



Audit Report



Report Number: OIG-SBLF-13-005

STATE SMALL BUSINESS CREDIT INITIATIVE: New Jersey's
Use of Federal Funds for Other Credit Support Programs

February 27, 2013

Office of Inspector General

Department of the Treasury

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Abbreviations

The Act	Small Business Jobs Act of 2010
CDFI	Community Development Financial Institution
NJEDA	New Jersey Economic Development Authority
OIG	Office of Inspector General
SSBCI	State Small Business Credit Initiative

*The Department of the Treasury
Office of Inspector General*

February 27, 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 New Jersey'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). New Jersey was awarded approximately \$33.8 million in SSBCI funding, and in September 2011, received its first disbursement of approximately \$11.1 million of the awarded funds. As of June 30, 2012, the State reported that it had obligated or spent approximately \$3.5 million¹ of its first SSBCI disbursement. Of this amount, \$577,886 was obligated for two loans that New Jersey had reported to Treasury but withdrew before the audit. The remaining \$2.9 million² was spent on two loan participations, a credit guarantee, and a direct loan.

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

¹ Rounded down from \$3,518,886.

² Rounded down from \$2,935,000.

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

We contracted with TCBA Watson Rice LLP, and independent certified public accounting firm, to conduct the audit, which was performed from October 2012 to February 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 the four loan and guarantee expenditures totaling \$2.9 million for compliance with program requirements related to the use of proceeds, capital at risk, and other restrictions noted in the Act and SSBCI Policy Guidelines. It also interviewed New Jersey Economic Development Authority (NJEDA) management and staff who administer, account for, and report on SSBCI funding. The accounting firm did not review the State's administrative costs associated with the SSBCI award, since the State did not seek reimbursement of its expenses.

We conducted quality assurance procedures to ensure that the work performed by TCBA Watson Rice LLP was completed in accordance with *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 objective. We believe that the evidence obtained to address our audit objective provides a reasonable basis for our findings and conclusions. A more detailed description of our audit objective, scope, and methodology is in Appendix 1 of this report.

Results in Brief

We determined that New Jersey complied with all program requirements in administering the \$2.9 million of SSBCI funds. The State also collected complete lender and borrower assurances for the four transactions in a timely manner. The State's success in ensuring full compliance was attributable to several best practices that NJEDA employed to enhance its program oversight.

However, NJEDA reported two withdrawn transactions as a use of funds in the State's subsequent quarterly report, overstating its use of SSBCI funds. Because Treasury has not communicated a process for reporting withdrawn transactions, we recommend that it provide states with guidance on how to remove withdrawn transactions from quarterly and annual reports.

Treasury and NJEDA officials concurred with the report and expressed appreciation for the report's recognition of best practices employed by the State in administering the program. Treasury also stated its appreciation for the recommendation regarding the treatment of withdrawn transactions and reported that it is currently in the process of developing appropriate guidance and a process for removing withdrawn transactions from subsequent reports. Formal written responses from Treasury and the State of New Jersey 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 funds 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 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 states are made in three allocations: the first when the Secretary approves the state for participation, and the second and third after the state certifies that it has obligated, transferred, or spent at least 80 percent of the previous allocation. In addition, the state is required to certify that it has complied with all applicable program requirements.

The State of New Jersey's Participation in SSBCI

On September 22, 2011, Treasury approved the state of New Jersey's application for the SSBCI program and awarded it approximately \$33.8 million.³ That same month, Treasury disbursed the State's first allocation of funds, totaling approximately \$11.1 million.⁴

As of June 30, 2012, the State of New Jersey had spent approximately \$2.9 million in SSBCI funds on four loan and guarantee transactions:

- \$1.76 million financed two loan participations;
- \$675,000 supported a credit guarantee; and
- \$500,000 financed a direct loan.

The New Jersey Department of Treasury designated NJEDA to receive and administer the SSBCI funds under the State's Allocation Agreement with Treasury. NJEDA is an independent State agency that serves the State's business community by financing small and mid-sized enterprises. NJEDA's administration of the State's credit support programs for small businesses predates the State's participation into the SSBCI program.

³ Rounded up from the actual amount of \$33,760,698.

⁴ Rounded down from \$11,141,031.

Venture Capital Fund

To expand the amount of capital available to technology businesses, which are important to New Jersey's economy, NJEDA makes investments as a limited partner in venture capital funds focusing on technology businesses in New Jersey. NJEDA has created a suite of programs to make capital and resources available to small technology businesses. NJEDA participated in venture fund investments prior to the State's acceptance into the SSBCI program. Until June 30, 2012, the State had not used SSBCI funds for venture capital investments.

Loan Participations

NJEDA, through financial institutions, offers loan participations designed to expand the amount of capital available to small and mid-sized businesses. These targeted businesses also may receive participation financing if they are located in targeted municipalities (areas of distress), or represent industries that NJEDA has targeted for assistance, such as manufacturing, industrial, and technology. NJEDA offered loan participations prior to the State's participation in SSBCI. SSBCI funds provided by the loan participation program may be used to pay for fixed assets, working capital, and debt refinancing.

Direct Loans

NJEDA offers direct loans to assist small to mid-sized businesses. These loans include Clean Energy Solutions Capital Investment loans and other direct loans, as well as providing financing to Community Development Financial Institutions (CDFIs) with existing revolving loan funds.

Credit Guarantees

NJEDA offers credit guarantees aimed at assisting small to mid-sized businesses. These include general business loan guarantees, guarantees provided through a relationship with the bank that originates the loan, and guarantees for lines of credit.

New Jersey Complied With SSBCI Program Requirements and Restrictions

In administering the \$2.9 million in SSBCI loans and guarantees, New Jersey 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, investment proceeds, loans, and guaranteed loans 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, and 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 that there be at least 20 percent of private capital at risk for each transaction that uses SSBCI funds. As shown below, each of the four transactions, totaling \$2.9 million, met program requirements:

- Approximately \$1.3 million⁵ in SSBCI funds financed a loan participation for a business that designs and builds trade show exhibits and displays. This participation was matched by a \$7 million⁶ bank loan for a total investment of \$8.3 million.⁷ Private capital at risk was approximately 84 percent. The company said it would use the loan to consolidate two leased operating facilities into one location.
- Another \$516,000 in SSBCI funds was paid out for a loan participation involving a convenience store business. A bank invested an additional \$1.8 million,⁸ for total financing of \$2.3 million.⁹ Private capital at risk was approximately 78 percent.

⁵ Rounded up from \$1.25 million.

⁶ Rounded down from \$7,060,000.

⁷ Rounded down from \$8,310,000.

⁸ Rounded down from \$1,807,000.

⁹ Rounded down from \$2,323,000.

The company said it would use the loan to purchase the property that the operating business occupies.

- Approximately \$675,000 in SSBCI funds was committed to guarantee debt of a company that rents equipment and provides trucking and storage services. This guarantee was made on a total bank financing of \$1.4 million.¹⁰ Private capital at risk was approximately 50 percent. The company said it would use the loan to consolidate existing debt.
- Approximately \$500,000 in SSBCI funds was loaned directly to a nonprofit CDFI. The loan was matched by a \$500,000 loan from a private foundation, for total financing of \$1 million. Private capital at risk was 50 percent. The CDFI said it would use the loan to provide credit to small businesses.

NJEDA collected complete lender and borrower assurances for the four transactions in a timely manner. SSBCI Policy Guidelines require that lenders or investors obtain borrower or investee assurances that (1) loan or investment proceeds will be used for approved business purposes; (2) loan or investment proceeds will not be used for specifically prohibited purposes; (3) the borrower or investee and the lender or investor are not related parties; (4) the borrower or investee is not engaged in specifically prohibited activities; and (5) the principals of the borrower or investee have not been convicted of a sex offense against a minor.

Further, under the SSBCI Policy Guidelines, each state must obtain an assurance from the lender/investor affirming (1) the loan or investment is not for a prior investment that is not covered under the approved state program or that was owed to the borrower or investee or an affiliate of the lender or investor, (2) the loan or investment is not a refinancing of an loan or investment previously made to the borrower or investee by the lender or investor or an affiliate of the lender investor, and (3) no principal of the lender or investor 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.

¹⁰ Rounded up from \$1.35 million.

NJEDA Exhibited Best Practices in SSBCI Administration

NJEDA's success in ensuring full compliance with SSBCI requirements was attributable to several best practices that NJEDA employed to enhance its program oversight. Chief among them was an *SSBCI Application Eligibility Criteria Checklist* that listed each of the required SSBCI assurances and specific SSBCI program requirements. NJEDA required that the checklist be completed and signed prior to each transaction, which ensured that all SSBCI requirements and guidelines were evaluated prior to completion of each transaction, mitigating the risk of non-compliance. NJEDA's management team and staff also demonstrated a strong knowledge of the SSBCI program requirements, which helped ensure that transactions financed with SSBCI funds were clearly evaluated for compliance.

Additionally, NJEDA had a very structured and well-documented credit underwriting policy, and a strong conflict of interest policy and procedure to minimize potential conflicts. NJEDA's Board of Directors also provided clearly defined authority to delegate to its underwriting and closing department the approval of transactions that meet certain criteria. This separation of duties served to further reduce opportunities for conflicts of interest.

Other Observations

SSBCI Quarterly Reports filed by the State for the quarters ending June 30, 2012, and September 30, 2012, included two credit transactions totaling \$577,886 in SSBCI funds. The transactions, which involved the same borrower, had already been withdrawn from the program because the lead lender did not proceed with the transactions.

According to NJEDA officials, Treasury provided informal guidance to continue to report the two withdrawn loans as uses of funds in subsequent reporting periods. To ensure that states accurately report their uses of funds, Treasury should issue guidance on the process for

removing transactions that should not be reported as a use of funds in subsequent quarterly and annual reports.

Recommendation

We recommend that the Deputy Assistant Secretary for Small Business, Housing, and Community Development provide guidance to states on how to remove withdrawn transactions from subsequent Quarterly and Annual Reports.

Management Comments and OIG Response

We provided a draft of this report to Treasury on February 11, 2013, and received formal written comments on February 25, 2013, in which Treasury and New Jersey concurred with our report and expressed appreciation for the recognition of identified best practices. Treasury management also acknowledged the recommendation regarding the treatment of withdrawn transactions and is currently in the process of developing appropriate guidance and a process for removing withdrawn transactions from subsequent reports. Formal written responses from Treasury and the State of New Jersey 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 Clayton Boyce, Audit Director, at (202) 927-5642.

/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 TCBA Watson Rice LLP, and independent certified public accounting firm, to conduct the audit, which was performed from October 2012 to February 2013. The audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. As of June 30, 2012, the State reported that it had obligated or spent \$3.5 million¹¹ of its first State Small Business Credit Initiative (SSBCI) disbursement. Of this amount, \$577,886 was obligated for two loans that New Jersey had reported to Treasury but withdrew before the audit. The remaining \$2.9 million¹² was spent on two loan participations, a credit guarantee, and a direct loan.

To test participant compliance, the accounting firm reviewed the four loan and guarantee expenditures totaling \$2.9 million for compliance with program requirements related to the use of proceeds, capital at risk, and other restrictions noted in the Act and SSBCI Policy Guidelines. It also reviewed associated policies, procedures, and other written guidance provided by the New Jersey Economic Development Authority (NJEDA) and interviewed NJEDA management and staff who administer, account for, and report on SSBCI funding. The interviews were conducted at NJEDA offices in Trenton, N.J., to understand and assess:

- Administrative structures, including the capacity of NJEDA to manage accounts and report on the SSBCI activities.
- Procedures in place to process small business loans, loan participations, credit guarantees, and venture capital investments, and to ensure compliance with the requirements of the Act and Treasury guidelines.
- Procedures for evaluating the financial and operational fitness of lenders participating in the program.

The accounting firm did not review the State's administrative costs associated with the SSBCI award, since the State did not seek reimbursement of its expenses.

¹¹ Rounded down from \$3,518,886.

¹² Rounded down from \$2,935,000.

We conducted quality assurance procedures to ensure that the work performed by TCBA Watson Rice LLP was completed in accordance with *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 objective. We believe that the evidence obtained to address our audit objective provides a reasonable basis for our findings and conclusions.

Appendix 2: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

February 25, 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 *New Jersey's Use of Funds for 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 New Jersey complied with all State Small Business Credit Initiative (SSBCI) program requirements. We also appreciate that the Report attributes New Jersey's success to several SSBCI administration best practices, including the use of a compliance checklist prior to completing each transaction; as well as the New Jersey Economic Development Authority team's strong knowledge of SSBCI program requirements, structured and well-documented credit underwriting policy, and strong conflicts of interest policy and procedures. As part of Treasury's effort to share successful program management practices among SSBCI participants, we will communicate these best practices and continue to encourage states to use compliance checklists prior to closing transactions.

In addition, we appreciate the recommendation regarding the treatment of withdrawn transactions. SSBCI currently is developing appropriate guidance and a process for removing withdrawn transactions from subsequent reports. We will continue to update your team as the process moves forward.

Enclosed, please find a letter from the New Jersey 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.", with a stylized flourish at the end.

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

Enclosure



State of New Jersey
OFFICE OF THE STATE TREASURER
PO Box 002
TRENTON NJ 08625-0002

CHRIS CHRISTIE
Governor

KIM GUADAGNO
Lt. Governor

ANDREW P. SIDAMON - ERISTOFF
State Treasurer

February 19, 2013

Mr. Don Graves, Jr., Deputy Assistant Secretary
Small Business, Community Development and Housing Policy
United State Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Deputy Assistant Secretary Graves:

On behalf of the State of New Jersey, I would like to thank you for the opportunity to review the draft report by the Office of Inspector General (OIG) entitled *New Jersey's Use of Federal Funds for Other Credit Support Programs*. New Jersey Department of Treasury and its contract entity, New Jersey Economic Development Authority (NJEDA), concur with the audit report which concluded that NJEDA was successful in ensuring full compliance with the requirements of the State Small Business Credit Initiative (SSBCI). The State is also pleased with the recognition by OIG of several NJEDA processes as best practices in the administration of the program.

It has been a pleasure working with US Treasury on the SSBCI Program. The Program has provided New Jersey with additional funds critical to improving access to capital for small businesses. The State looks forward to continued success with the Program.

Sincerely,

Andrew P. Sidamon-Eristoff
State Treasurer

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Appendix 3: Major Contributors

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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

United States House of Representatives

Chairman and Ranking Member
Committee on Small Business

Chairman and Ranking Member
Committee on Financial Services

Government Accountability Office

Comptroller General of the United States