VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

REPORT ON AUDIT FOR THE YEAR ENDED JUNE 30, 2009

APA
Auditor of Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the Virginia Small Business Financing Authority (the Authority) for the year ended June 30, 2009 found:

- proper recording and reporting of financial information, in all material respects, in the Commonwealth Accounting and Reporting System;
- no matters involving internal controls and its operations necessary to bring to management's attention; and
- an instance of noncompliance with applicable laws and regulations or other matters that is required to be reported.

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AUDIT FINDINGS AND RECOMMENDATIONS

Strengthen Credit and Loan Servicing Guidelines

The Virginia Small Business Financing Authority's (Authority) Credit and Loan Servicing Guidelines do not include procedures for recording an allowance for uncollectible loan receivables. During the fiscal year the Authority had a client with delinquent account activity over ninety days past due; however, the Authority's year-end financial statements and the Department of Accounts receivable's submission did not include an allowance for the uncollectible amount. In this case, although the Authority had collateral on the loan, financial records should not have shown the total balance as a receivable.

According to the Commonwealth's Accounting Policies and Procedures, management should establish an allowance for doubtful accounts to reflect an estimate of the amount of receivables which may prove to be uncollectible. An allowance for doubtful accounts provides the reader of the financial statements with information that the Authority is experiencing difficulty collecting certain accounts.

We recommend that the Authority strengthen their Credit and Loan Servicing Guidelines to include procedures on how to properly record delinquent account activity on the financial statements. The procedures should reflect a conservative approach to ensure that the Authority's program assets are not overstated.

At the conclusion of the 2009 audit, we determined that the Authority has updated their Credit and Loan Servicing Guidelines, which were approved by the Authority's Board of Directors at the June 2010 meeting.

AUTHORITY BACKGROUND

The 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 eleven members of the Authority's 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.

Various fees and interest earnings cover the majority of the Authority's administrative expenses. Business Assistance provides space for the Authority's staff and pays certain administrative expenses, to the extent that Business Assistance has the resources available to assume these costs; however, they do not have a requirement to cover these costs.

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 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 or 501(c) 3 organizations, while the indirect assistance programs provide support to Virginia businesses through loan guarantee and loan insurance programs. The goal of these programs is to encourage economic development through either job creation or retention by small businesses.

The current economic condition has impacted lending within the programs. Over the past fiscal year, there has been a general decline in new loans for the direct and indirect assistance programs, with the exception of the Providing Access to Capital Entrepreneur (PACE) and the Tobacco Capital Access (TCAP) Programs. The increased activity within the PACE and TCAP Programs reflects an increased participation by banking institutions. The Authority does not expect overall lending activity to increase until the economy improves.

More information about the various programs administered by the Authority since each program's inception is detailed below.

Bond Programs

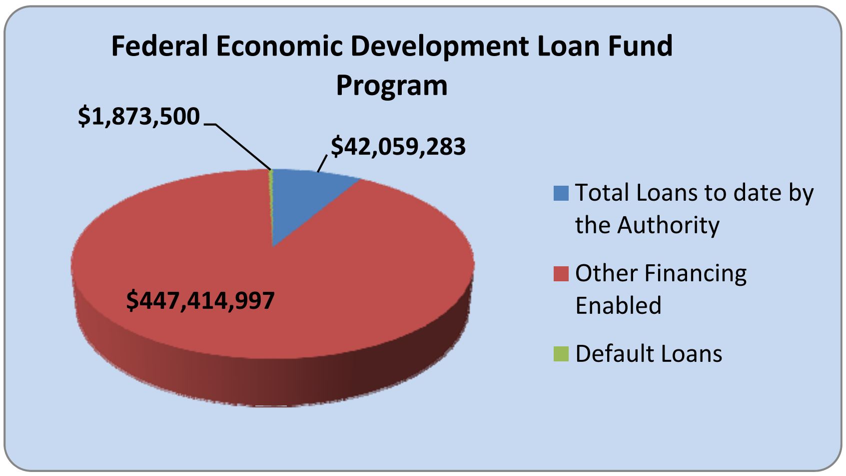
The ***Industrial Development Bond Program*** is a financing vehicle in which the Authority serves as a conduit issuer of tax-exempt and taxable industrial development bonds for qualifying businesses and 501(c) 3 entities. The nature of the entity and consideration of the Commonwealth's available allocation 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 has responsibility for debt service. As such, the Authority takes on no risk as a result of this program.

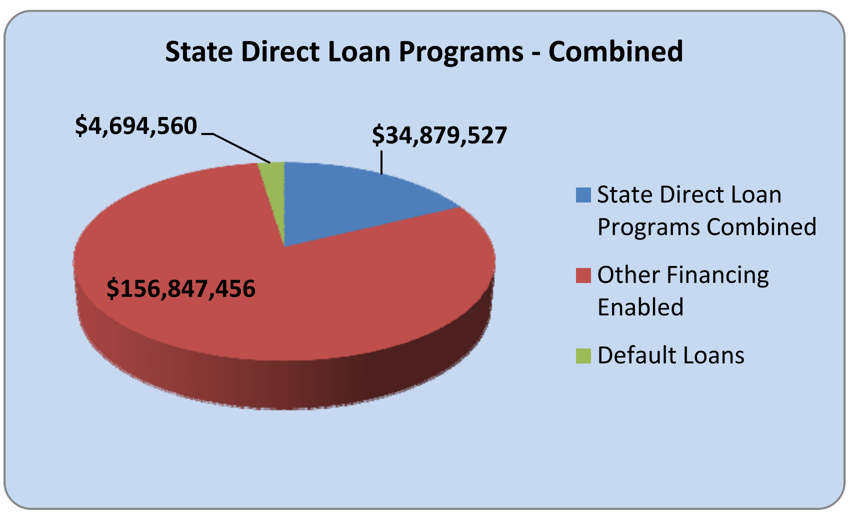
Since the program's inception, the Authority has facilitated the issuance of 109 bonds, averaging five bond issuances per year. At June 30, 2009, there were 39 bond issuances outstanding. The Authority collects application and administration fees associated with the bond issuances. These funds support the ongoing operating expenses of the Authority and may also provide additional funding to other programs administered by the Authority.

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 ongoing operating expenses of the Authority.



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 82 loans, averaging four new loans per year. However, during fiscal year 2009 there were no new loans issued. The default rate for the program was 4.5 percent in fiscal year 2009 compared to 4.6 percent in fiscal year 2008.



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, and 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 83 loans, with one new loan issuance occurring during fiscal year 2009. The default rate for the program remained constant at 14.3 percent between fiscal years 2008 and 2009.

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, there have been 290 loans issued, averaging $22,425 per loan; and during fiscal year 2009, the program issued four new loans. The default rate for the program was 2.5 percent for fiscal year 2009 compared to 2.7 percent in fiscal year 2008.

- The *Small Business Environmental Compliance Assistance Fund* 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 issued 42 loans, averaging $51,013 per loan.

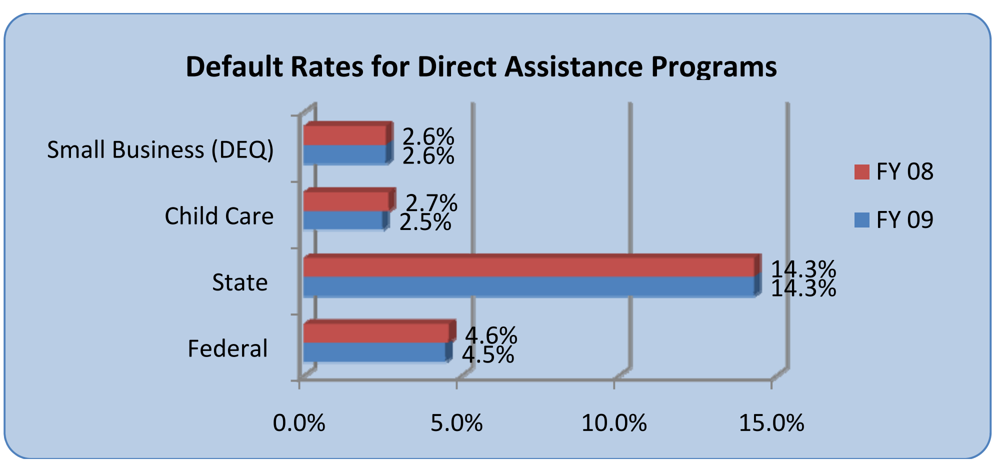
  In fiscal year 2009, DEQ discontinued the Environment Compliance Assistance fund. Prior to the discontinuance of the fund, one new loan was enrolled in the program. Beginning in fiscal year 2010, the Authority will manage the remaining loans until paid off. The default rate for the program remained constant at 2.6 percent between fiscal years 2008 and 2009.

Like the other revolving loan programs, existing loan and interest payments provide funding for new loans. Further, a portion of the interest earnings support the ongoing operating expenses of the Authority.

Direct Assistance Program Default Rates

Default rates for direct assistance programs remained constant between fiscal years 2008 and 2009. With the programs, the credit underwriting and approval of applicants is performed by the Authority. 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.

The following chart provides comparative information on default rates related to the Authority's direct assistance programs for fiscal years 2008 and 2009.



Indirect Assistance Programs

The Authority's various indirect assistance programs provide access to capital by encouraging banks to make loans that they would otherwise not make to an individual borrower with a riskier profile. These programs provide loan insurance or loan guarantees to the banks as described further below.

- 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, should they occur. Since the program's inception, there have been 1,085 loans, averaging 92 new loans per year. During fiscal year 2009, there were 59 new loans. The default rate for the program doubled between fiscal years 2008 and 2009. Further information regarding the increased default rate is discussed below.

- 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 97 loans, averaging 16 new loans per year. During fiscal year 2009, the program issued 31 new loans. The Authority believes the increased activity reflects the Southside region banks becoming more comfortable and familiar with the program. Though activity in the program increased, the default rate doubled between fiscal years 2008 and 2009. Further information regarding the increased default rate is discussed below.

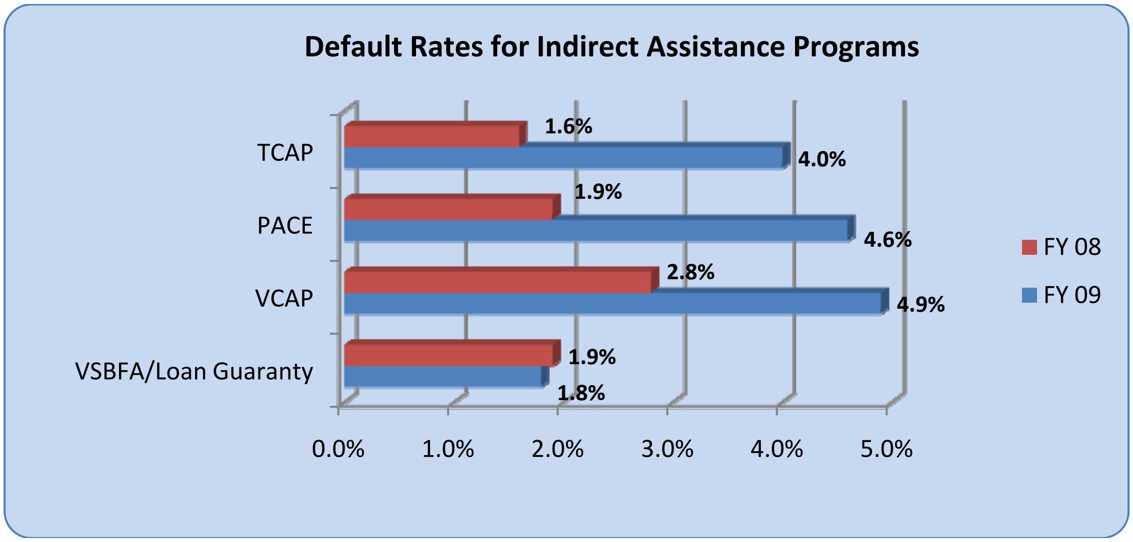
- The *Loan Guaranty Program* provides participating banks deficiency guarantees for loans made to Virginia businesses that do not qualify for conventional bank financing. Borrowers work with participating Virginia banks to apply for this assistance. The program as designed encourages the banks to work with borrowers as they have some guaranty of recouping funds. Since the program's inception, there have been 206 loans, averaging six new loans per year, with five new loans issued during fiscal year 2009. The default rate for the program was 1.8 percent in fiscal year 2009 compared to 1.9 percent in fiscal year 2008.

- 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 43 loans, averaging five new loans per year, with seven new loans issued during fiscal year 2009. The default rate for the program was 4.6 percent in fiscal year 2009 compared to 1.9 percent in fiscal year 2008.

Indirect Assistance Program Default Rates

The Authority anticipated that current economic conditions would affect the default rates in the TCAP and VCAP programs since they facilitate access to financing for riskier borrowers. Between fiscal years 2008 and 2009, defaults in loans for the programs doubled in size. 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 2008 and 2009.



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. During fiscal year 2009, the Authority received $171,034 from Business Assistance. On average, this support has totaled $192,242 per year.

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 on the following page presents the Authority's operating activities for fiscal year 2009. 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 year ending June 30, 2009

Revenues:	
Interest earned on loans	$ 580,745
Fees and penalties	309,633
Interest earned on cash and investments	261,478
Support from Department of Business Assistance	171,034
Other revenues	77,250
Income from Security Lending Transactions	40,381
Total revenues	$1,440,521
Expenses:	
Personal services	384,141
Program disbursements	238,559
Expenses from Department of Business Assistance	171,034
Expenses from Security Lending Transactions	27,042
Contractual services	17,951
Other expenses	41,385
Total expenses	880,112
Net income	$ 560,409

Source: Virginia Small Business Financing Authority's Fund Accounting

Commonwealth of Virginia

Walter J. Kucharski, Auditor

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

June 30, 2010

The Honorable Robert F. McDonnell
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

We have audited the financial records and operations of the Virginia Small Business Financing Authority (Authority) for the period July 1, 2008 through June 30, 2009. 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 information in the Commonwealth Accounting and Reporting System, review the adequacy of internal controls over the administration and processing of programs administered by the Authority, and test compliance with applicable laws and regulations.

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 materiality and control risk in determining the nature and extent of our audit procedures. We 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 gaining an understanding of processes and controls by reviewing current policies and procedures, making inquiries of management, accounting staff, and other appropriate staff; examining program utilization and administration documentation, and selecting and testing various transactions, including trend analysis.

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 and other Authority financial records. Overall, we found that the Authority has implemented controls to administer their loan and loan guaranty fund programs, properly administers these programs; and the revenues and expenses for the Authority's operating activities as reported by the Authority are materially correct.

We noted no matters involving internal control and its operation that we consider necessary to be reported to management. We noted a matter involving non-compliance with applicable laws and regulations that requires management's attention and corrective action. This matter is described in the section entitled "Audit Findings and Recommendations." The Authority has taken adequate corrective action with respect to the audit finding reported in this letter.

Exit Conference and Report Distribution

We discussed this report with management on June 30, 2010. Management's response has been included at the end of this report.

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

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June 30, 2010

Mr. Walter J. Kucharski
Auditor of Public Accounts
Commonwealth of Virginia
The James Monroe Building
101 North 14th Street, 8th Floor
Richmond, Virginia 23219

Dear Mr. Kucharski:

I have reviewed your audit finding and recommendation regarding the need for the Virginia Small Business Financing Authority (VSBFA) to include procedures in its Credit and Loan Servicing Guidelines for recording an allowance for uncollectible loan receivables. As you are aware, the VSBFA already makes allowances for potentially bad debt in its indirect loan programs (Loan Guaranty Program, Virginia Capital Access Program, Tobacco Capital Access Program, and P.A.C.E. Programs). We do agree, however, that it is appropriate to amend our procedures to include such an allowance for our direct loan programs (Economic Development Loan Fund, State Direct Loan Program, Child Care Financing Program, and Environmental Compliance Assistance Fund) in our Credit Guidelines and to recognize that allowance in our financial statements. In fact, the staff has already made this recommendation to our Board of Directors at our June 2010 meeting and its was unanimously approved.

Sincerely,

Scott E. Parsons

Scott E. Parsons
Executive Director
Virginia Small Business Financing Authority
Phone: 804-371-8256
E-Mail: scott.parsons@vdba.virginia.gov

Cc: Peter S. Su
Director, Department of Business Assistance

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VIRGINIA DEPARTMENT OF BUSINESS ASSISTANCE
Connecting Businesses with Resources

VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

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