VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

REPORT ON AUDIT

FOR THE YEARS ENDED

JUNE 30, 2011 AND JUNE 30, 2012

Auditor of Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the Virginia Small Business Financing Authority (the Authority) for the years ended June 30, 2011 and June 30, 2012, found:

- proper recording and reporting of all transactions, in all material respects, in the Commonwealth Accounting and Reporting System;

- no matters involving internal control and its operations necessary to bring to management's attention; and

- no instances of noncompliance with applicable laws and regulations or other matters that are required to be reported.

Additionally, we found that the Authority has implemented controls to administer their loan and loan guaranty fund programs and properly administers these programs.

-TABLE OF CONTENTS-

	Pages
AUDIT SUMMARY	
AUTHORITY BACKGROUND	1
PROGRAM HIGHLIGHTS	1-5
FINANCIAL HIGHLIGHTS	5-6
INDEPENDENT AUDITOR'S REPORT	7-8
AGENCY OFFICIALS	9

AUTHORITY BACKGROUND

The Virginia Small Business Financing Authority (Authority) has been in existence since 1984 and provides financial assistance to Virginia-based businesses through bond issuances, direct loans, loan guarantees, and portfolio loan loss reserves; as well as other technical assistance. The Governor appoints the Authority's 11 member Board of Directors.

The Director of the Department of Business Assistance (Business Assistance) appoints the Authority's Executive Director, who oversees the Authority's operations. The Authority's staff, who are also Business Assistance employees, support the Authority by reviewing program applications, conducting credit analysis, monitoring the progress of projects that have received funding, and servicing loan receivables. The Authority is included as part of Business Assistance's general fund appropriations, however various fees and interest earnings cover the majority of the Authority's administrative expenses.

PROGRAM HIGHLIGHTS

The exact nature and number of programs administered by the Authority have continually changed over time. The Authority's financing programs fall into three broad categories: bonds, direct assistance, and indirect assistance.

Through the bond program, the Authority provides Virginia businesses and 501 (c) 3 non-profits with access to low cost bond financing which they would otherwise not be able to obtain on their own. The direct assistance programs provide loans to qualified Virginia businesses and 501 (c) 3 organizations, while the indirect assistance programs provide support to Virginia businesses through loan guarantees and loan insurance programs. The goal of these programs is to encourage economic development through either job creation or retention by small businesses.

The economic condition of fiscal years 2011 and 2012 had an impact on lending within the programs. The general decline in the issuance of new loans and guarantees continued from fiscal year 2010, with the exception of the Industrial Development Bond program in fiscal year 2011 and the Loan Guaranty (LGP), Providing Access to Capital Entrepreneur (PACE), and the Tobacco Capital Access (TCAP) programs in fiscal year 2012. Bond issuance to non-profit entities increased during fiscal year 2011 largely due to a carryover from the American Recovery and Reinvestment Act of 2009 which relaxed the IRS limits on "bank qualified" bonds for issuers. The increased activity within the LGP, PACE, and TCAP programs reflect an increase in participation by banking institutions during fiscal year 2012. The Authority does not expect overall lending activity to increase until the economy improves.

Detailed below is more information about the various programs since their inception as administered by the Authority.

Bond Programs

The ***Industrial Development Bond Program*** is a financing vehicle in which the Authority serves as a conduit issuer of tax-exempt and taxable industrial development bonds for qualifying businesses and 501(c) 3 entities. The nature of the entity and consideration of the Commonwealth's available allocation of private activity bonds determine whether or not the bond issuance will be tax-exempt.

The private sector provides the bond financing, not the Authority or the Commonwealth, and the respective small business or non-profit has responsibility for debt service. As such, the Authority takes on no risk as a result of this program. The Authority is responsible for collecting application and administration fees associated with the bond issuances. These funds support the ongoing operating expenses of the Authority and also provide additional funding to other programs administered by the Authority.

Since the program's inception, the Authority has facilitated the issuance of 153 bonds, averaging nine bond issuances per year. During fiscal years 2011 and 2012, the Authority issued 22 and two new bonds, respectively. In fiscal year 2010 the Authority had issued 20 new bonds.

The increased use of the Bond Program by non-profit entities during fiscal year 2011 occurred because of the American Recovery and Reinvestment Act of 2009, by which the federal government increased the allowable limit of "bank qualified" debt for issuers from $10 million to $30 million for non-profits seeking financing.

During fiscal year 2012, usage of the Bond Program by non-profit entities decreased due to the federal government reverting back to its more stringent rules surrounding bond financing and refinancing. The bond laws changed from fiscal year 2010 where the federal government allowed lower interest rates and better tax advantages for the stimulus funds. The increased IRS limits on "bank qualified" bonds expired on December 31, 2010 and the Authority expects a more normalized level of bond issuance for years to come due to the more stringent rules related to bond financing.

Direct Assistance Programs

The following revolving loan programs provide loans, generally up to $1 million in value, to bridge the gap between private debt financing and private equity. As borrowers repay the loan principal and interest, the Authority uses the proceeds to issue new loans. The remaining interest earned supports the Authority's ongoing operating expenses.

- The *Federal Economic Development Loan Fund Program* provides loans to new and expanding businesses or economic development authorities in qualified geographical areas that create or save jobs in Virginia, or provide economic and "quality of life" development within the community. Included within this program is the Virginia Defense Conversion Loan Fund Program, which provides loans to defense dependent Virginia businesses, which have suffered losses as a result of military downsizing, and are seeking to transition to private sector markets and diversify their operations. Since the program's inception, the program has issued 84 loans, averaging one new loan per year. During fiscal year 2011, there was one new loan issued, while there were none issued in 2012. The default rate for the program was 5.2 percent in fiscal year 2011 and 5.1 percent in fiscal year 2012, which is lower than the 5.4 percent in fiscal year 2010.

- The *State Direct Loan Program* provides loans to Virginia businesses as market needs dictate and without the geographical restrictions of the Economic Development Loan Fund Program. The original program started in 1988 and ceased making new loans in 2005. The program's existing assets went to fund a separate but similar Commonwealth initiative outside of the Authority's purview. In 2007, the Authority used internal resources to re-establish the program. Since the program's inception, the program has issued 86 loans, with two loans issued in fiscal year 2011 and one in fiscal year 2012. The default rate for the program remained constant at 14.3 percent between fiscal years 2011 and 2012.

In addition to the economic development oriented loan programs described above, the Authority also administers two smaller direct assistance programs on behalf of other state agencies, which provide loans to specific types of businesses for restricted purposes.

- The *Child Care Financing Program* provides assistance to licensed home based daycare providers and childcare centers through installment loans. The borrower can use the loans to either enhance the quality of care, or meet or maintain state or local childcare requirements, including health, safety, and fire codes. The Authority administers this revolving loan program on behalf of the Department of Social Services. Since the program's inception in 1994, the Authority has issued 304 loans, averaging $25,567 per loan in fiscal year 2011 and $26,184 per loan in fiscal year 2012. The program issued three new loans during fiscal year 2011 and 2 new loans during fiscal year 2012, which were less than the nine issuances in fiscal year 2010. The decrease in loan issuances is attributed to business owners, entrepreneurs, and bankers being more conservative in pursuing loans until the economy rebounds. The default rate for the program was 2.1 percent for fiscal year 2011 and 1.9 percent for fiscal year 2012, compared to 2.1 percent in fiscal year 2010.

- The *Small Business Environmental Compliance Assistance Fund (ECAF)* is a revolving loan program for small businesses that need equipment to comply with the Clean Air Act or for voluntary pollution prevention. The Authority administers this program on behalf of the Department of Environmental Quality (DEQ). Since the program's inception in 2000, the Authority has issued 42 loans, averaging $51,013 per loan. In fiscal year 2009, DEQ discontinued the Environment Compliance Assistance fund and currently the Authority's only responsibility is managing the remaining ECAF loans until they mature. The default rate for the program remained constant at 2.8 percent between fiscal years 2011 and 2012.

Direct Assistance Program Default Rates

Default rates for direct assistance programs remained constant between fiscal years 2011 and 2012. With the programs, the Authority performs the credit underwriting and approval of applicants for the direct assistance programs. For approved program participants, the Authority performs all loan closing, billing, accounting, reporting, and collection functions. The Authority works with both the bank and program participants to encourage timely payments. The Authority charges off loans when it can ascertain the amount of loss, or when a loan reaches a 120 day delinquency status and repayment appears highly unlikely. For non-bankruptcy cases, the Authority sends the loan to the Office of the Attorney General and to the Commonwealth's debt set-off program to facilitate collection.

Indirect Assistance Programs

The Authority's various indirect assistance programs provide guarantees and loan loss reserve insurance to banks to assist them in making loans to small businesses. These programs mitigate a bank's risk, which enables it to make more loans.

- The *Virginia Capital Access Program (VCAP)* encourages banks to lend to small businesses by providing a form of loan portfolio insurance through loan loss reserve accounts. Loan enrollment premiums fund the program and payments come from the bank, borrower, or both, with a premium match by the Authority. The reserve account then offsets default losses, as they occur. Since the program's inception, there have been 1,187 loans. The default rate for the program increased from 6.0 to 7.0 percent between fiscal years 2010 and 2011 and remained constant at 7.0 percent between fiscal years 2011 and 2012.

- The *Tobacco Capital Access Program (TCAP)* is very similar to the Virginia Capital Access Program, with the exception that it solely provides assistance to small businesses located within the Southside Tobacco Region. Since the program's inception, there have been 171 loans, averaging 19 new loans per year. During fiscal year 2011, the program issued 21 new loans, while there were 31 issued during fiscal year 2012. The Authority believes the increased activity reflects the Southside region banks becoming more comfortable and familiar with the program. The default rate in addition to the program's activity continued an increasing trend during the fiscal years. The default rate for the program decreased from 5.6 to 4.7 percent between fiscal years 2010 and 2011 and increased from 4.7 to 5.5 percent between fiscal years 2011 and 2012.

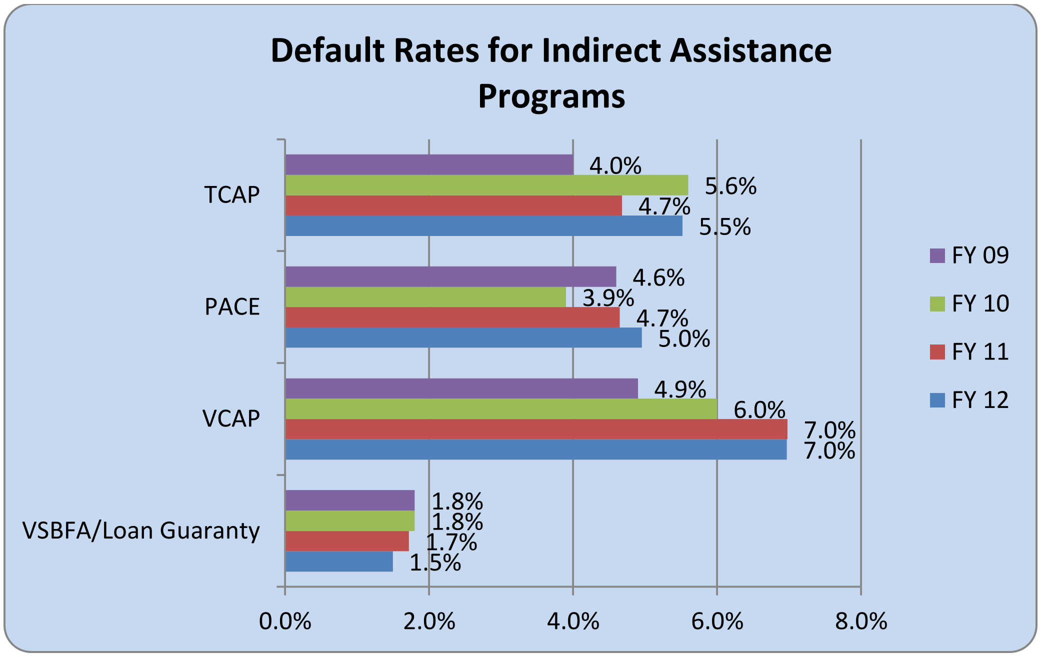
- The *Loan Guaranty Program* provides participating banks deficiency guarantees for loans made to Virginia businesses that do not qualify for conventional bank financing. Borrowers work with participating Virginia banks to apply for this assistance. The program encourages the banks to work with borrowers as they have some guarantee of recouping funds. Since the program's inception, there have been 229 loans. There were five new loans issued in fiscal year 2011 and 17 new loans issued in fiscal year 2012. The default rate for the program decreased from 1.8 to 1.7 percent between fiscal years 2010 and 2011 and decreased from 1.7 to 1.5 percent between fiscal years 2011 and 2012.

- The *Providing Access to Capital for Entrepreneurs (PACE) Program*, administered on behalf of the Department of Minority Business Enterprises by the Authority, provides credit enhancements to participating banks through either loan portfolio insurance or loan guarantees. Participants must meet certain eligibility criteria established by the Department of Minority Business Enterprises. Since the program's inception, there have been 56 loans, averaging five new loans per year. There were two new loans issued during fiscal year 2011 and three new loans issued during fiscal year 2012. The default rate for the program increased from 3.9 to 4.7 percent between fiscal years 2010 and 2011 and increased from 4.7 to 5.0 percent between fiscal years 2011 and 2012.

Indirect Assistance Program Default Rates

The Authority anticipated economic conditions to have an impact on default rates in the TCAP and VCAP programs since they facilitate access to financing for riskier borrowers. The Authority also anticipated increases in default rates for the PACE program due to increases in loans charged off books. During fiscal years 2011 and 2012, defaults in loans for the programs continued to grow, however the rate of growth was slower in comparison to fiscal year 2010 when defaults on loans increased substantially in size from fiscal year 2008. With both TCAP and VCAP, the Authority enters into participation agreements with certain banks who then determine the creditworthiness of the program participants. Participating banks are responsible for determining creditworthiness since they, not the Authority, underwrite the loans for approved participants.

Additionally, reserve accounts are set up with participating banks, which lessens the bank's loss in the event of a default. The following chart provides comparative information on default rates related to the Authority's indirect assistance programs for fiscal years 2009 through 2012.



FINANCIAL HIGHLIGHTS

Operating Activities

The Authority funds the majority of its operational expenses through the collection of program application fees and late payment penalties, as well as interest earned on the loans themselves and cash on hand. In addition, as mentioned previously, the Department of Business Assistance provides some financial support to the Authority that pays the Executive Director's salary as well as some of the Authority's operating expenses. The Authority received $154,196 annually during fiscal year 2011 and 2012 from Business Assistance.

To ensure the principal within each program is available to support the program's goals, most have limitations as to the amount and timing of when the Authority can use their revenues to offset operating expenses. For example, only 50 percent of the current revenues generated from the Federal Economic Development Loan Fund Program can support operating costs.

The schedule below presents the Authority's operating activities for fiscal years 2011 and 2012. Payroll costs make up the majority of the Authority's operating expenses. Program disbursements reflect transfers to banks in support of the loan loss reserve programs. The remaining income carries forward to cover future administrative costs or provide additional principal for the programs.

Operating Activities
For the fiscal years ending June 30, 2011 and June 30, 2012

	FY 2011	FY 2012
Revenues:		
Interest earned on loans	$ 580,394	$ 530,260
Fees and penalties	702,365	741,384
Interest income	126,303	137,923
Support from Department of Business Assistance	154,196	154,196
Other revenues	17,294	26,798
Total revenues	$1,580,552	$1,590,561

	FY 2011	FY 2012
Expenses:		
Personal services	$ 399,888	$ 632,768
Program disbursements	85,373	90,355
Expenses from Department of Business Assistance	154,196	154,196
Contractual services	50,222	54,961
Supplies and materials	-	2,299
Other miscellaneous expenses	28,681	1,480
Total expenses	$ 718,360	$ 936,059
Net income	$ 862,192	$ 645,502

Source: Virginia Small Business Financing Authority's Fund Accounting

Commonwealth of Virginia

Auditor of Public Accounts

Martha S. Mavredes, CPA
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

January 17, 2013

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable John M. O'Bannon, III
Chairman, Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the **Virginia Small Business Financing Authority (Authority)** for the years ended June 30, 2011 and June 30, 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide 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.

Audit Objectives

Our audit's primary objectives were to evaluate the accuracy of recorded financial transactions in the Commonwealth Accounting and Reporting System, review the adequacy of the Authority's internal controls, test compliance with applicable laws and regulations and review corrective actions of audit findings from prior year reports.

Audit Scope and Methodology

The Authority's management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered significance and risk in determining the nature and extent of our audit procedures. Our review focused primarily on the policies and procedures over the Authority's administration of their loan and loan guaranty fund programs. In addition, we reviewed certain controls over the Authority's information systems and financial reporting.

We performed audit tests to determine whether the Authority's controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of the Authority's operations. We tested transactions and performed analytical procedures, including budgetary and trend analyses.

Conclusions

We found that the Authority properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System. The Authority records its financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The financial information presented in this report came directly from the Commonwealth Accounting and Reporting System or other Authority financial records. Additionally, we found that the Authority has implemented controls to administer their loan and loan guaranty fund programs and properly administers these programs.

We noted no matters involving internal control and its operation that we consider necessary to be reported to management. The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Exit Conference and Report Distribution

We discussed this report with management on January 24, 2013.

This report is intended for the information and use of the Governor and General Assembly, management, and the citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

LJH/clj

VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

Scott Parsons, Executive Director