VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

RICHMOND, VIRGINIA

REPORT ON AUDIT

FOR THE YEAR ENDED

JUNE 30, 2001

Auditor of
Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the Virginia Small Business Financing Authority for the year ended June 30, 2001, found:

- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in the Authority's financial accounting records;

- no material weaknesses in internal control; and

- no instances of noncompliance that are required to be reported.

Commonwealth of Virginia

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Walter J. Kucharski, Auditor

March 8, 2002

The Honorable Mark R. Warner
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Vincent F. Callahan, Jr.
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT

We have audited the financial records and operations of the **Virginia Small Business Financing Authority** (Authority) for the year ended June 30, 2001. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

Audit Objective, Scope, and Methodology

Our audit's primary objectives were to evaluate the accuracy of recording financial transactions on the Commonwealth Accounting and Reporting System, review the adequacy of the Authority's internal control, and test compliance with applicable laws and regulations.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of the Authority's operations. We also tested transactions and performed such other auditing procedures as we considered necessary to achieve our objectives. We reviewed the overall internal accounting controls, including controls for administering compliance with applicable laws and regulations. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances:

Cash Receipts and Disbursements (including loan activity)
Loan Receivables

We obtained an understanding of the relevant internal control components sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. 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.

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.

Our audit was more limited than would be necessary to provide assurance on internal control or to provide an opinion on overall compliance with laws and regulations. Because of inherent limitations in internal control, errors, irregularities, or noncompliance may nevertheless occur and not be detected. Also, projecting the evaluation of internal control to future periods is subject to the risk that the controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

Audit 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.

We noted no matters involving internal control and its operation that we consider to be material weaknesses. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to financial operations may occur and not be detected promptly by employees in the normal course of performing their duties.

The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

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.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on April 11, 2002.

AUDITOR OF PUBLIC ACCOUNTS

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AGENCY HIGHLIGHTS

The Virginia Small Business Financing Authority (Authority) provides financial assistance to small businesses in the Commonwealth by providing loans, guaranties, insurance, and other assistance, thereby encouraging the investment of private capital in small business. In addition, the Authority issues tax-exempt industrial development bonds for businesses. In order to be eligible for assistance, the business must meet one of the following criteria:

- Have fewer than 250 employees.
- Have $10,000,000 or less in annual gross revenue over each of the last three years.
- Have a net worth of $2,000,000 or less.

The business must submit a completed application to the Authority. The Authority's Board then approves or disapproves assistance based upon established criteria. The Board may grant exceptions to the criteria based upon the specific circumstances of a business requesting assistance.

The Authority's operating revenues and expenses during fiscal year 2001 are summarized below.

	June 30, 2001
Operating Revenues:	
Interest income	$346,308
Loan enrollment premiums	187,352
Loan application & guaranty fees	24,104
Bond fees	76,000
Total	$633,764
Operating Expenses:	
Personal services	$389,594
Loan loss reserve payments	77,929
Contractual services	19,854
Miscellaneous	28,757
Total	$516,134

The Authority invests excess cash of the Loan Guaranty and Child Day Care Financing Programs and its operating cash in the Local Government Investment Pool (LGIP). The Authority has deposited excess cash of its remaining programs with the Treasurer of Virginia.

The Director of the Department of Business Assistance appoints the Authority's Executive Director. Further, the Department provides office space and pays certain administrative expenses, including the Executive Director's salary. Below is a summary of the Authority's major assistance programs.

Revolving Loan Program

The Authority operates a Revolving Loan Program, which markets two types of loans providing up to the lesser of $1,000,000 or 40 percent of the project cost. The Virginia Economic Development Revolving Loan Fund provides loans to small companies to bridge the gap between private debt financing and private equity for projects that will result in job creation or retention. The Virginia Defense Conversion Revolving

Loan Fund provides loans to defense-dependent companies seeking to diversify and expand into commercial markets. The Authority received state and federal funds to establish the Revolving Loan Program. At June 30, 2001, the Revolving Loan Program had loans outstanding totaling $7,021,799 and cash and investments balances of $21,621,644, which is comprised of $14,199,911 in federal funds and $7,421,733 in state funds.

In December 1998, the Authority sold 50 outstanding loans totaling $12,102,052 from the Revolving Loan Program. The Authority is using the proceeds from the sale to make new loans. The Authority's cash balances remain relatively high due to the good economy in recent years and the eligibility requirements that small businesses must meet in order to qualify for a loan. As a result of the recent economic downturn, the Authority is developing an aggressive marketing campaign to economic developers. In addition, the Authority plans to increase the usage of the Revolving Loan Program by adding a loan guaranty component, increasing the amount of funds available per job created, and expanding loan eligibility to include technology and tourism businesses.

At year-end, the Authority had 19 loans outstanding as part of the Revolving Loan Program, of which eight were delinquent. Delinquent loans were not included in the portfolio sale in December 1998 since the Authority would have had to significantly discount the loans. As a result, many of the loans in its portfolio are delinquent. During the year the Authority wrote off $1,080,408 in delinquent loans for the program. The Authority works with a law firm, assigned by the Attorney General's office, to pursue collection of delinquent loans. During fiscal year 2001, the Authority entered into seven new loans totaling $3,597,928.

Loan Guaranty Program

The Authority guaranties loans made to small businesses by banks. The Authority provides guaranties up to the lesser of $300,000 or 75 percent of a bank loan for lines of credit and short-term working capital loans. The Authority charges an annual guaranty fee of 1.5 percent of the guarantied portion of the loan. At June 30, 2001, the Authority had outstanding loan guaranties totaling $1,262,263. The Authority maintains a loan reserve of eight percent of the outstanding loan guaranty balance. The loan loss reserve was $100,981 at fiscal year end. If a loan goes into default, the Authority uses funds in the loan loss reserve to cover the guaranty. Lending banks pursue collection of loans in default. The Authority receives a portion of any recovered funds as reimbursement on the loan guaranty paid to the bank. Through the program, the Authority has guarantied $11,068,505 in loans. Historically, the loan default rate has been 3.8 percent and defaults since inception in 1987 have amounted to $422,747.

Child Day Care Financing Program

The Authority provides direct loans up to $50,000 to child day care providers for quality enhancement projects and to meet or maintain childcare standards. The Authority received funding for the program from the Department of Social Services as a pass-through from the federal Child Care and Development Block Grant. The Authority takes applications, approves and makes direct loans, develops and implements marketing programs, and provides oversight and supervision to the loan officer of the program. At June 30, 2001, the Authority had 144 loans outstanding totaling $1,238,281. During the year the Authority wrote off $25,874 of delinquent loans. The Authority works with the Attorney General's office to pursue collection of any defaulted loans. The Authority receives reimbursement for program administrative expenses.

Virginia Capital Access Program

The Authority provides a form of loan portfolio insurance for participating banks through special loan loss reserve accounts. The loan enrollment premiums paid by the bank or borrower and matched by the Authority fund this program. The lender bank and/or borrower contribute between three and seven percent of the loan amount into the loan-loss reserve account. The Authority matches at least the amount contributed by the borrower and bank. The maximum amount that the Authority will match is 14 percent of the enrolled loan amount. The monies in these loan loss reserve accounts cover losses on loans enrolled by the participating bank. The participating bank determines what loans to enroll in the program without the Authority's involvement. The Authority initially launched the program using $74,717 from its operating account and has since received General Fund appropriations. The total balance of the loan loss reserve accounts at participating banks at June 30, 2001, was $748,381, which is a $434,036 increase from the prior year. The increase is the result of additional banks participating in the program and a change in the match provided by the Authority.

Environmental Compliance Assistance Fund

The Authority provides direct loans up to $100,000 to small businesses that are proactively replacing equipment that is more beneficial to the environment. The Authority received funding for the program from the Department of Environmental Quality. The Authority takes applications, approves and makes direct loans, and markets the loan program. The Authority receives reimbursement from the fund for administrative expenses. At June 30, 2001, the Authority had eight loans outstanding totaling $307,957. During fiscal year 2001, the Authority had no write offs of delinquent loans.

Industrial Development Bond Program

The Authority issues tax-exempt revenue bonds to provide creditworthy businesses with access to long-term, fixed asset financing at favorable interest rates for new and expanding manufacturing facilities and exempt projects, such as solid waste disposal facilities. As a conduit issuer, the Authority tracks what businesses need financing and determines the economic benefit on a statewide level. Neither the Authority nor the Commonwealth guarantee payment and, as described in Section 9-221 of the Code of Virginia, no bonds issued by the Authority constitute a debt, liability, or general obligation of the Commonwealth. Participating businesses are responsible for making principal payments. The Authority charges an annual administrative fee of $1/8^{th}$ of 1 percent of the outstanding principal amount of the bonds it has issued, payable on each anniversary date of the closing of the bond issue.