Audit Report

Report Number: OIG-SBLF-13-003

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

January 29, 2013

Office of Inspector General

Department of the Treasury

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Abbreviations

The Act	The Small Business Jobs Act of 2010
OIG	Office of Inspector General
OMB	Office of Management and Budget
SSBCI	State Small Business Credit Initiative
TDA	Texas Department of Agriculture
TLG	Texas Loan Guarantee Program
TSBVC	Texas Small Business Venture Capital Fund

OIG

Audit Report

The Department of the Treasury
Office of Inspector General

January 29, 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 Texas' 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). Texas was awarded approximately $46.6 million,[1] and as of June 30, 2012, had received its first allocation of approximately $15.4 million.[2] Texas allocated the funds to two other credit support programs: the newly established Texas Small Business Venture Capital (TSBVC) fund, and the existing Texas Loan Guarantee (TLG) program. At the time of our audit in August 2012, the State had obligated or spent $6.3 million related to the TSBVC. No SSBCI funds had been used by the TLG.

The Act requires the 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 funds that the participating state or administering entity should have known was unauthorized or prohibited, and which is a highly unreasonable departure or willful disregard from the standards of ordinary care. Intentional misuse is defined as any unauthorized or prohibited use of funds that the participating state or its administering entity knew was unauthorized or prohibited.

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[1] Rounded up from the actual award amount of $46,553,879.
[2] Rounded up from the actual allocation amount of $15,362,781.

Our audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. To address the objective, we reviewed all five investments, totaling $6.3 million, financed by TSBVC as of June 30, 2012. We reviewed the investments to determine whether they complied with program requirements for business purpose, capital at risk, and other requirements and restrictions established by the Act and SSBCI Policy Guidelines.

We also reviewed $105,000 of administrative costs that the State charged against SSBCI funds to ensure they were allowable and allocable in accordance with Treasury Guidelines and Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*.[3] Appendix 1 contains a more detailed description of our audit objective, scope, and methodology.

Our review disclosed that Texas complied with the business purpose, capital at risk, and all other program requirements and restrictions established by the Act and SSBCI Policy Guidelines for the five investments. The State's success in ensuring full compliance with SSBCI requirements was attributable to its use of a checklist to evaluate compliance with program requirements prior to the completion of each transaction. In addition, the $105,000 in expenditures the State incurred for administration of its programs was properly tracked and determined to be allowable and allocable in accordance with Treasury Guidelines and OMB Circular A-87. Therefore, we are making no recommendations to Treasury. Treasury management and the State of Texas provided formal written responses concurring with our report, which are included in their entirety in Appendix 2.

We conducted our audit between August 2012 and October 2012 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

[3] Office of Management and Budget Circular Number A-87, revised May 10, 2004.

conclusions based on our audit objectives. We believe that the evidence obtained to address our audit objectives provides a reasonable basis for our findings and conclusions.

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, and venture capital programs. Each participating state is required to designate specific departments, agencies, or political subdivisions to implement the programs approved for funding. The designated state entity distributes the 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 participant. 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 participating state is required to certify that it has complied with all applicable program requirements.

The State of Texas' Participation in SSBCI

On August 1, 2011, Treasury approved Texas' application for participation in SSBCI, awarding it approximately $46.6 million. On August 15, 2011, Treasury disbursed the first allocation of the State's

award, approximately $15.4 million. The Allocation Agreement between Texas and Treasury provided funds to expand the existing TLG program and to establish the TSBVC fund. Both programs are administered by the Texas Department of Agriculture (TDA).

The State reported on June 30, 2012, that $105,000 had been used to pay costs associated with administering the programs. This amount represents approximately 0.7 percent of the $15.4 million the State received from its first allocation of SSBCI funds.

Texas Loan Guarantee Program

Since 1987, TDA has operated the TLG program, which provides financial assistance to rural Texas in the form of loan guarantees of up to 50 percent of the loan amount. Under the program, borrowers apply for loans directly to lending institutions, including banks, credit unions, and Community Development Financial Institutions. The lending institutions determine whether the applicant is eligible for the program and is creditworthy. If a guarantee is required for approval of the loan, the lending institution may apply to TDA for participation in the TLG program. TDA plans to use SSBCI funds to expand the availability of loan guarantees statewide and to a broader range of businesses. At the time of our audit in August 2012, no SSBCI funds had been expended through the TLG program.

Texas Small Business Venture Capital Fund

Texas used SSBCI funds to create the TSBVC fund. TSBVC, together with private investors, provides capital to small businesses and underserved communities in Texas. TDA provides oversight and management of the program and has partnered with fund management firms to administer the TSBVC. By investing in fund management firms rather than directly investing in projects, TDA can take advantage of the participating firms' research capabilities and sector knowledge to ensure professional management and investment in eligible projects. At the time of our audit in August 2012, Texas had obligated or spent approximately $6.3 million of its SSBCI allocation on five TSBVC investments.

Texas Complied With All SSBCI Program Requirements and Restrictions

In administering the $6.3 million of SSBCI investments through the TSBVC fund, Texas 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 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 venture capital funds receiving SSBCI funds to have a meaningful amount of their own capital resources at risk. Venture capital investment networks in which the fund or network making the investment decision in the eligible small business bears at least 20 percent of the risk of loss satisfies this requirement.

Each of the following five investments made through the TSBVC program met these requirements:

- Approximately $1.5 million[4] in SSBCI funds was invested in a clean energy company that uses biotechnology to recover oil from depleted wells. This investment was enhanced by $2 million from the Advantage Capital Partners and an additional $16.5 million in other private support, for a total investment of $20 million. Therefore, private capital at risk was 93 percent. The company said it would use the funds for development, working capital, and general corporate purposes.
- $500,000 in SSBCI funds was invested in a company that designs and markets watches. This investment was matched

[4] The exact amount was $1,499,998.

by an additional $500,000 investment by Enhanced Capital Partners for a total investment of $1 million. Therefore, private capital at risk was 50 percent. The company said it would use the funds to reduce overdue accounts payable and for other working capital purposes.

- $1.5 million of SSBCI funds was invested in an information management company that provides enterprise software to help manage unstructured information found in files and emails. This was matched by an additional $1.5 million investment by Enhanced Capital Partners, for a total investment of $3 million. Therefore, Enhanced Capital Partners bore 50 percent of the risk of loss in the investment. The company said the funds would be used for general working capital purposes.
- $625,000 of SSBCI funds was invested in a company that designs and sells semiconductors, but does not manufacture them. An additional $3.375 million was invested by Enhanced Capital Partners, for a total investment of $4 million. Therefore, the private investor bore approximately 84 percent of the risk of loss in the investment. The company said it would use the investment for general working capital.
- $2.2 million in SSBCI funds was invested in a polyurethane foam products manufacturing company. Enhanced Capital Partners matched this amount with an additional $2.2 million, for a total investment of $4.4 million. Therefore, private capital at risk was 50 percent. The company said it would use the investment for working capital to purchase inventory.

Texas also collected complete investor and investee assurances in a timely manner. SSBCI Policy Guidelines require that investors obtain investee assurances that (1) investment proceeds will be used for approved business purposes, (2) investment proceeds will not be used for specifically prohibited purposes, (3) the investee and investor are not related parties, (4) the investee is not engaged in specifically prohibited activities, and (5) the principals of the 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 investor affirming that (1) the investment is not for prior investment that is not covered under the approved state program or that was owed to the investee or an affiliate of the investor, (2) the investment is not a refinancing of an investment previously made to

the investee by the investor or an affiliate of the investor, and (3) no principal of the investor has been convicted of a sex offense against a minor.[5] For each transaction, assurances must be completed and executed prior to the transfer of funds.

Texas Exhibited Best Practices in SSBCI Administration

Texas strictly adhered to the requirements of the Act and SSBCI Policy Guidelines, collecting all investor and investee assurances and ensuring that they were executed prior to the transfer of funds. The State's success in ensuring full compliance with SSBCI requirements is attributable to several best practices the State employed that enhanced its program oversight.

Chief among them was the State's development of an investment checklist, which listed each of the required SSBCI assurances in addition to the State's specific program requirements. The State required that the checklist be completed and signed prior to each investment, which ensured that all investments were evaluated for compliance with SSBCI requirements and policy guidelines prior to funding, mitigating the risk of non-compliance.

Administrative Costs Charged to SSBCI Were Allowable and Allocable

All costs comprising the $105,000 of SSBCI funds expended by Texas for administration of its programs were allowable and allocable in accordance with Treasury Guidelines and OMB Circular A-87. Section 4.2 of the Texas 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,*

[5] Under Treasury's October 2011 SSBCI Policy Guidelines, "principal" is defined as: the proprietor of a sole proprietorship; each partner in a partnership; each of the five most highly compensated executives, officers, or employees of a corporation, limited liability company, association, or a development company; or each direct or indirect holder of 20 percent or more of the ownership stock or stock equivalent of that entity.

Local, and Indian Tribal Governments) and codified in 2 C.F.R. part 235.

Texas 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, TDA 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.

Recommendations

Because our audit disclosed that Texas complied with all SSBCI program requirements and with OMB and Treasury guidelines for allocating administrative costs, we made no recommendations to Treasury.

Management Comments and OIG Response

We provided a draft of this report to Treasury on January 10, 2013, and received formal written comments on January 24, 2013, in which Treasury management and Texas concurred with our report. Formal written responses from Treasury and the State of Texas are included in their entirety in Appendix 2.

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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.

Debra Ritt

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

Appendix 1: Objective, Scope, and Methodology

The objective of our audit was to test participant compliance with program requirements and prohibitions to identify reckless or intentional misuse. As of June 30, 2012, Texas had used approximately $6.3 million in Federal Funds through its participating program, the Texas Small Business Venture Capital (TSBVC) fund.

The scope of our audit included all $6.3 million of SSBCI investment activity from the date of Texas' approval as an SSBCI participant, August 1, 2011 to June 30, 2012. During this period, the TSBVC fund made five investments with SSBCI funds.

We reviewed program policies, procedures, and other written guidance provided by the Texas Department of Agriculture in order to understand and assess the following:

- Procedures in place to administer the program and ensure compliance with the requirements of the Act and associated Treasury guidelines.
- Accounting and reporting processes, including methodologies for calculating and reporting administrative expenses.

During August, September, and October 2012 we conducted off-site reviews of each of the five investments from our offices in Washington, D.C. We compared the documentation in the investment files to the specific requirements and prohibitions of the Act and associated SSBCI Policy Guidelines.

We conducted our audit between August 2012 and October 2012 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 objectives. We believe that the evidence obtained to address our audit objectives provides a reasonable basis for our findings and conclusions.

Appendix 2: Management Response

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 24, 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 *Texas' Use of Federal 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 Texas complied with all State Small Business Credit Initiative (SSBCI) program requirements. We also appreciate that the Report attributes Texas' success to the use of a compliance checklist prior to completing each transaction. As part of Treasury's effort to share successful program management practices among SSBCI participants, we will continue to encourage states to use compliance checklists prior to closing transactions.

Enclosed, please find a letter from the Texas 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,

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

Enclosure

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TEXAS DEPARTMENT OF AGRICULTURE

TODD STAPLES
COMMISSIONER

January 23, 2013

VIA ELECTRONIC MAIL

Mr. Don Graves, Deputy Assistant Secretary
Small Business, Community Development and Housing Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Deputy Graves:

The Texas Department of Agriculture concurs with the results of the Treasury Office of the Inspector General's report, *Texas's Use of Funds Received from the State Small Business Credit Initiative,* which concluded that Texas complied with all SSBCI Program requirements and restrictions.

Sincerely,

Drew DeBerry
Deputy Commissioner

DD/KR/kr

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Appendix 3: Major Contributors

Debra Ritt, Special Deputy Inspector General

Clayton Boyce, Audit Director

John Rizek, Audit Manager

Andrew Morgan, Auditor in Charge

Nicolas Harrison, 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

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