VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

REPORT ON AUDIT

FOR THE YEAR ENDED

JUNE 30, 2010

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, 2010 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;

- no instances of noncompliance with applicable laws and regulations or other matters that is required to be reported; and

- the Authority has adequately addressed deficiencies identified in the prior year audit report.

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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 11 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. The Authority is included as part of Business Assistance's General Fund appropriations, however various fees and interest earnings cover the majority of the Authority's administrative expenses.

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 and 501 (c) 3 non-profits 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 and 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 economic condition of fiscal year 2010 had an impact on lending within the programs. The general decline in the issuance of new loans and guarantees continued from fiscal year 2009, with the exception of the Providing Access to Capital Entrepreneur (PACE), Child Care Financing, and Industrial Development Bond programs. The increased activity within the PACE Program reflects an increase in participation by banking institutions, while referrals from economic developers and banks drove the increase of activity in the Child Care Financing Program. Bond issuance to non-profit entities increased during the year largely due to the American Recovery and Reinvestment Act of 2009 which relaxed the IRS limits on "bank qualified" bonds for issuers. The Authority does not expect overall lending activity to increase until the economy improves.

Detailed below is more information about the various programs since their inception as administered by the Authority.

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.

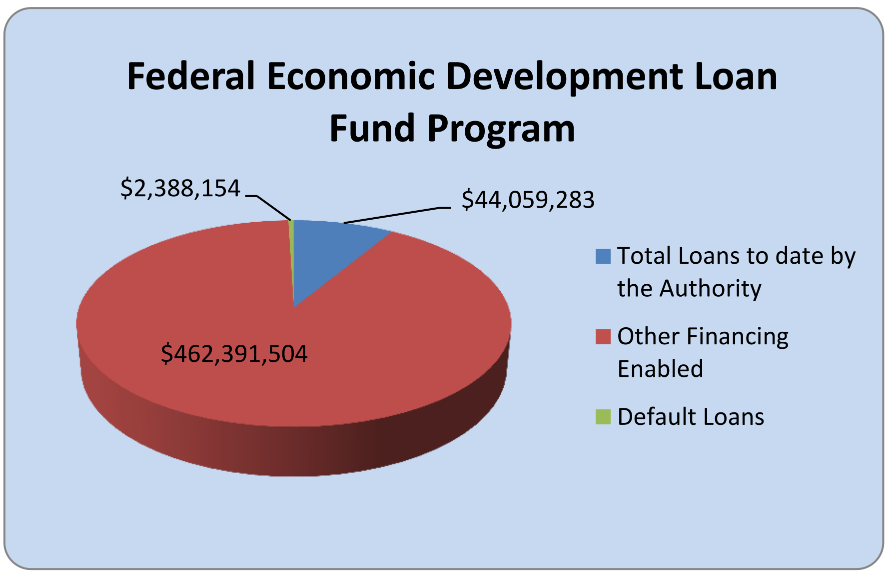
The private sector provides the bond financing, not the Authority or the Commonwealth, and the respective small business or non-profit has responsibility for debt service. As such, the Authority takes on no risk as a result of this program. The Authority is responsible for collecting application and administration fees associated with the bond issuances. These funds support the ongoing operating expenses of the Authority and also provide additional funding to other programs administered by the Authority.

Since the program's inception, the Authority has facilitated the issuance of 129 bonds, averaging seven bond issuances per year. During fiscal year 2010, the Authority issued 20 new bonds which was a significant increase in comparison to the prior fiscal year when there were five new issuances.

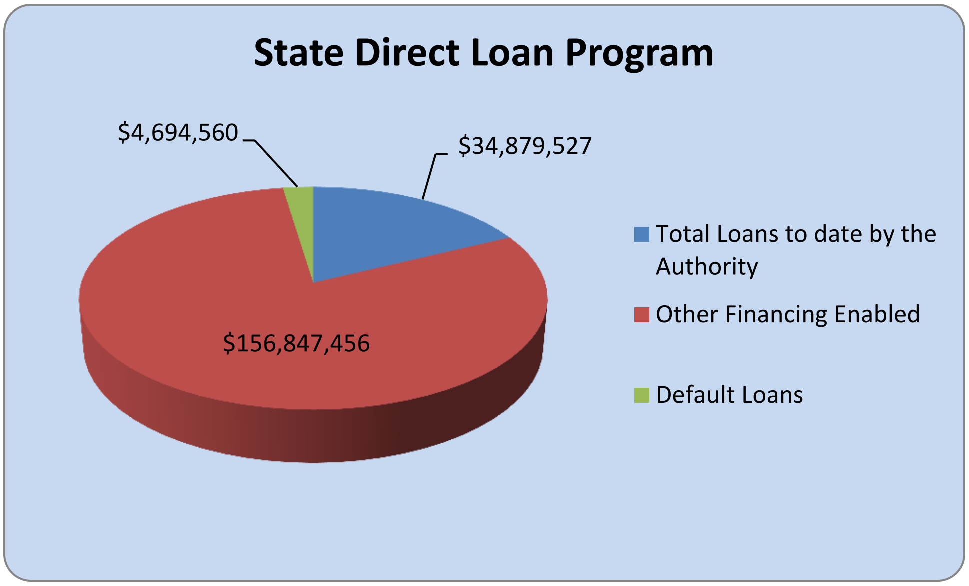
The increased use of the Bond Program by non-profit entities occurred because of the American Recovery and Reinvestment Act of 2009 by which the federal government increased the allowable limit of "bank qualified" debt for issuers from $10 million to $30 million for non-profits seeking financing. The increased IRS limits on "bank qualified" bonds expired on December 31, 2010 and the Authority anticipates the volume of bond issuances will decrease as a result.

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 83 loans, averaging four new loans per year. During fiscal year 2010 there was one new loan issued. The default rate for the program was 5.4 percent in fiscal year 2010 compared to 4.5 percent in fiscal year 2009. The increase in the default rate relates to the charge off of two customer accounts during fiscal year 2010.



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 no new loan issuance occurring during fiscal year 2010. The default rate for the program remained constant at 14.3 percent between fiscal years 2009 and 2010.

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, the Authority has issued 299 loans averaging $24,628 per loan. During fiscal year 2010, the program issued nine new loans which was an increase from the four issuances in the previous fiscal year. The increase in loan issuances relates to economic developers and banks referring more customers to the program. The default rate for the program was 2.1 percent for fiscal year 2010 compared to 2.5 percent in fiscal year 2009.

- The *Small Business Environmental Compliance Assistance Fund (ECAF)* 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 and currently the Authority's only responsibility is managing the remaining ECAF loans until they mature. The default rate for the program remained constant at 2.6 percent between fiscal years 2009 and 2010.

Direct Assistance Program Default Rates

Default rates for direct assistance programs remained constant between fiscal years 2009 and 2010 with the exception of the Federal Economic Development Loan Program, whose rate increased as a result of the charge off of two customer accounts during the year. The Authority performs the credit underwriting and approval of applicants for the direct assistance programs.

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.

Indirect Assistance Programs

The Authority's various indirect assistance programs provide guarantees and loan loss reserve insurance to banks to assist them in making loans to small businesses. These programs mitigate a bank's risk which enables it to make more loans.

- 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, as they occur. Since the program's inception, there have been 1,102 loans, averaging 81 new loans per year. During fiscal year 2010, the program issued 17 new loans. The default rate for the program increased from 4.9 to 6.0 percent between fiscal years 2009 and 2010. Further information regarding the increased default rate is 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 119 loans, averaging 17 new loans per year. During fiscal year 2010, the program issued 22 new loans. The Authority believes the increased activity reflects the Southside region banks becoming more comfortable and familiar with the program. The default rate in addition to the program's activity continued an increasing trend during the year. The default rate for the program increased from 4.0 to 5.6 percent between fiscal years 2009 and 2010. Further information regarding the increased default rate is below.

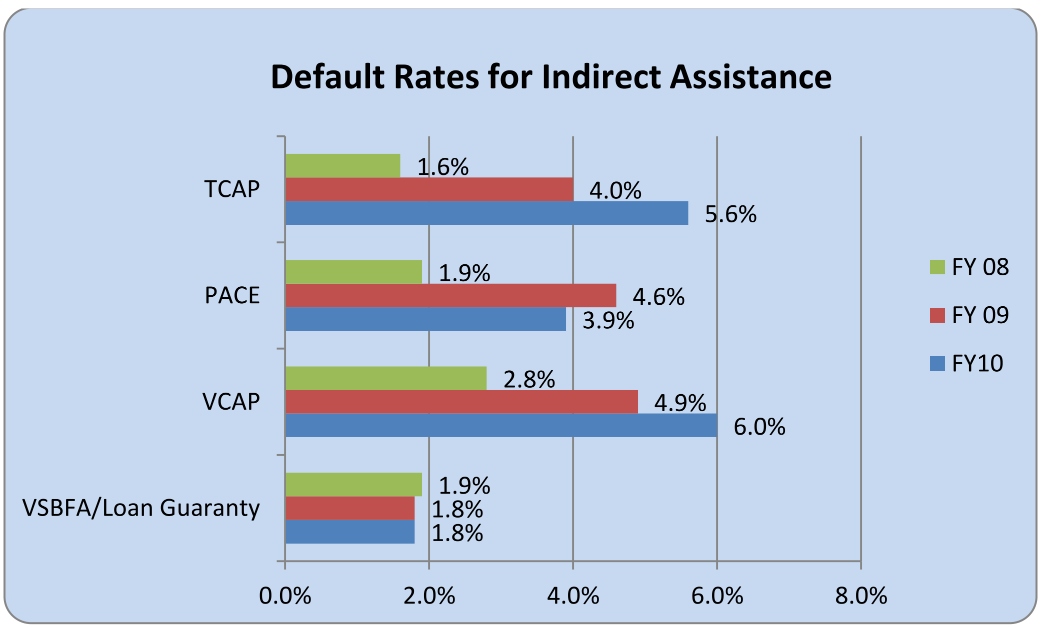
- The *Loan Guaranty Program* provides participating banks deficiency guarantees for loans made to Virginia businesses that do not qualify for conventional bank financing. Borrowers work with participating Virginia banks to apply for this assistance. The program encourages the banks to work with borrowers as they have some guaranty of recouping funds. Since the program's inception, there have been 207 loans, averaging 6 new loans per year, with one new loan issued during fiscal year 2010. The default rate for the program remained constant at 1.8 percent between fiscal years 2009 and 2010.

- 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 51 loans, averaging five new loans per year, with eight new loans issued during fiscal year 2010. The default rate for the program decreased to 3.9 percent in fiscal year 2010 compared to 4.6 percent in fiscal year 2009.

Indirect Assistance Program Default Rates

As indicated in the prior year audit report, the Authority anticipated economic conditions to have an impact on default rates in the TCAP and VCAP programs since they facilitate access to financing for riskier borrowers. During fiscal year 2010, defaults in loans for the programs continued to grow, however the rate of growth was slower in comparison to fiscal year 2009 when defaults on loans doubled in size from fiscal year 2008. 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, 2009, and 2010.



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 2010, the Authority received $153,450 from Business Assistance. On average, this support has totaled $191,607 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 below presents the Authority's operating activities for fiscal year 2010. 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, 2010

Revenues:	
Interest earned on loans	$ 548,995
Fees and penalties	480,446
Interest Income	206,738
Support from Department of Business Assistance	153,450
Other revenues	23,025
Total revenues	$1,412,654
Expenses:	
Accounts charged off	515,727
Personal services	421,724
Expenses from Department of Business Assistance	153,450
Program disbursements	72,607
Contractual services	14,943
Other expenses	499
Total expenses	$1,178,950
Net income	$ 233,704

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

April 15, 2011

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable Charles J. Colgan
Chairman, Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the **Virginia Small Business Financing Authority (Authority)** for the year ended June 30, 2010. 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 the Authority's recorded financial information in the Commonwealth Accounting and Reporting System and the Authority's accounting records, review the adequacy of internal controls over the administration and processing of programs administered by the Authority, test compliance with applicable laws and regulations and review corrective actions of audit findings from the prior year report.

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 significance and risk in determining the nature and extent of our audit procedures. Our review 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 appropriate personnel, and inspection of documents and records. We tested transactions and performed analytical procedures, 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 and the Authority's accounting records. 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. Additionally, we found that the Authority has implemented controls to administer their loan and loan guaranty fund programs and properly administers these programs.

We noted no matters involving internal control and its operation that we consider necessary to be reported to management. The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards. The Authority has taken adequate corrective action with respect to the audit finding reported in the prior year.

Exit Conference and Report Distribution

We discussed this report with management on April 8, 2011.

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

LDJ: clj

VIRGINIA SMALL BUSINESS FINANCING AUTHORITY

Scott Parsons, Executive Director

BOARD OF DIRECTORS

Song Park, Chairman
Michael Joyce, Vice Chairman

George Bryan	John Jacquemin
Jane-Scott Cantus	Jeffrey Jones
Dr. Gopinath Jadhav	Pallabi Saboo

John Waddell

The Honorable Manju Ganeriwala, ex-officio voting member

Peter Su, ex-officio voting member

Scott Parsons, Secretary and Treasurer