA loan application.²¹ Revenue projections from the loan application and actual revenue data from the franchise organization were available for 19 of these 24 franchisees, all of whom were owners of start-up franchises. On average, for these 19 franchisees, first-year revenue projections on their SBA loan applications were 2.7 times the actual revenues the franchisees made in their first year of operations.²² The first-year revenue projections for these 19 loans ranged from 1.02 times to 8.6 times the actual revenues the franchisee made in the first year of operations.

In the 88 loan files we reviewed for the four lenders, we found 10 loans that involved a specific loan agent other than the one who was the subject of the allegation. We found first-year revenue projections in the loan files for 5 of these 10 loans.²³ For these 5 loans, we compared the first-year revenue projections from the loan files to the actual revenue of the business during the first year of operations. The revenue projections for the five loans were, on average, 1.5 times the actual revenues the franchisees made in their first year of operations. The first-year revenue projections on the SBA applications for these five loans ranged from 1.03 times to 2.8 times the franchisees' actual first-year revenues.

In addition, federal regulations require franchise organizations to provide potential franchisees with certain information in their FDD—the disclosure document intended to aid individuals who are considering opening or

²¹The loans we identified involving the loan agent and her employer were disbursed prior to their debarment. Overall, among the four lenders with the most defaults and loans to the franchise organization, we identified 40 loans made to 24 franchisees that involved the loan agent or her employer. We also identified 5 loan agents who assisted with 10 loans. For the remaining 38 loans we received for the four lenders, we did not find evidence in the loan files that indicated the involvement of any loan agent.

²²For the 19 loans involving the loan agent, we found that all but 3 of the franchisees had first-year revenue projections that were at least 1.44 times actual first-year revenues.

²³The 5 loans involved three different loan agents.

purchasing a franchise.²⁴ While the franchise organization can choose to include earnings statements in the FDD, federal regulations do not require franchise organizations to provide actual first-year average revenues for start-up businesses in the disclosure document.²⁵

Franchisees should include first-year revenue estimates in an SBA loan application; however, this information is not necessarily available to potential franchisees in the FDD and they may have to conduct due diligence to identify this information from other sources, if available. For example, some franchisees we interviewed said they relied solely on information provided by the loan agent for developing revenue estimates. Other franchisees we spoke to highlighted different sources of financial information about the franchise organization, including existing or previous franchisees and the franchise organization's FDD when developing revenue estimates.

Several franchisees told us that they use FDDs when developing revenue estimates, but we found that the reported average revenue in the franchise organization's FDD tended to be higher than our calculated first-year average revenues. We reviewed the FDDs of the select franchise organization in order to determine the average revenue it reported to potential franchisees. The franchise organization's average revenue in its FDD accounted for all franchisees in operation the full calendar year before issuance of the FDD, not just first-year average revenue.²⁶ We used the franchise organization's revenue data to calculate, to the extent possible, first-year average revenues for only its start-up businesses.²⁷ We then compared our first-year average revenue calculation to the average revenue figures reported in the franchise organization's FDD over a 10-year period. For 9 of the 10 years we reviewed, the average revenue in the franchise organization's FDD was higher than our average

²⁴16 C.F.R. § 436.2. This regulation was issued by the Federal Trade Commission and it stipulates that the financial performance representation must have a reasonable basis and substantiation at the time it was made.

²⁵16 C.F.R. § 436.5.

²⁶Apart from assessing the franchisees accounted for in the franchise organization's average revenue calculations, we did not assess the methodology for the revenue calculation in the franchise organization's FDDs.

²⁷Our first-year average revenue calculation excluded 63 businesses the franchise organization told us were not start-up businesses. In addition, we excluded businesses that had potential reliability issues, including, but not limited to businesses that did not report 12 consecutive months of revenue or reported duplicate months of revenue.

revenue calculations, after we excluded from our calculation all businesses the franchise organization told us were not start-up franchises. In addition, for the 10-year period the average revenue in the franchise organization's FDD had a median value that was 1.43 times our average revenue calculation. In addition, we calculated the average revenue figure for the franchise organization, including the 63 businesses the franchise organization told us were not start-up businesses. The result of this calculation did not differ substantially from the franchise organization's average revenues in the FDDs. See appendix III for additional details about our analysis.

SBA's website offers some information about the challenges of franchising, and it directs potential franchisees to the website of the Federal Trade Commission's BCP for additional guidance. Likewise, the BCP's *Buying a Franchise: A Consumer Guide* warns potential franchisees about unauthorized or misleading earning representations, highlighting the importance of franchisees conducting due diligence when applying for a franchise loan. According to SBA officials, SBA has limited interaction with franchisees because it delegates the application process to the preferred lenders. However, officials said individuals can visit one of SBA's district offices, which provide resources for starting a business. Further, SBA has programs that are intended to help businesses start and grow by providing training, counseling, and access to resources, such as Small Business Development Centers, which provide services through professional business advisors. We identified other resources available to potential franchisees. For instance, a third party currently submits Freedom of Information Act requests for SBA franchise loan data, which it then uses to conduct franchise performance analysis. The analysis, which includes default rates and charge-off rates listed by franchise organization, is available to the public for a fee.

SBA Is Taking Steps to Enhance Oversight of Loan Agents

To enhance oversight of loan agents, in October 2010, SBA announced it would begin requiring lenders to submit reports on fees paid to loan agents and other agents who assist borrowers during the loan origination process. SBA requires preferred lenders to submit a form, called the Fee Disclosure Form and Compensation Agreement (Form 159), which SBA officials said can be used to document information about participants in the loan origination process, including whether a borrower used a loan agent, and if so, the loan agent's name, company, and compensation.

Lenders submit Form 159 to SBA's fiscal and transfer agent (FTA), who has been recording loan agent information on behalf of SBA since December 2010.²⁸

Further, in March 2011, SBA published a notice with guidance to lenders on how to submit the form to the agency's FTA, and the notice highlighted SBA's efforts to create a database that would include all information on the form.²⁹ SBA's FTA maintains the database that includes information from the form. In addition, during our review, officials said SBA is adapting the form to obtain more-complete information about the role and activities of individuals who assist potential borrowers during the loan origination process, including loan agents. SBA plans to update the form in fiscal year 2014. Officials further stated that SBA has taken, and is considering, other steps to enhance oversight of loan agents. For example, SBA has added a provision in its standard operating procedures that allows the agency to fully deny liability in the event that the lender makes a loan on the basis of a loan package prepared by a debarred loan agent. In addition, the agency publishes a list of debarred individuals including loan agents on its website.

Officials also described other efforts under consideration to enhance oversight of loan agents, such as a licensing or certification program. Such a system, agency officials said, would allow SBA to assign unique identifiers to loan agents. Officials also highlighted discussions with the Conference of State Bank Supervisors, which took place in October 2012, regarding the use of the Nationwide Mortgage Licensing System and Registry (NMLS) or a similar platform for improving SBA's tracking of loan agents.³⁰ An SBA attorney advisor noted, however, that legal issues could preclude the effective use of NMLS for SBA's purposes without additional legislation, and that this option is still under discussion. According to SBA officials, oversight of loan agents is primarily the responsibility of the

²⁸Small Business Administration, *Loan Agent Data Submission for 7(a) Loans*, Information Notice Number 5000-1177.

²⁹Small Business Administration, *Submission of Form 159 for 7(a) Loans*, Information Notice Number 5000-1200.

³⁰The NMLS is a record for nondepository, financial services licensing or registration for participating state agencies. This is the sole system of licensure for mortgage companies for 54 state agencies and the sole system of licensure for Mortgage Loan Originators for 58 state and territorial agencies.

preferred lenders, since they have delegated authority over the loan origination process.

SBA Has Initiated Efforts to Enhance Reliability of Some Franchise Loan Data

During the course of our review, we identified discrepancies in SBA’s franchise loan data that highlight incomplete or inaccurate data in certain fields SBA uses for risk-based oversight of its loans portfolio, which SBA has initiated efforts to address. Using data from SBA’s Loan Accounting System (LAS), in our review of the 88 loan files for four lenders of the franchise organization with the highest loan volume and default rates, we found discrepancies between the loan files and LAS. These discrepancies generally represent two facets of data reliability—completeness and accuracy. For example, we found differences with respect to dates of defaults, default status, and whether the franchise was a start-up or existing business. Table 1 provides an overview of the discrepancies we identified.

Table 1: Summary of Discrepancies Found in the Small Business Administration’s (SBA) Franchise Loan Data

Data reliability characteristic	Discrepancy
Completeness	<ul style="list-style-type: none"> We identified four loans during our review of loan files for the four lenders with high default rates and loans that were not in the data provided from SBA’s Loan Accounting System (LAS).^a During our interviews with franchisees, we identified three loans that were not in the LAS data or in the loan files provided by SBA. SBA did not identify loans that involved the loan agent who was the subject of the allegation for three of the four lenders in our review. We identified eight loans through loan file review that indicated the participation of the agent or her employer. These loans included one early defaulted loan, four defaulted loans, and three nondefaulted loans.^b
Accuracy	<ul style="list-style-type: none"> We identified one defaulted loan, on the basis of information in the loan files from the four lenders, that was not marked as such in SBA’s data. We found eight loans where the date of default in the loan files was different from the date recorded in SBA’s data, three of which were different by at least 3 months.^c We identified three franchisees that were recorded as “existing” businesses in SBA data, yet the loan files showed these were start-up franchisees. The loan data provided from LAS included one loan for a franchisee that was an entirely different franchise organization than the one we reviewed.

Source: GAO review and analysis of SBA’s loan data and loan files.

Notes: Data are from SBA’s loan data and loan files for the select franchise organization.

^aFor some fields in LAS, SBA relies on lenders to ensure the completeness and accuracy of its data. According to SBA, the lender either did not flag these loans as franchise loans or did not include the franchise name when submitting the loan.

^bThe eight loans we identified were made to eight distinct franchisees. One of the defaulted loans involving the loan agent had been identified by the lender as an early defaulted loan in its request for an SBA guarantee payment, indicating it had defaulted within 18 months of final disbursement. Officials said SBA reviewed this loan and determined it was not an early default, since it had defaulted after 18 months from final disbursement. In addition, officials noted the lender that

originated this loan did not accept the revenue projections in the loan application at face value, since the lender lowered the borrower's revenue projections by 20 percent when determining repayment ability. At the time of our work, SBA had not yet completed its review of the other early defaulted loan we found among the eight loans.

^cSBA used the date of default to create a field showing whether the franchisees had defaulted, early defaulted, or nondefaulted loans. SBA created the field for purposes of our review and using estimates, since it is not available in LAS. Given the discrepancies we found in the data for default dates, we asked SBA to reassess the number of early defaulted loans for all lenders to franchisees of the franchise organization, and requested that SBA take into consideration the change in the early default definition. In response to our request, SBA identified four potential early defaulted loans made by lenders to franchisees of the franchise organization, which were not previously identified because SBA did not initially take into account the change in the definition or early defaults. Upon further review of the loan transcripts, SBA officials determined that three of the four loans were not early defaulted loans.

SBA officials said the agency takes steps to ensure the reliability of its loan data and has initiated efforts intended to improve the completeness and accuracy of some fields in LAS related to its franchise loan portfolio in general. Preferred lenders enter select data into LAS, and they certify that the information they enter into the system is accurate and complete, officials said.³¹ In addition, officials noted SBA assesses the accuracy of certain data fields when the lender submits a monthly loan status report or loan files to request a guarantee payment, and an external auditor reviews a sample of loans in LAS to validate that the financial data for the loans are accurate.³² Officials also said SBA is working with a third-party vendor to improve the consistency of franchise information in its database by replacing SBA's current franchise codes with publicly available identifiers used in the franchise industry, and to verify the accuracy of franchise information in LAS that lenders previously entered. As of July 2013, officials said the franchise identifiers were ready for use, and the agency planned to notify lenders about them. In addition, in August 2013, officials said they estimate the franchise identifiers will be introduced at the beginning of fiscal year 2014. SBA officials noted efforts to improve historical franchise data would be contingent on funding. Because SBA's

³¹Preferred lenders are responsible for inputting some fields into LAS such as the franchise organization code, which is the unique identifier, as well as the organization's name, borrower's name, the gross approval amount of the loan, and whether the borrower sought financing for starting a new business or acquiring an existing one. In the case of the franchise organization we reviewed, if the lender did not input the franchise code or name correctly, SBA would not be able to identify the loan in its database. Other fields in LAS are generated by SBA or the system itself, including the guaranty percentage, the requested guarantee payment, and date of the request.

³²Lenders submit a monthly status report of SBA-guaranteed loans to SBA using the Guaranty Loan Status and Remittance Form, Form 1502. The form includes information about the loan, such as loan status, amount disbursed, guarantee portion amounts, and fees.

franchise data-improvement efforts are in the early stages, it is too soon to assess whether SBA's actions will address the issues with data reliability we identified.

Agency and Third-Party Comments and Our Evaluation

We provided a draft of this report to SBA for its review and comment. SBA provided technical comments, which were incorporated, as appropriate. We also provided relevant sections of a draft of this report to the four lenders who made loans to franchisees of the franchise organization. We received technical comments from three of the lenders and incorporated them, as appropriate, and one lender did not provide comments.

In their comments, one of the lenders asked to be dropped from the report because of what it described as a relatively fewer number of loans and defaults compared to the other lenders. However, we included information on the SBA-guaranteed loans made by this lender to franchisees to provide more context and perspective on loans to franchisees. While relatively smaller based on the number of made and defaulted loans to franchisees than other lenders, it met our criteria of lenders with the highest number of loans and defaults. The only other lender with a comparable number of loans had one defaulted loan.

In addition, we provided a draft of this report to the franchise organization for its review and comment. The representatives of the franchise organization provided comments on a draft of this report, which we have reprinted in appendix IV. In their comments, representatives of the franchise organization stated that our comparison of average revenues in the FDD and our first-year average revenue calculations is potentially misleading and inaccurate because the two sets of data being compared are not analogous. Specifically, representatives of the franchise organization stated that we are comparing two different sets of data and that we point out a significant difference in revenue without explaining the differences in such figures. The representatives requested that we more clearly state the differences between revenue information contained in the FDD and our calculations, which we did.

However, we disagree with the representatives' comments that our comparison is potentially misleading and inaccurate. The report comments on the use of the FDD for projecting first-year revenue, not on the accuracy of the average revenue reported in the franchise organization's FDDs. Specifically, the report states that the average revenue in the FDD accounted for all franchisees in operation the full

calendar year before issuance of the FDD. However, we added additional language to clarify that our calculation is of first-year average revenue obtained from reviewing additional revenue data we obtained from the franchise organization. Our comparison highlights the difficulties of using the FDD as a basis for projecting first-year revenues, since the revenue reported in the franchise organization's FDD is derived from businesses in operation at least the full calendar year prior to issuance of the FDD. As noted in our report, while franchise organizations can choose to include earnings statements in the FDD, federal regulations do not require them to provide *first-year* average revenues for start-up businesses in the disclosure document.³³ However, franchisees are required to include first-year revenue estimates in SBA loan applications, and this information is not necessarily available to potential franchisees in the FDD; thus, they may have to conduct additional due diligence to identify this information from other sources, if available. As noted in our report, several franchisees told us that they use FDDs when developing revenue estimates, and we found that the reported average revenue in the franchise organization's FDD tended to be higher than our first-year average revenue calculations. The purpose of our analysis was not to assess the accuracy of the franchise organization's reported revenues in the FDD, as the representatives suggest in their comments, but to demonstrate how the FDD figures were, on average, higher than our first-year average revenue calculations.

In addition, as noted in the report, our calculation of average revenues including existing businesses did not vary substantially from the franchise organization's figures. Representatives of the franchise organization requested that we state more clearly in the text of the report that we did not identify a substantial difference between our average revenue calculations and the franchise organization average revenue in the FDD when including existing businesses. We modified our report to more clearly state this information. However, by excluding existing businesses in our calculation, to the extent possible, we highlighted how average revenues disclosed in the franchise organization's FDDs tended to be higher than first-year average revenues, which we believe is material to our discussion about the importance of franchisees' conducting due diligence when applying for a 7(a) loan. The franchise organization agreed that potential franchisees must be careful in using information in

³³16 C.F.R. § 436.5.

the FDD for estimating first-year revenue. In addition, the representatives of the franchise organization noted additional provisions in the FDD that address how a prospective franchisee can gather further information. We modified the report to include language to address this issue.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the acting Administrator of the Small Business Administration, the appropriate congressional committees, and other interested parties. In addition, the report is available at no charge on the GAO website at <http://www.gao.gov>.

If you or your staff members have any questions concerning this report, please contact Stephen M. Lord at (202) 512-6722 or lords@gao.gov or Wayne A. McElrath at (202) 512-6722 or mcelrathw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made major contributions to this report are listed in appendix V.



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Appendix I: Objectives, Scope, and Methodology

This report describes (1) the magnitude of Small Business Administration (SBA)-guaranteed loans to franchisees of the franchise organization, and (2) the results of our investigation into the allegation, and aspects of SBA's oversight of its 7(a) loan program with respect to loans made to franchisees of the franchise organization.

To conduct our audit work, we examined data for all SBA-guaranteed loans to franchisees of the select franchise organization approved from January 1, 2000, to December 31, 2011, in order to assess loan volume, default rates, and the amount of SBA's guarantee payments made for 170 loans to franchisees of the franchise organization from 54 lenders. We selected this date range in order to obtain a broad understanding of SBA-guaranteed loans to the franchisees during different economic conditions and from multiple lenders. The original dataset we received from SBA included 184 loans to franchisees; however, 16 of these indicated that the lender canceled the guarantee on the loan and 2 were outside the scope of our review.¹ We therefore excluded these loans from our analysis of SBA's loan data for the franchise organization. From these data, we selected four lenders with the highest loan volume and default rates. Three of these four lenders are preferred lenders that have delegated authority to make lending decisions on behalf of SBA.² We also reviewed 88 SBA loan packages for these four lenders in order to assess characteristics of individual loans, such as the extent to which the franchisees' projected first-year revenues differed from actual first-year revenues, and to assess the accuracy of certain data fields in the SBA franchise loan data. These loan packages included all loan packages for these lenders during this time period. We obtained copies of SBA's risk-based review reports for the four lenders. We also searched the website PACER.gov to determine if any of the franchisees that received 1 of the

¹We identified two SBA-guaranteed loans that fell outside the scope of our review, including one loan approved for a different franchise organization and another loan that was not originated by one of the four lenders. The number of loans we received in the original dataset that were relevant to our review, excluding these two loans and the 16 canceled loans, was 166 loans. However, during our review of the loans from the four lenders to the franchise organization, we identified four loans that were not in the dataset we received from SBA. Thus, in all, we reviewed 170 loans from the four lenders to the franchise organization.

²Prior to March 2011, the four lenders had delegated authority.

88 SBA loans filed for bankruptcy.³ We obtained franchise loan information from the four lenders when available. To assess the reliability of the SBA franchise loan data for the franchisees of the franchise organization, we (1) interviewed agency officials knowledgeable about the data, (2) performed electronic testing for completeness and accuracy on select data fields, and (3) traced fields in SBA's loan database to primary source files when possible. We found discrepancies between data in SBA's loan database and information in the loan files we reviewed. We discussed reasons for the differences between the data sources, as well as the agency's processes and policies for managing the quality of franchise loan data, with SBA officials. After discussions with SBA, we determined the SBA loan data were sufficiently reliable for reviewing loans to the franchise organization.

Moreover, we analyzed revenue data that we obtained from the franchise organization to calculate actual first-year revenues of franchisees, when possible. We compared these calculations with the projected first-year revenues in SBA loan applications for 19 franchisees who used the loan agent, or her employer, who was the subject of the allegation. We also used the franchise organization's revenue data to calculate average first-year revenues for a broader population of franchisees, and compared it to average revenues reported in the franchise organization's disclosure documents. We noted several data limitations with the franchise organization's revenue data. The scope of our review included businesses with a full 12 months of revenue data that began from years 2000 to 2011, since our objective was to calculate an entire year of business revenue for businesses that opened during that time period. The original revenue data provided by the franchise organization included 746 businesses. After excluding 59 businesses with fewer than 12 months of revenue data and 149 businesses that may have opened prior to January 2000 (16 businesses affected by both of these issues), the total population of businesses in the revenue data was reduced to 554. In addition, we identified 115 businesses with revenue data that highlighted potential reliability issues, including missing, duplicate, and nonsequential revenue data. For purposes of data reliability, we excluded these businesses from our calculations, and conducted analysis on the remaining 439 businesses. To the extent possible, we calculated an average revenue figure that reflected first-year revenue of start-up

³Public Access to Court Electronic Records (PACER) is an electronic public access service that provides case information from federal appellate, district, and bankruptcy courts.

franchisees. Accordingly, for part of our analysis, we excluded 63 businesses from the revenue dataset that the franchise organization identified as existing businesses, for a total population of 376 businesses. The franchise organization was not able to confirm that it identified all existing businesses, so our average revenue calculations may include both start-up franchisees and existing franchisees. Nonetheless, we believe the average revenue figures we calculated provide a reasonable basis of comparison to projected revenues for select start-up franchisees, as well the franchise organization's disclosure documents. We discussed this methodology with representatives of the franchise organization, who confirmed our approach was reasonable. To further assess the reliability of the revenue data, we interviewed representatives of the franchise organization and performed electronic testing on the data provided. We determined that the franchise organization's revenue data were sufficiently reliable for the purposes of this report.

We also interviewed SBA officials about their activities related to oversight of the four lenders, efforts to track and monitor loan agents, and the assistance provided to potential franchisees during the loan application process. In addition, we examined SBA's policies and procedures for overseeing lenders in the 7(a) program. We also reviewed reports by SBA's Office of Inspector General (OIG) and other related documents.⁴

To conduct our investigative work, we reviewed an allegation that a loan agent intentionally exaggerated first-year revenue projections on SBA loan applications in order to ensure that franchisees would qualify for SBA 7(a) loans. We interviewed the owner of the franchise organization, the loan agent who was the subject of the allegation, her employer, eight former franchisees that were referred to us during the course of the investigation, and a bank officer that reviewed loans related to the allegation. To better understand the franchisees' experience with the 7(a) loan program, we interviewed 14 additional franchisees of the select

⁴Small Business Administration, Office of Inspector General, *The SBA's Portfolio Risk Management Program Can Be Strengthened*, Report No. 13-17 (July 2, 2013); *Report on the Most Serious Management and Performance Challenges Facing the Small Business Administration in Fiscal Year 2013*, Report No. 13-02 (Oct. 15, 2012); *Addressing Performance Problems of High-Risk Lenders Remains a Challenge for the Small Business Administration*, Report No. 12-20R (Sept. 28, 2012); Report No.11-16 (July 13, 2011); and *Material Deficiencies Identified in Early-Defaulted and Early-Problem Recovery Act Loans*, Report No. ROM 10-19 (Sept. 24, 2010).

franchise organization who received 19 SBA-guaranteed loans from one of the four lenders with the highest loan volume and default rates. These franchisees were selected on the basis of a range of factors, including whether they used a loan agent, geographic dispersion, and performance status of the loan. We also interviewed three additional loan agents. In addition, on the basis of the 88 loan packages we reviewed for the four lenders, we identified 24 franchisees that used the loan agent connected to the allegation, or her employer, 19 of whom had data available to compare the first-year revenue projections on their SBA loan applications with the franchisees' actual first-year revenue. We cannot generalize our findings from these interviews to other franchisees, loan agents, franchise organizations, or borrowers in the 7(a) program. Our intent was not to identify potential fraud or abuse for all franchise loans of the franchise organization or the 7(a) loan program as a whole.

We conducted this performance audit from March 2012 to September 2013, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our related investigative work in accordance with the standards prescribed by the Council of the Inspectors General on Integrity and Efficiency.

Appendix II: Summary of Risk-Based Reviews of Four Lenders

As part of its oversight efforts, the Small Business Administration (SBA) generally conducts reviews of all 7(a) lenders with SBA-guaranteed loan portfolios of \$10 million or more on a 12- to 24-month cycle. SBA can conduct additional reviews of the lenders if it identifies specific performance concerns. Officials highlighted additional factors that could determine whether a lender is subject to a risk-based review, including the lenders' risk ratings, industry concentration, and the results of previous reviews. SBA conducted risk-based reviews of the four lenders we selected for further review. Table 2 summarizes the risk-based reviews we received from SBA for the four lenders.

Table 2: Summary of Small Business Administration's (SBA) Risk-Based Reviews of Four Lenders

Lender	SBA review
Lender A	SBA conducted five risk-based reviews from 2003 through 2011. In four reviews, SBA assessed Lender A's management of its SBA loan program as acceptable or acceptable with corrective actions required. In one review, which was the only one conducted after an SBA Office of Inspector General (OIG) report on this lender, SBA determined the lender's SBA loan program was marginally acceptable with corrective actions required. From 2000 through 2012, Lender A's delegated authority had not been suspended or removed. Lender A is currently a preferred lender.
Lender B	SBA conducted five risk-based reviews from 2004 through 2010. Five reviews determined the lender's SBA loan program was acceptable with corrective actions required. From 2000 through 2012, Lender B's delegated authority had not been suspended or removed. However, Lender B no longer has preferred lending status.
Lender C	SBA conducted four risk-based reviews from 2003 through 2010. In the 2003 and 2006 reviews, SBA assessed the lender as acceptable. For the last two reviews, SBA determined the lender's SBA loan program was acceptable with corrective actions required. From 2000 through 2012, Lender C's delegated authority had not been suspended or removed. Lender C is currently a preferred lender.
Lender D	SBA conducted three risk-based reviews from 2007 through 2011. The three reviews determined the lender's SBA loan program was acceptable with corrective actions required. From 2000 through 2012, Lender D's delegated authority had not been suspended or removed. Lender D is currently a preferred lender.

Source: GAO analysis of SBA's data.

Note: Data are from SBA's risk-based reviews and SBA information.

SBA has the authority to suspend, revoke, or deny renewal of or issue a shortened period for delegated authority of preferred lenders. According to officials, SBA suspended or revoked the delegated authority for two preferred lenders in the 7(a) program from 2000 through 2012. Rather than suspending or revoking delegated authority, officials said SBA is more likely to deny a renewal of delegated authority or grant a shortened renewal period, since the renewal period can be from 6 months to 2 years. From fiscal year 2009 through 2012, SBA denied delegated authority to 367 lenders. In addition, approximately 1,058 lenders received at least one shortened renewal of 6 to 12 months. SBA can also place lenders on a "watch list," which is one of SBA's monitoring tools to

identify high-risk lenders that warrant elevated oversight attention. Officials told us that high-risk lenders on the watch list include institutions that have received a review assessment of less than acceptable with corrective actions required and marginally acceptable with corrective actions required.

According to SBA, it is developing a new lender oversight framework to conduct risk-based reviews. This new framework of risk-based reviews is intended to measure the level of risk of each lender participating in the 7(a) program. As part of this effort, SBA officials said that they plan to conduct a pilot project to review 20 to 30 lenders, which is to include evaluations of issues related to loan agents and franchisees. As of August 2013, SBA had completed 18 pilot reviews. In addition, SBA officials said the agency will conduct various types of risk-based reviews based on issues unique to a particular lender.

Appendix III: Financial Disclosure Document (FDD) Analysis and Franchising Due Diligence

The franchise organization we reviewed included average revenue in the FDD that accounted for all franchisees, including both start-up and existing franchisees in operation the full calendar year before issuance of the FDDs. We obtained and analyzed the franchise organization's revenue data to calculate first-year average revenues, to the extent possible, and compared them to average revenues reported in the franchise organization's FDDs.¹ We found the average revenues reported in the franchise organization's FDDs from 2000 to 2009 were higher than our average revenue calculations, with the exception of 1 year. Specifically, for the 10-year period of FDDs we reviewed, the average revenue in the franchise organization's FDD had a median value that was 1.43 times our average revenue calculation.² The average revenue in the FDD for 1 of the 10 years was lower than our average calculation (our average revenue calculation was 90 percent of the FDD for that year). However, for the other 9 years, the FDD was at least 1.35 times and at most 1.74 times the average revenue figures we calculated.

As discussed, current federal regulations stipulate that franchise organizations have discretion in what they report in the section of the FDD that is devoted to earnings statements, provided there is a reasonable basis and written substantiation for the information. All of the FDDs we reviewed for the franchise organization cautioned potential franchisees that they may not achieve the average revenue reported in the FDD and that many factors influence the revenue of the franchise. These FDDs also note that the potential franchisees accept the risk of not

¹The average revenue calculations excluded 63 *businesses* the franchise organization was able to identify as an existing business. In addition, the average revenue calculations excluded franchisees that had potential reliability data issues, including franchisees with data that skipped months and had duplicate values. We also excluded franchisees that did not have a full 12 months of revenue data. We did not assess the franchise organization's methodology for calculating the revenue figures in the FDD or the reliability of the revenue information. See app. I for additional information on our use of the franchise organization's revenue data.

²We also calculated the average revenue figure for the franchise organization including *both* start-up and the 63 existing franchisees. We did not identify a substantial difference between our average revenue calculations and the franchise organization's average revenue in the FDD when including the existing businesses. The median value for the 10-year period of FDDs was 1.42, indicating that the average revenue in the FDD was 1.42 times our average revenue calculation when we included both start-up and existing franchisees. Over the 10-year period, the average revenue in the franchise organization's FDD was at least 1.07 times and no more than 1.58 times our average revenue calculation that included both start-up and 63 existing franchisees.

achieving the stated average revenue, and that the franchise organization has not audited nor in any other manner substantiated the truthfulness, accuracy, or completeness of any information supplied by its franchisees.

Appendix IV: Comments from Representatives of the Franchise Organization

Note: Footnote numbers in the draft report may differ from those in this report.

August 27, 2013

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RE: GAO Draft Report GAO-13-759, "Small Business Administration: Review of 7(a) Guaranteed Loans to Select Franchisees"

Dear Mr. Lord and Mr. McElrath:

Thank you for the opportunity to review and comment on a draft of the GAO's Report GAO-13-759, "Small Business Administration: Review of 7(a) Guaranteed Loans to Select Franchisees." We write on behalf of the franchise organization referenced in the Draft Report to offer the following comments.

1. The Franchising Industry and Regulatory Environment

As the Draft Report discusses the franchise organization's franchise disclosure document ("FDD") and certain franchisees' use of the FDD information in their loan applications, we believe it is important to place these activities in the appropriate legal and regulatory context for both the GAO and for any readers of the final Report.

As the Draft Report correctly notes, the Federal Trade Commission's Franchise Rule ("Franchise Rule") requires that a franchisor provide extensive information about a franchise opportunity to prospective franchisees. The Franchise Rule requires that franchisors provide prospective franchisees an FDD with detailed information about the franchisor, the franchise investment, the franchise agreement, and the franchise system in 23 "Items" of information. The purpose of the FDD is to enable a prospective franchisee – with its legal and financial advisors – to make an informed decision about buying a franchise. The Franchise Rule assumes that a prospective franchisee will make an active inquiry using all available sources of information (including current and former franchisees) in making its decision whether to acquire franchise rights. The purpose of the FDD is to provide the prospective franchisee information needed for purchasing a franchise, and not for obtaining financing.

As the Draft Report acknowledges, the Franchise Rule permits but does not require a franchisor to provide a financial performance representation ("FPR") in its FDD. If the franchisor elects to provide an FPR, it must do so in writing in Item 19 of the FDD, and it must have a reasonable basis and written substantiation for the FPR at the time it is made. The

Franchise Rule provides broad latitude to franchisors as to the information contained in their FPRs, due to the wide variety of franchised businesses; differing information that is collected and presented; and other factors. As the Draft Report notes, the Franchise Rule does not mandate the use of FPRs. Many franchisors use FDDs to provide additional information to prospective franchisees, but most do not.

2. The Franchise Organization's FDD

a. Comparison of FDD Data with GAO Data

We found the Draft Report's discussion and analysis of the franchise organization's financial performance representations in Item 19 of its FDD (as compared to the GAO's "start-up" calculations) to be confusing, and potentially misleading and inaccurate.

By way of background, the franchise organization provides, *inter alia*, gross revenue information for its franchisees in Item 19 of its FDD. The Item 19 gross revenue information in the FPRs was for all franchised businesses that were operating throughout the entire calendar year prior to each FDD's issuance date. The franchise organization included this information in all of its FDDs during the 2000 to 2011 time period.

As you know, the GAO requested (and the franchise organization provided) the revenue data for its franchisees for the years 2000 through 2011 so that the GAO could analyze this data. According to the Draft Report, the GAO used this data to calculate franchisees' "first-year average revenues for only its start-up businesses." The GAO then compared the revenues it calculated to the revenues reported by the franchise organization in its FDD and concluded that:

... for the 10-year period of FDDs we reviewed, the average revenue in the franchise organization's FDD had a median value that was 1.43 times our average revenue calculation.

We find this comparison and the related discussions in the Draft Report (and Appendices) to be misleading. The implication in the Draft Report is that the franchise organization's figures are inaccurate. In fact, this comparison is not valid because the two sets of data being compared – the FDD data and the GAO's data – are not analogous. As noted above, the franchise organization's FDD does not report revenue figures for franchisees that are within their first calendar year of operation. For its revenue data to be contained in the FDD calculations, the franchisee must have been in operation for the entire calendar year. This is clearly stated alongside the data in Item 19 of the FDD. Thus, "first-year" or "start-up" revenues are not reported in the franchise organization's FDD.

By contrast, we understand that the GAO data includes only gross revenue information for franchisees in their first year of operation and excludes data for (1) any franchises that opened before January 1, 2000 and (2) any franchises that were sales of existing franchised businesses (i.e., franchise transfers). Therefore, the GAO's revenue calculations are not based on the same data set underlying the revenue reported in the FDD.

In sum, after reviewing the Draft Report, we are concerned that the comparisons the GAO is making between its calculations and the revenues reported by the franchise organization in its FDD are inaccurate and misleading, because (1) they are comparing two very different sets of data, and (2) the Draft Report indicates that there is a significant difference in the revenue figures without pointing out the differences in such figures. Given the presentation of this comparison in the Draft Report, we believe this is confusing and misleading to the reader.

If the GAO retains this discussion in the Draft Report, we believe it should (1) much more clearly state the differences between (a) the revenue information contained in the franchise organization's FPRs and (b) the "first-year" or "start-up" revenue information the GAO calculated, and (2) much more clearly highlight in the text of the Draft Report the conclusions in the first two sentences of Footnote 35, presented below, as to consistency with the GAO's calculations of the franchise organization's revenue calculations.

Footnote 35 in Appendix III of the Draft Report acknowledges the consistency of the franchise organization's FDD figures with the GAO's figures. It states that:

We also calculated the average revenue figure for the franchise organization including both start-up and the 63 existing franchisees. We did not identify a substantial difference between our average revenue calculations and the franchise organization's average revenue in the FDD when including the existing businesses.

As noted, this should be stated much more clearly in the text of the Draft Report.

As the GAO rightly notes in the Draft Report, the Franchise Rule does not require franchise organizations to include revenue figures for start-up businesses in their FPRs. 16 C.F.R. § 436.5. For your information, most franchisors that include FPRs in their FDDs do not use figures for start-up businesses for a variety of reasons, including the inherent unreliability of the data provided by start-ups; the ramp-up time involved; the seasonality of the business; and other factors.

b. Franchisees' Use of FDD Data for Franchise Financing

The Draft Report notes, or at least implies, that a franchisee needs to be careful in using information in an FDD in making determinations concerning estimated first-year revenues generally, and for purposes of loan financing in particular. The franchise organization agrees with this for several reasons. First, to that end, the FDD includes a number of provisions in Item 19 that specifically address how a prospective franchisee can gather further information, including:

- (1) Encouraging prospective franchisees to contact and speak with existing franchisees; and
- (2) Encouraging prospective franchisees to consult with business, financial, and other advisors.

**Appendix IV: Comments from Representatives
of the Franchise Organization**

As the Draft Report does note, Item 19 of the FDD further cautions potential franchisees that they may not realize the revenues reported in the FDD because many factors – including factors specifically enumerated in Item 19 – influence individual financial results. The FDD contains extensive and detailed cautionary notes for prospective franchisees on this issue.

Second, Item 7 of the franchise organization’s FDD provides potential franchisees with estimated ranges of start-up costs that the franchisee may incur in opening a franchise, including the need for working capital and additional funds. The estimates provided in Item 7 contain similar cautionary notes and also contain explicit language warning the potential franchisee, for example, that (i) that the estimated “start-up” period is merely an estimate, and may actually be shorter or longer, and (ii) that new businesses typically generate negative cash flow.

Finally, prospective franchisees should not rely on an FDD for first year revenue information for SBA loans because the FDD is not designed for this purpose. The FDD is designed to provide prospective franchisees information and sources of information to do proper due diligence to plan their business investment and to protect themselves (e.g., from unscrupulous loan brokers).

* * *

Thank you for your consideration of these comments. We ask that they be appended to the Report as published to the public and provided to any other recipients.

Sincerely,



The franchise organization and its representatives

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Staff Acknowledgments

In addition to the contacts named above, Heather Dunahoo, Assistant Director; Rick Hillman; Maria McMullen; Linda Miller; Gloria Proa; Gavin Ugale; Elizabeth Wood; and Heneng Yu made key contributions to this report.

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