



Audit Report



Report Number: OIG-SBLF-13-011

STATE SMALL BUSINESS CREDIT INITIATIVE: Washington's Use of Federal Funds for Capital Access and Other Credit Support Programs

August 15, 2013

Office of
Inspector General

Department of the Treasury

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Contents

Results In Brief	2
Background	3
Washington’s Participation in SSBCI	4
Washington Enterprise Cascadia Loan Participation Program	4
W Fund Venture Capital Program.....	5
Washington Complied With All SSBCI Loan and Investment Requirements and Restrictions	5
Washington’s Administrative Costs Were Overstated by \$5,779	6
Recommendations.....	7
Management Comments and OIG Response	7
Appendix 1: Objective, Scope, and Methodology	9
Appendix 2: Management Response.....	11
Appendix 3: Major Contributors	13
Appendix 4: Distribution List	14

Abbreviations

CDFI	Community Development Financial Institutions
OIG	Office of Inspector General
OMB	Office of Management and Budget
SSBCI	State Small Business Credit Initiative
The Act	Small Business Jobs Act of 2010

*The Department of the Treasury
Office of Inspector General*

August 15, 2013

Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Housing, and
Community Development

This report presents the results of our audit of the state of Washington's use of funds awarded under the State Small Business Credit Initiative (SSBCI), which was established by the Small Business Jobs Act of 2010 (the Act). Treasury awarded Washington approximately \$19.7 million¹ in SSBCI funding, and as of June 30, 2012, the State received its first allocation of approximately \$6.5 million.² As of June 30, 2012, Washington had expended or obligated approximately \$7.1 million,³ of which approximately \$5.3 million⁴ was for the Enterprise Cascadia Loan Participation Program, approximately \$1.7 million⁵ was for the W Fund Venture Capital Program, and \$92,291 comprised administrative expenses.

The Act requires the U.S. Treasury Office of Inspector General (OIG) to conduct audits of the use of funds made available under SSBCI and to identify any instances of reckless or intentional misuse. Treasury has defined reckless misuse as a use of allocated funds that the participating state or administering entity should have known was unauthorized or prohibited, which is a highly unreasonable departure or willful disregard from the standards of ordinary care, and may be a single instance or a series of instances. Intentional misuse is defined as

¹ Rounded down from \$19,722,515.

² Rounded down from \$6,508,431.

³ Rounded up from \$7,067,093. This number is in excess of the State's first allocation, as Treasury permits states to obligate funds in excess of individual allocations.

⁴ Rounded down from \$5,330,581

⁵ Rounded up from \$1,650,000

a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited.

We contracted with Crowe Horwath LLP, an independent certified public accounting firm, to conduct the audit, which was performed from December 2012 to July 2013. The audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds.

To test participant compliance, the accounting firm reviewed all \$7.1 million enrolled in Washington's Enterprise Cascadia Fund and advanced to the W Fund between the signing of the Allocation Agreement on October 31, 2011, and June 30, 2012. The accounting firm also reviewed the administrative expenses charged against SSBCI funds to ensure they were allowable, reasonable, and allocable, in accordance with the Office of Management and Budget (OMB) Circular A-87 and *SSBCI Policy Guidelines*.

We conducted quality assurance procedures to ensure that the work performed by Crowe Horwath LLP was completed in accordance with *Government Auditing Standards*. We believe that the evidence obtained to address the audit objective provides a reasonable basis for the audit findings and conclusions. Appendix 1 contains a more detailed description of our objective, scope, and methodology.

Results In Brief

We determined that all \$7 million in loans and investments enrolled in the Washington Enterprise Cascadia Fund and the W Fund as of June 30, 2012, complied with SSBCI program requirements and restrictions, and that borrower and lender assurances were complete and timely. However, the \$92,291 in administrative expenses the State reported to Treasury was overstated by \$5,779 as a result of an accounting change that was not reflected in the State's *SSBCI Quarterly Report*.

We recommend that Treasury authorize an adjustment to Washington's SSBCI Quarterly Report to remove the \$5,779 in administrative costs originally charged to SSBCI funds, but subsequently transferred to an alternative funding source.

Treasury officials accepted the report's recommendation regarding adjusting Washington's administrative costs and said it will work with the State to accomplish the adjustment. Washington officials also agreed with all of the report statements. Formal written responses from Treasury and the state of Washington are included in their entirety in Appendix 2.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funding to strengthen Capital Access Programs and other credit support programs that provide financial assistance to small businesses and manufacturers. Capital Access Programs provide portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. Other credit support programs include collateral support, loan participation, loan guarantee, credit support, and venture capital programs.

Each participating state is required to designate specific departments, agencies, or political subdivisions to implement the funding. The designated state entity distributes SSBCI funds to various public and private institutions, which may include a subdivision of another state, a for-profit entity supervised by the state, or a non-profit entity supervised by the state. These entities use funds to make loans or provide credit access to small businesses.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. To ensure that funds are properly controlled and expended, the Act requires that Treasury execute an Allocation Agreement with participants setting forth internal controls and compliance and reporting requirements before allocating SSBCI funds.

SSBCI disbursements to participating states are made in three allocations: the first when the Secretary approves the state for participation, and the second and third after the participating state certifies that it has obligated, transferred, or spent at least 80 percent of the previous allocation. In addition, the participating state is required to certify that it has complied with all applicable program requirements.

Washington's Participation in SSBCI

On October 17, 2011, Treasury approved the state of Washington's application for the SSBCI program and awarded it approximately \$19.7 million. That same month, Treasury disbursed the State's first allocation of funds, totaling approximately \$6.5 million. As of June 30, 2012, the state of Washington had expended, transferred, or obligated approximately \$7.1 million, of which \$92,291 was used for administrative costs.

The Allocation Agreement between Washington and Treasury was signed on October 31, 2011, which designated the Washington Department of Commerce as the entity to implement the State's programs. The Allocation Agreement authorized use of the SSBCI funds for three programs: (1) the Washington Capital Access Program, (2) the Enterprise Cascadia Loan Participation Program, and (3) the W Fund Venture Capital Program. As of June 30, 2012, no funds had been used by the Washington Capital Access Program. The Enterprise Cascadia Loan Participation Program had expended or obligated approximately \$5.3 million, and the W Fund Venture Capital Program had expended or obligated approximately \$1.7 million.

Washington Enterprise Cascadia Loan Participation Program

The Washington Enterprise Cascadia Loan Participation Program uses SSBCI funds to provide access to capital for small businesses, with over 70 percent of its historical lending having occurred in communities designated by Treasury's Community Development Financial Institutions (CDFI) Program as distressed. Under the program, capital is extended as companion loans and delivered as: General Direct Loans, Indian Country Direct Loans, and Open Loan Participation Agreements. As of

June 30, 2012, the State had expended or obligated \$5,330,581 in SSBCI funds for 8 loan participation transactions.

W Fund Venture Capital Program

The W Fund Venture Capital Program was created to advance funds to technology-based startups that do not typically qualify for conventional business loans because of their long development cycles that affect their ability to demonstrate a means to sustain the debt burden of a conventional loan. The Venture Capital Program targets investments in life sciences, biotech, energy, and information technology/software companies in the state of Washington. As of June 30, 2012, the State had expended or obligated \$1,650,000 in SSBCI funds for W Fund investments.

Washington Complied With All SSBCI Loan and Investment Requirements and Restrictions

All \$7 million in loans and investments enrolled in the Washington Enterprise Cascadia Fund and the W Fund as of June 30, 2012, totaling approximately \$7 million, complied with the business purpose, capital-at-risk, and other requirements and restrictions established by the Act and *SSBCI Policy Guidelines*.

According to *SSBCI Policy Guidelines*, loan proceeds must be used for a "business purpose." A business purpose includes, but is not limited to, startup costs, working capital, business procurement, franchise fees, equipment, inventory, as well as the purchase, construction renovation or tenant improvements of an eligible place of business that is not for passive real estate investment purposes. The definition of business purpose excludes activities that relate to acquiring or holding passive investments such as commercial real estate ownership, the purchase of securities, and lobbying activities. *SSBCI Policy Guidelines* also require participating lenders to have a meaningful amount of their own capital at risk. This requirement was fulfilled for the loans reviewed as lenders had guaranteed over 20 percent of the loan principal in each of the loans tested.

Washington also collected complete borrower assurances in a timely manner for all loans reviewed. *SSBCI Policy Guidelines* require that lenders obtain borrower assurances that (1) loan proceeds will be used for approved business purposes, (2) loan proceeds will not be used for specifically prohibited purposes, (3) the borrower and lender are not related parties, (4) the borrower is not engaged in specifically prohibited activities, and (5) the principals of the borrower have not been convicted of a sex offense against a minor.

Finally, Washington collected complete lender assurances in a timely manner. *SSBCI Policy Guidelines* require that each state must obtain an assurance from the lender affirming that (1) the loan is not for prior debt that is not covered under the approved state program or that was owed to the lender or an affiliate of the lender, (2) the loan is not a refinancing of a loan previously made to the borrower by the lender or an affiliate of the lender, and (3) no principal of the lender has been convicted of a sex offense against a minor. For each transaction, assurances must be completed and executed prior to the transfer of funds.

Washington's Administrative Costs Were Overstated by \$5,779

Washington overstated by \$5,779 its administrative costs in its June 30, 2012, *SSBCI Quarterly Report* to Treasury. Of the \$92,291 in costs reported, \$5,779 comprised payroll costs for administration of the SSBCI program that were incurred during the reporting period, but subsequently transferred to an alternate funding source.

Each state is required to submit a *SSBCI Quarterly Report* to Treasury within 30 days after the end of each quarterly reporting period. This report details the state's use of SSBCI funds, including funds used for direct and indirect administrative costs. Accurate reporting by states is imperative to ensure that Treasury can effectively monitor each state, and Congress has accurate data with which it can evaluate the overall effectiveness of SSBCI in improving credit access for small businesses.

According to Washington officials, after having submitted the June 30, 2012, *SSBCI Quarterly Report* to Treasury, they identified an alternative source of funding to pay the personnel costs of an individual who worked on the SSBCI program. With this funding available, and in order to keep SSBCI administrative costs down, officials transferred the \$5,779 in costs from the SSBCI account to the alternative source. However, this transfer was not reflected in the *SSBCI Quarterly Report*, resulting in a variance that was identified during the audit. Upon identification of the variance, Washington officials notified Treasury of a need to adjust their *SSBCI Quarterly Report* to reflect the cost transfer. Treasury advised Washington that it would authorize the adjustment upon completion of the OIG's audit.

Under Section 6.1 of the *SSBCI Allocation Agreement*, inaccurate reporting can trigger a general event of default of the State's *Allocation Agreement* with Treasury. However, because the overstatement was immaterial and the State requested that its report be adjusted, we are not recommending that Treasury consider whether a general event of default under the *SSBCI Allocation Agreement* has occurred.

Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Housing and Community Development:

- 1) Authorize an adjustment to Washington's *SSBCI Quarterly Report* to remove the \$5,779 in administrative costs originally charged to SSBCI funds, but subsequently transferred to an alternative funding source.

Management Comments and OIG Response

We provided a draft of this report to Treasury officials on July 25, 2013, and received formal written comments on August 9, 2013, in which Treasury accepted the report's recommendation. Management stated it was pleased that Washington complied with all SSBCI program requirements. Management also accepted the

recommendation to adjust Washington's administrative costs, and stated it will work with the State to accomplish the adjustment. Washington state officials agreed with all of the statements made in the report.

We believe that Treasury's planned action is fully responsive to the recommendation. Formal written responses from Treasury and the state of Washington are included in their entirety in Appendix 2.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the evaluation. If you wish to discuss the report, you may contact me at (202) 622-1090, or Lisa DeAngelis, Audit Director, at (202) 927-5621.

/s/

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight

Appendix 1: Objective, Scope, and Methodology

We contracted with Crowe Horwath LLP, an independent certified public accounting firm, to conduct the audit, which was performed from December 2012 to July 2013. The audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds.

To determine participant compliance, the accounting firm reviewed all \$7 million⁶ enrolled in Washington's Enterprise Cascadia Fund and advanced to the W Fund that was awarded between the signing of the Allocation Agreement on October 31, 2011, and June 30, 2012. The firm reviewed loan documentation for the loans to determine whether Washington complied with program requirements for use of proceeds, capital-at-risk, borrower and lender assurances, and other requirements and restrictions noted in the Act and *SSBCI Policy Guidelines*.

The accounting firm also reviewed the Washington Department of Commerce's accounting procedures and *SSBCI Quarterly Reports* for completeness and accuracy, and interviewed Washington officials who administer, account for, and report on SSBCI funding. The firm visited the Washington Department of Commerce offices in Olympia and Seattle, WA to interview its accounting and finance staff that are responsible for preparing and submitting the *SSBCI Quarterly Reports* to Treasury. Finally, the accounting firm reviewed the administrative expenses charged against the SSBCI funds to ensure they were allowable, reasonable, allocable, and adequately supported in accordance with OMB Circular A-87 and *SSBCI Policy Guidelines*.

We conducted quality assurance procedures to ensure that the work performed by Crowe Horwath LLP was completed in accordance with *Government Auditing Standards*. Those standards require that the audit be planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained to address the

⁶ Rounded up from \$6,980,581.

audit objective provides a reasonable basis for the audit findings and conclusions.

Appendix 2: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

August 9, 2013

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report entitled *Washington's Use of Federal Funds for Capital Access and Other Credit Support Programs* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

We are pleased with the Report's finding that Washington complied with all State Small Business Credit Initiative (SSBCI) program requirements. In addition, we accept the recommendation regarding adjusting Washington's administrative costs and will work with the State to accomplish the adjustment.

Enclosed, please find a letter from the Washington SSBCI program concurring with the Report's findings. Thank you once again for the opportunity to review the Report. Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,

A handwritten signature in black ink, appearing to read "Don Graves, Jr.", written in a cursive style.

Don Graves, Jr.
Deputy Assistant Secretary for Small Business,
Community Development, and Affordable Housing
Policy

Enclosure



STATE OF WASHINGTON
DEPARTMENT OF COMMERCE

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www.commerce.wa.gov

August 1, 2013

Mr. Don Graves, Jr.
Deputy Assistant Secretary
Small Business, Community Development, and Housing Policy

Dear Mr. Graves:

The Washington State Department of Commerce is responsible for managing the State Small Business Credit Initiative program the United States Treasury approved us for on October 31, 2011. We acknowledge receiving and reading the draft audit ref.OIG-SBLF-13-00X dated July 2013. We are in agreement with all statements made in the audit and acknowledge that no findings were identified.

We are very happy with the program performance and look forward to disbursement of the third tranche we were awarded.

Sincerely,

A handwritten signature in blue ink that reads "Daniel Malarkey".

Daniel Malarkey
Deputy Director

Appendix 3: Major Contributors

Debra Ritt, Special Deputy Inspector General

Lisa DeAngelis, Audit Director

John Rizek, Audit Manager

Andrew Morgan, Auditor-In-Charge

Safal Bhattarai, Auditor

Joe Berman, Referencer

Appendix 4: Distribution List

Department of the Treasury

Deputy Secretary
Office of Strategic Planning and Performance Management
Risk and Control Group

Office of Management and Budget

OIG Budget Examiner

United States Senate

Chairman and Ranking Member
Committee on Small Business and Entrepreneurship

Chairman and Ranking Member
Committee on Finance

Chairman and Ranking Member
Committee on Banking, Housing and Urban Affairs

Chairman and Ranking Member
Committee on Homeland Security and Governmental Affairs

Chairman and Ranking Member
Appropriations Subcommittee on Financial Services and General
Government

United States House of Representatives

Chairman and Ranking Member
Committee on Small Business

Chairman and Ranking Member
Committee on Financial Services

Chairman and Ranking Member
Committee on Oversight and Government Reform

Chairman and Ranking Member
Appropriations Subcommittee on Financial Services and General
Government

Government Accountability Office
Comptroller General of the United States