



Audit Report



Report Number: OIG-SBLF-13-008

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

June 4, 2013

Office of
Inspector General

Department of the Treasury

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Abbreviations

ADECA	Alabama Department of Economic and Community Affairs
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*

June 4, 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 Alabama'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 Alabama approximately \$31.3 million¹ in SSBCI funding, and as of June 30, 2012, the State received its first allocation of approximately \$10.3 million.² As of June 30, 2012, Alabama had obligated or spent approximately \$3.8 million,³ of which approximately \$3.7 million⁴ was for the Alabama Loan Guarantee Program, and \$45,172 was for program administration.

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

¹ Rounded down from \$31,301,498.

² Rounded down from \$10,329,494.

³ Rounded up from \$3,781,772.

⁴ Rounded down from \$3,736,600.

We contracted with Crowe Horwath LLP, an independent certified public accounting firm, to conduct the audit, which was performed from December 2012 to May 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 14 loans enrolled in Alabama's Loan Guarantee Program made between the signing of the *SSBCI Allocation Agreement* on August 24, 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.

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. A more detailed description of our objective, scope, and methodology is in Appendix 1 of this report.

Results In Brief

We determined that Alabama complied with all program requirements in administering the \$3.8 million of SSBCI funds used as of June 30, 2012. The State's success in ensuring full compliance was attributable to a best practice that the Alabama Department of Economic and Community Affairs (ADECA) employed to enhance its program oversight. The State required that a loan checklist listing the SSBCI requirements be completed prior to each loan enrollment to ensure that all loans were evaluated for compliance with SSBCI requirements.

However, Alabama overstated the amount of SSBCI funds used by approximately \$1 million⁵ on its March 31, 2012 Quarterly Report,

⁵ Rounded up from \$961,000

and by approximately \$4 million⁶ on its June 30, 2012 Quarterly Report. This occurred because the State incorrectly included private lender contributions to loan loss reserves for loans guaranteed with SSBCI funds. Because the inaccuracies were identified by Treasury and corrected prior to our audit, we are making no recommendations.

Treasury and Alabama officials concurred with our report and expressed appreciation for the recognition of identified best practices. Treasury management also stated that it will continue to encourage the use of compliance checklists prior to closing transactions and to share Alabama's successful timekeeping process with other participating states. Formal written responses from Treasury and the state of Alabama 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.

⁶ Rounded down from \$4,039,000

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.

Alabama's Participation in SSBCI

On August 10, 2011, Treasury approved the state of Alabama's application for the SSBCI program and awarded it approximately \$31.3 million. The Allocation Agreement between Alabama and Treasury was signed on August 24, 2011, and authorized use of the SSBCI funds to implement the Alabama Capital Access Program, the Alabama Loan Guarantee Program, and the Alabama Loan Participation Program. That same month, Treasury disbursed the State's first allocation of funds, totaling approximately \$10.3 million. As of June 30, 2012, the state of Alabama had obligated or spent approximately \$3.8 million of the first allocation.

Alabama Capital Access Program

The Alabama Capital Access Program was established to take advantage of the funding designated by the Act. The program is a private-public match program that provides portfolio insurance to participating financial institutions to enable them to expand small business lending. The portfolio insurance or loan loss reserve account protects the lender against losses up to the balance in the lender's reserve account. As of June 30, 2012, the State had not used SSBCI funds for any Capital Access Program loans.

Alabama Loan Guarantee Program

The Alabama Loan Guarantee Program was created to enable lenders to make term loans or provide lines of credit to new or existing small

businesses. Under the program the State guarantees 50 percent of the loan principal from losses resulting from loan defaults. As of June 30, 2012, the State had obligated or spent approximately \$3.7 million in SSBCI funds on 14 loans enrolled in the Alabama Loan Guarantee Program.

Alabama Loan Participation Program

The Alabama Loan Participation Program was established to enable small businesses to obtain medium-to long-term financing to grow and expand. The program operates like a purchase transaction or purchase participation, in which the State purchases a portion of a loan originated by a lender. The program enables the State to act as a lender, in partnership with a financial institution lender, to provide small business loans at attractive terms. As of June 30, 2012, the State had not used SSBCI funds for any loan participation transactions.

Alabama Complied With All SSBCI Loan Requirements and Restrictions

All 14 loans enrolled in the Alabama Loan Guarantee Program as of June 30, 2012, totaling approximately \$3.7 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.

Alabama also collected complete borrower assurances in a timely manner for all 14 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.

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 50 percent of the loan principal.

Further, Alabama 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.

Alabama Exhibited Best Practices in Its Administration of SSBCI Funds

Alabama's success in ensuring full compliance with SSBCI requirements was attributable to best practices the State employed that enhanced its program oversight. Chief among them was the State's development of a loan checklist, which listed each of the SSBCI requirements in addition to the State's specific program requirements. The State required that the checklist be completed prior to each loan, which ensured that all loans were evaluated for compliance with SSBCI requirements and policy guidelines prior to funding, mitigating the risk of non-compliance.

Additionally, ADECA had a timekeeping process in place to ensure salaries and benefits charged to SSBCI funds are allocable to the program in accordance with OMB Circular A-87. Staff complete and certify individual time reports each pay period. The time reports list all

programs the staff member worked on during the pay period, and the number of hours allocable to each program. The data from the time reports is entered into the payroll system, in which programs are individually coded to ensure that expenses are recorded to the appropriate funds source.

Administrative Costs Charged to SSBCI Were Reasonable, Allowable, and Allocable

All costs comprising the \$45,172 of SSBCI funds expended by Alabama for administration of its programs were reasonable, allowable, and allocable in accordance with *SSBCI Policy Guidelines* and Office of Management and Budget (OMB) Circular A-87. Section 4.2 of the Alabama Allocation Agreement states that the participating state shall only use the allocated funds for the purposes and activities specified in the agreement and for paying allowable costs of those purposes and activities in accordance with the cost principals set forth in OMB Circular A-87 (Cost Principles for State, Local, and Indian Tribal Governments) and codified in 2 C.F.R. Part 235.

Alabama provided supporting documents for all individual administrative expenses charged to SSBCI showing that the expenses were allowable, reasonable, and allocable to the program. Of note, State personnel assigned to administer the program maintained timesheet records that separated work hours charged to the SSBCI program from other State programs for which they were responsible. Therefore, employee salary and benefit allocations were fully transparent.

Other Observations

Alabama overstated the amount of SSBCI funds used by approximately \$1 million on its March 31, 2012 Quarterly Report, and by approximately \$4 million on its June 30, 2012 Quarterly Report. This occurred because ADECA incorrectly included private lender contributions to loan loss reserves for those loans guaranteed with SSBCI funds. Under Section 6.1 of the *SSBCI Allocation Agreement* signed by Alabama, inaccurate Quarterly Reporting can trigger a

general event of default of the State's Allocation Agreement with Treasury.

Use of funds is an important program performance measure. 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

Treasury identified the reporting errors while reviewing the State's second disbursement request. According to ADECA officials, the errors occurred because they initially did not have a full understanding of the information to be input into the Quarterly Reports. However, we believe that Treasury guidance on what is to be reported quarterly is sufficiently clear to enable states to report accurately. Section 4.7 of the *SSBCI Allocation Agreement* signed by Alabama directs the State to report on how it used "allocated funds." *SSBCI Policy Guidelines* and the Quarterly Report form also clearly define what constitutes a use of funds.

Treasury allowed Alabama to revise its Quarterly Reports to reflect the accurate amounts. Our review of these revisions and subsequent reports for the quarters ending September 30, 2012 and December 31, 2012 disclosed that they were accurate. Because Treasury identified the inaccuracies and corrective actions were taken prior to our audit, we are not recommending that Treasury consider whether a general event of default under the Allocation Agreement has occurred.

Management Comments and OIG Response

We provided a draft of this report to Treasury on May 23, 2013, and received formal written comments on May 30, 2013, in which Treasury and Alabama concurred with our report and expressed appreciation for the recognition of identified best practices. Treasury management also stated that as part of its efforts to share successful program management practices among SSBCI participants, it will continue to encourage the use of compliance checklists prior to closing transactions and to share Alabama's successful timekeeping

process with other participating states. We considered management's comments to be responsive to the report findings and conclusions. Formal written responses from Treasury and the state of Alabama 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 May 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 the 14 loan expenditures made under the Alabama Loan Guarantee Program totaling \$3.7 million that were awarded between the signing of the *SSBCI Allocation Agreement* on August 24, 2011, and June 30, 2012. The firm reviewed loan documentation for the loans to determine whether Alabama complied with program requirements for use of proceeds, capital-at-risk, and other requirements and restrictions noted in the Act and *SSBCI Policy Guidelines*.

The accounting firm also reviewed the Alabama Department of Economic and Community Affairs' (ADECA) accounting procedures and SSBCI Quarterly Reports for completeness, and interviewed Alabama officials who administer, account for, and report on SSBCI funding. The firm visited ADECA in Montgomery, AL to interview its SSBCI compliance officer and the accounting and finance staff, who are responsible for preparing and submitting 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 audit objective provides a reasonable basis for the audit findings and conclusions.

Appendix 2: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

May 30, 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 *Alabama'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 Alabama complied with all State Small Business Credit Initiative (SSBCI) program requirements. We also appreciate that the Report attributes Alabama's success to the use of a loan checklist prior to completing each transaction and a timekeeping process to verify that administrative expenses complied with program requirements. As part of Treasury's efforts to share successful program management practices among SSBCI participants, we will continue to encourage Participating States to use compliance checklists prior to closing transactions and expect to share Alabama's successful timekeeping process with other Participating States.

Enclosed, please find a letter from the Alabama 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
Small Business, Community Development, and
Housing Policy

Enclosure

1

OFFICE OF THE GOVERNOR

ROBERT BENTLEY
GOVERNOR



STATE OF ALABAMA

ALABAMA DEPARTMENT OF ECONOMIC
AND COMMUNITY AFFAIRS

JIM BYARD, JR.
DIRECTOR

May 28, 2013

Mr. Clifton Kellogg
Director, State Small Business Credit Initiative
Department of the Treasury
Washington, DC 20220

Dear Director Kellogg:

RE: Alabama State Small Business Credit Initiative

The State of Alabama is pleased with our report from The Office of Inspector General. Alabama will continue to work hard to insure we operate within parameters set for the SSBCI Program.

We appreciate the courtesy and understanding shown to our staff during the audit process and look forward to the opportunities provided by the State Small Business Credit Initiative program. Being able to provide assistance to small businesses in Alabama is a major priority and we welcome the help you are providing.

Thank you and please let me know if you have any questions.

Sincerely,

A handwritten signature in blue ink, appearing to read "Jim Byard, Jr.", with a long horizontal flourish extending to the right.

Jim Byard, Jr.
Director

JB:WHW:tn

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Appendix 3: Major Contributors

Debra Ritt, Special Deputy Inspector General

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Andrew Morgan, Auditor-In-Charge

Nicolas Harrison, Auditor

Kimberly McKeithen, 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

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