



Audit Report



Report Number: OIG-SBLF-14-009

STATE SMALL BUSINESS CREDIT INITIATIVE:

North Carolina's Use of Federal Funds for Capital Access and
Other Credit Support Programs

March 27, 2014

Office of
Inspector General

Department of the Treasury

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Abbreviations

NCREDC	North Carolina Rural Economic Development Center
National Standards	SSBCI National Standards for Compliance and Oversight
OCSP	Other Credit Support Programs
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*

March 27, 2014

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 North Carolina'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 North Carolina approximately \$46.1 million¹ in January 2011, and as of December 31, 2012, the State had received approximately \$30.4 million² of the awarded funds. As of December 31, 2012, North Carolina had obligated or spent approximately \$28 million³ of the funds disbursed, including approximately \$15.9 million⁴ for the North Carolina Loan Participation Program, \$10.3 million for the North Carolina Venture Capital Fund-of-Funds Program, and \$579,168 for the North Carolina Capital Access Program. The State also incurred \$878,671 in administrative costs.

Our 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, we reviewed a random sample of 45 small business loans and investments, totaling approximately \$4.9 million,⁵ that were made under the three approved State programs between the signing of the Allocation Agreement on

¹ Rounded up from \$46,061,319.

² Rounded down from \$30,400,470.

³ Rounded up from \$27,642,504.

⁴ Rounded up from \$15,884,665.

⁵ Rounded up from \$4,880,235.

May 23, 2011, and December 31, 2012. Of the 45 loans and investments reviewed, 31 were from the North Carolina Capital Access Program, 9 were from the North Carolina Loan Participation Program, and 5 were from the North Carolina Venture Capital Fund-of-Funds Program.

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

We reviewed the loans and investments to determine whether they complied with program requirements for use of proceeds, capital-at-risk, and other restrictions in the Act or in *SSBCI Policy Guidelines*. We also interviewed management and staff from the North Carolina Department of Commerce and the North Carolina Rural Economic Development Center (NCREDC), which administer, account for, and report on SSBCI funding. We also reviewed the State's administrative costs charged against SSBCI funds to ensure they were reasonable, allowable and allocable in accordance with the *SSBCI Policy Guidelines*, and Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*.⁶

We performed our audit from April 2013 to March 2014 in accordance with *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient and 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

⁶ Office of Management and Budget Circular Number A-87, revised May 10, 2004.

our audit objective, scope, and methodology is contained in Appendix 1 to this report.

Results in Brief

We determined that North Carolina appropriately used most of the \$4.9 million in SSBCI funds obligated or expended that we tested, but contributed \$6,690 to a reserve fund under the Capital Access Program for a loan that refinanced one previously made to the borrower by the same lender. Such refinancings are prohibited by the Act and constitute a misuse of funds. Prior to the transfer of SSBCI funds, North Carolina collected two separate documents from the lender attesting that the loan being enrolled was not made for a prohibited purpose. Because Treasury, through the *National Standards*, does not require participating states or administering entities to independently verify the accuracy of lender representations as to the nature and compliance of loans, we did not find the misuse to be “reckless” or “intentional.”

Upon learning that the SSBCI loan was prohibited, North Carolina requested that the lender return the SSBCI funds and remove the matching borrower and lender fees from its reserve account. The State intends to place the loan into another non-SSBCI Capital Access Program operated by NCREDC and to return all associated SSBCI funds to the SSBCI bank account for future use. Going forward, North Carolina and the NCREDC have acknowledged that they will require additional documentation from financial institution lenders before enrolling loans in the SSBCI Capital Access Program.

The audit also disclosed that North Carolina did not obtain fully compliant lender sex offender assurances for 19 (or 42 percent) of the 45 transactions tested, as required by the Act, *SSBCI Policy Guidelines* and the *National Standards*. Despite the inadequate assurances, North Carolina certified for June 2012, September 2012, and December 2012 that it was in compliance with all SSBCI requirements, which was materially inaccurate.

Additionally, North Carolina inaccurately reported to Treasury the total

amount of an enrolled investment on three separate occasions because it misreported the private investor's contribution to the investment. These errors occurred because fund managers reported preliminary numbers from investment documents before receiving the final executed agreements, and miscommunication occurred between fund managers and NCREDC. However, the SSBCI funds invested were reported accurately, but misreporting the total funding can distort critical program performance indicators. Both the materially inaccurate compliance certifications and misreported total investment amounts can trigger an event(s) of default of North Carolina's SSBCI Allocation Agreement with Treasury.

Finally, we noted that North Carolina reported \$10.3 million in capital commitments with SSBCI funds to 4 angel investment funds as obligated funds even though only \$2.9 million had been pledged to investees. Angel Funds comprise a group or network of investors that pool their investment capital; and it can take months, even years, to identify and commit funds to specific investees. Although Treasury considers capital commitments to Angel Funds as obligated funds, we are concerned Treasury's method of reporting on capital commitments as obligations before specific investees are identified may misrepresent the amount of funds a state has used and inflate program accomplishments. Moreover, this reporting practice allows states to prematurely qualify for successive funding disbursements before committing capital to investees and is inconsistent with Treasury's guidance for annually reporting leverage ratios.

We recommend that Treasury verify that the State has withdrawn \$6,690 in SSBCI support from the refinanced loan and reimbursed the SSBCI account for its contribution. We also recommend that Treasury determine whether there has been a general event of default under North Carolina's Allocation Agreement resulting from either the State's materially inaccurate compliance certifications and/or its inaccurate reporting of Venture Capital investments and, if so, take appropriate action to either reduce, suspend, or terminate funding. Further, we recommend that Treasury (1) revise the definition of funds obligated for Venture Capital programs to include only funds that have been designated for specific investees, (2) require participants to distinguish

in their Quarterly Reports the Venture Capital funds previously reported as obligated from those obligated to Angel Funds but not yet disbursed to investees, and (3) adopt a standard definition of “funds used” for all program reporting purposes instead of defining “funds used” differently for different purposes.

Treasury officials accepted recommendations 1, 2, and 5, stating that they will verify that North Carolina has withdrawn SSBCI funds from the prohibited loan and replenished the SSBCI account, determine whether a general event of default has occurred, and make every effort to follow the definition of “funds used” in the *SSBCI Policy Guidelines*. Treasury proposed alternative actions for recommendations 3 and 4, offering to confirm prior to disbursing funds that states are not holding excess idle cash that is unlikely to be used within a reasonable time period, and to disclose in Summary Quarterly Reports that funds obligated include those not yet linked to specific small business investments. Formal written responses from Treasury and the state of North Carolina are included 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 (OCSP) 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. OCSPs 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 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 each participating state, 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 annually certify that it has complied with program requirements.

North Carolina's Participation in SSBCI

On January 14, 2011, Treasury approved the state of North Carolina's application for participation in SSBCI, awarding it approximately \$46.1 million. The Allocation Agreement between North Carolina and Treasury was signed on May 23, 2011, and authorized use of the SSBCI funds for the North Carolina Capital Access Program. Subsequently, Treasury amended the State's Allocation Agreement to add two new approved OCSPs—the North Carolina Loan Participation Program and the North Carolina, Venture Capital Fund-of-Funds Program—effective January 25, 2012. In May 2011, Treasury disbursed the State's first allocation of approximately \$15.2 million, and in October 2012, disbursed a second allocation of approximately \$15.2 million after the State certified it had obligated over 80 percent of its first disbursement.⁷ As of December 31, 2012, North Carolina had obligated or expended approximately \$28 million of the two allocations. The State designated NCREDC to administer the approved state programs on behalf of, and in conjunction with, the North Carolina Department of Commerce.

North Carolina's Capital Access Program

NCREDC has administered the North Carolina Capital Access Program since it was established in 1994. The North Carolina Capital Access

⁷ The actual first and second disbursements were each \$15,200,235.

Program helps banks make business loans that are riskier than conventional bank loans. The program is a private-public match program that provides portfolio insurance to participating financial institutions to enable financial institutions to expand small business lending. As of December 31, 2012, the State had obligated or expended \$579,168 in SSBCI funds on 243 loans enrolled in the North Carolina Capital Access Program.

North Carolina's Other Credit Support Programs

As mentioned above, North Carolina modified its Allocation Agreement with Treasury to include the North Carolina Loan Participation Program and North Carolina Venture Capital Fund-of-Funds Program. These programs are also managed by the NCREDC, with assistance from the North Carolina Department of Commerce.

The North Carolina Loan Participation Program was established to enable small businesses to obtain medium- to long-term financing to grow and expand. Under the program the State purchases up to 20 percent of loans originated by financial institution lenders to provide small business loans at attractive terms. As of December 31, 2012, the State had obligated or expended approximately \$15.9 million in SSBCI funds on 63 loans enrolled in the North Carolina Loan Participation Program.

The North Carolina Fund-of-Funds Program invests in privately managed Venture Capital funds and various Angel Funds⁸ which, in turn, invest in individual businesses during their initial start-up stages. The businesses are primarily technology-based companies with high growth potential. The State chooses fund managers that screen and select investees without direct State involvement. As of December 31, 2012, the State had obligated or expended approximately \$10.3 million in SSBCI funds on 16 investments under the North Carolina Fund-of-Funds Program.

⁸ Angel Funds are usually comprised of a group of individual investors who pool their money to make a number of individual investments.

North Carolina Generally Used \$4.9 Million in SSBCI Funds Appropriately, but Misused \$6,690 on a Refinanced Loan

Of the 45 SSBCI transactions totaling approximately \$4.9 million that we tested, 44 were in compliance with program use of proceed requirements. However, North Carolina contributed \$6,690 of its SSBCI allocation to a reserve fund for a \$300,000 Capital Access Program loan that refinanced one previously made to the borrower by the same lender, which constitutes a misuse of funds.

The refinancing of existing debt is prohibited by the Act, *SSBCI Policy Guidelines*, and the April 25, 2012, *SSBCI Frequently Asked Questions*, all of which were in place at the time of the SSBCI loan origination in October 2012. Specifically, the Act prohibits “the enrollment of a loan to a borrower that is a refinancing of a loan previously made to that borrower by the financial institution lender or an affiliate of the financial institution lender.” Additionally, the *SSBCI Policy Guidelines* require that “each participating state must obtain an assurance from the financial institution lender affirming the loan is not a refinancing of a loan previously made to that borrower by the financial institution lender or an affiliate of the financial institution lender.” Finally, the *SSBCI Frequently Asked Questions* acknowledge the prohibition and provide that an exception can be made only when a loan is repaying or refinancing the amount due on a matured loan or line of credit.

Approximately \$77,000 of the \$300,000 loan in question was used to refinance a note from the same lender that matures in October 2015. The refinanced note originated on August 4, 2004, and a Note Modification Agreement executed on September 22, 2009 extended the maturity date to October 5, 2015. The remaining \$223,000 in loan proceeds was used to make building improvements to the retailer’s store. The loan did not meet the criteria for exception from the prohibition outlined in the *SSBCI Frequently Asked Questions* because the refinanced note matures in October 2015.

Although the use of SSBCI funds for the loan in question was clearly prohibited, we did not find that the misuse was “intentional” or

“reckless,” because the lender certified that the funds were not being used for a prohibited purpose, which the State accepted. To conclude that the misuse was reckless, the OIG would have to establish that North Carolina should have known that the lender’s certification was false and that the State’s acceptance of the lender’s certification was highly unreasonable or constituted a highly unreasonable departure from the standards of ordinary care. However, in this instance, we believe that North Carolina followed the established guidance and standards in accepting the lender’s assurances about its use of funds on the loan. We also did not find that the State’s acceptance of the lender’s certification was an unreasonable departure from the standards of ordinary care as the *National Standards* issued by Treasury does not require participating states to verify the accuracy of lender or investor assurances.

North Carolina relied on misrepresentations made by the financial institution lender as to the nature and compliance of the loan. Prior to the transfer of SSBCI funds, North Carolina collected an executed Capital Access Lender Participation Agreement from the lender stating that it would not enroll ineligible loans including the refinancing of a loan previously made to that borrower by the lender or an affiliate. Additionally, the State obtained the financial institution lender’s signed assurance certification, attesting that the loan being enrolled was not made for a prohibited purpose, and a Loan Information Sheet (executed over 3 months after enrollment of the loan in SSBCI) indicating that the funds would not be used to refinance a loan previously made to the borrower by the lender.

Upon learning that the SSBCI loan was prohibited, North Carolina requested that the lender return the SSBCI funds and remove the matching borrower and lender fees from the lender’s reserve account. North Carolina intends to place the loan into another non-SSBCI capital access program operated by NCREDC and will return all SSBCI funds associated with this loan to the SSBCI bank account for future use. Treasury will need to verify that the State has withdrawn the \$6,690 in SSBCI funds from the prohibited loan and that the SSBCI account has been reimbursed for the same amount.

Additionally, North Carolina and the NCREDC acknowledged that going forward, they will strengthen controls by requiring the following documentation before enrolling a loan in the SSBCI capital access program:

- The borrower's loan application;
- The lender's credit memo showing the use of loan proceeds; and
- The note between the borrower and lender; and if it involves any refinanced debt of the lender, the refinanced note showing that the debt has matured, additional funds have been advanced, and all other SSBCI guidelines have been satisfied.

We believe that requiring the additional documentation noted above prior to loan enrollment would help strengthen State oversight over the use of SSBCI funds.

North Carolina Did Not Fully Comply with Lender Sex Offender Assurance Requirements

In 19 of the 45 transactions reviewed, North Carolina did not comply with SSBCI lender sex offender assurance requirements. The Act and *SSBCI Policy Guidelines* require lenders to certify that their principals have not been convicted of a sex offense against a minor. The *National Standards* outline two ways in which participating states can meet their obligation for such certifications. States can require lenders to provide newly executed sex offender certifications, covering each principal of the lender, prior to enrolling each loan or investment in an SSBCI-approved program, or rely on annual lender certifications and the execution of a written agreement requiring the lender to notify the state should an event occur that renders the prior certifications obsolete. The *National Standards* also allow the agreement to be incorporated into another binding document, such as a lender participation agreement.

Although North Carolina chose the annual certification option, its

written agreements with lenders neglected to include a positive requirement that the lenders notify the State when an event occurs that would render the prior assurance certifications obsolete. Therefore, the State was not fully compliant with its lender sex offender assurance obligations. Without requiring lenders to provide notice of changes in principal status, the effectiveness of the assurance is greatly diminished. Because it is reasonable to expect that a lender's sex offender status could change during the time between enrolling loans and executing an annual renewal certification, it is imperative that the State comply with the standards in place to ensure accurate and reliable certifications.

Although North Carolina did not fully comply with the lender assurance requirements, for June 2012, September 2012, and December 2012, the State certified it was fully compliant with all program requirements. As a result, these certifications, which are required by Treasury's Allocation Agreement with North Carolina, were materially inaccurate. Under the Allocation Agreement signed by North Carolina, Treasury, in its sole discretion, may find the State to be in default of its Allocation Agreement if the State materially fails to comply with, meet, or perform any term, covenant, agreement, or other provision contained in the agreement. Further, Treasury may also find the State to be in default under the Allocation Agreement if any representation or certification made to Treasury is found to be inaccurate, false, incomplete, or misleading in any material respect.

The State's failure to fully comply with the assurance requirements and inaccurate certifications may constitute a general event of default under the Allocation Agreement. Therefore, Treasury will need to consider whether North Carolina has satisfactorily cured its non-compliance issues or whether future funding should be suspended, reduced, or terminated.

North Carolina Inaccurately Reported Venture Capital Investments to Treasury

On three occasions North Carolina made minor inaccuracies in reporting to Treasury the total amount of an enrolled investment. In

the first instance, the actual investment of \$1.2 million was reported as \$1.25 million, causing an overstatement of \$50,000. In the second instance, a \$1,302,310 investment was reported to Treasury as \$1,248,311 resulting in an understatement of \$53,999. In the third and final instance, a \$66,000 investment was reported as \$60,000, causing an understatement of \$6,000. In total, the reporting inaccuracies resulted in an approximately \$10,000 understatement of total investments made in the State's 2012 annual report, although the State had correctly reported the SSBCI contribution to the investments.

In all instances, the misreporting occurred because (1) fund managers reported preliminary numbers for private investors' contributions from investment documents before receiving the final executed agreements, and (2) information was miscommunicated between fund managers and NCREDC. Accurate reporting by states is imperative to ensure that Treasury can effectively monitor each state's performance and achievement of private leverage ratios.

Pursuant to Section 6.1 of the SSBCI Allocation Agreement signed by North Carolina, inaccurate reporting can also trigger a general event of default of the State's Allocation Agreement with Treasury. Although the reporting errors made by the State were minor, Treasury will need to consider whether these errors, in combination with the materially inaccurate compliance certifications, triggered a general event of default under the State's Allocation Agreement.

North Carolina Reported Multi-Year Venture Capital Commitments as Funds Used

North Carolina reported that it had obligated \$10.3 million in SSBCI funds to four angel investment funds, of which only \$880,700 had been pledged to investees. While the *SSBCI Policy Guidelines* permit the reporting of such commitments as obligations in *Quarterly Reports* filed by participating states, the obligated funds may sit for several years before actually being invested, which may distort program performance. Moreover, because the obligated funds are considered "funds used" for purposes of determining state eligibility for future

transfers of allocated funds, states may prematurely qualify for subsequent SSBCI disbursements. Finally, treating capital commitments to Angel Funds as “funds used” for reporting purposes is inconsistent with Treasury’s guidance for annually reporting leverage ratios. “Funds used” for leverage reporting is defined as only those funds that were invested or committed to specific businesses.

Angel Funds comprise a group or network of investors that pool their capital for investment in start-up businesses. When an Angel Fund issues a capital call, its investors are contractually obligated to provide committed funds within a fixed period of time. As of December 31, 2012, the North Carolina Fund-of-Funds Program managed by NCREDC had obligated \$10.3 million to four Angel Funds that consisted of Hatteras North Carolina Fund LP, IDEA Stimulus Fund LP, IMAF Common LLC, and Salem Investment Partners III LP. Operating agreements executed between NCREDC and the Angel Funds specified time periods in which the funds were to be invested that ranged from 25 months to 5 years. SSBCI funds are not transferred to the Angel Funds until specific investees are identified by the fund managers.

As shown in Table 1, at the time the SSBCI funds were reported as obligated in December 2012, only \$880,700 had been pledged to investees. Nine months later in September 2013, the amount pledged to investees increased to only \$2.9 million or 29 percent of the \$10.3 obligated and reported as “funds used.”

Table 1: Status of SSBCI Funds Obligated to North Carolina Angel Funds as of December 31, 2012 and September 30, 2013

Name of Angel Fund	Date Obligated	Amount Obligated	Amount Invested as of 12/31/12	Amount Invested as of 9/30/13	Obligated Amount Not Invested
Hatteras North Carolina Fund, LP	11/15/12	\$4,750,000	\$0	\$1,231,483	\$3,518,517
IDEA Stimulus Fund, LP	7/27/12	\$2,500,000	\$337,000	\$597,000	\$1,903,000
IMAF Common, LLC	8/31/12	\$300,000	\$43,700	\$146,227	\$153,773
Salem Investment Partners III, LP	8/30/12	\$2,750,000	\$500,000	\$1,000,000	\$1,750,000
Total		\$10,300,000	\$880,700	\$2,974,710	\$7,325,290

Source: Treasury SSBCI North Carolina Program Activity

Although Treasury officials consider North Carolina’s Angel Fund commitments to constitute obligated funds, the obligated amounts may not result in outlays in the near future as such funds typically have multi-year investment periods. As stated in Treasury’s *SSBCI Frequently Asked Questions*, obligations can be “SSBCI funds that have been committed, pledged, or otherwise promised, in writing as part of a Venture Capital investment transaction.” However, the four funds have investment windows of 4 to 5 years, including the extension periods. For example, three of the North Carolina Angel Funds have investment periods that end in December 2014 and which can be extended another 2 years, and the fourth fund has an investment period that does not end until November 2017. Therefore, the pledging of the remaining \$7.3 million could extend for several more years through the duration of the designated investment periods.

While obligating funds on a multi-year basis generally is an accepted practice, using those obligations to measure performance and qualifying a state for additional transfers of SSBCI funds is inappropriate and does not meet the intent of the Small Business Jobs Act. This practice can lead to the overstatement of program performance because states get the benefit of claiming their multi-year

Angel Fund obligations as “funds used” for their performance immediately, when the funds may not be invested in businesses for years, or in some cases, at all.

Moreover, having those obligations qualify a state for additional transfers of SSBCI funds does not meet the intent of the Small Business Jobs Act. The Act provides that SSBCI funds will be apportioned to each state in one-thirds and that successive transfers of funds shall be made “...when the state has certified to the Secretary that it has expended, transferred, or obligated 80 percent of the last transferred one-third...” If states are allowed to treat Angel Fund commitments where no investees have been identified as obligated funds, then theoretically a state participating in only an Angel Fund program could qualify for additional transfers of funds based solely on its commitments to such funds.

Because the intent of the Act is to ensure states are using funds provided before transferring additional allocations, allowing multi-year commitments where investees have not been identified to qualify as obligated funds would permit states to prematurely qualify for subsequent transfers of funds. This could lead to abuses because states could prematurely obligate and report SSBCI funds to accelerate their second and third funding disbursements.

Finally, SSBCI sometimes describes commitments to Angel Funds as “funds used” for reporting purposes, which is inconsistent considering Treasury’s definition of “funds used” for annually reporting leverage ratios. The state’s Allocation Agreement defines “funds used” for leverage reporting as only those funds that were invested or committed to specific businesses. Using two different definitions of “funds used” is confusing and provides inconsistent evaluation metrics for evaluating state accomplishments.

To prevent states from prematurely qualifying for subsequent SSBCI fund transfers and to improve the accuracy and consistency in reporting program accomplishments, Treasury will need to revise the definition of obligated funds for Venture Capital programs to include only those funds that have been designated for specific investees,

require participants to distinguish in their Quarterly Reports Venture Capital funds previously reported as obligated from those funds obligated to Angel Funds but not yet disbursed to investees. Treasury will also need to adopt a standard definition of “funds used” for all program reporting purposes instead of defining “funds used” differently for different purposes.

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

All 46 administrative cost transactions sampled, totaling \$720,257, were reasonable, allowable, and allocable in accordance with *SSBCI Policy Guidelines* and the Office of Management and Budget (OMB) Circular A-87,⁹ *Cost Principles for State, Local, and Indian Tribal Governments*.

North Carolina provided supporting documentation for all sampled 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 timecard records that separated work hours charged to the SSBCI program from other programs for which they were responsible. Therefore, employee salary and benefit allocations were fully transparent.

Recommendations

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

1. Verify that \$6,690 in SSBCI funds has been withdrawn from the prohibited loan and that the SSBCI account has been reimbursed for the same amount.

⁹ OMB Circular A-87 is codified in 2 C.F.R. Part 225.

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2. Determine whether there has been a general event of default under North Carolina's Allocation Agreement resulting from the State's failure to fully comply with the lender assurance requirements and for inaccurate reporting of Venture Capital investment amounts. If such an event has occurred and has not been adequately cured, determine whether it warrants a reduction, suspension, or termination of future funding to the State.
 3. Revise the definition of funds obligated for Venture Capital programs to include only funds that have been designated for specific investees.
 4. Require participants to distinguish in their Quarterly Reports the Venture Capital funds previously reported as obligated to specific investees from that obligated to Angel Funds but not yet disbursed to investees.
 5. Adopt a standard definition of "funds used" for all program reporting purposes instead of defining "funds used" differently for different purposes.

Management Comments and OIG Response

We provided a draft of the report to Treasury on February 4, 2014, and received formal written comments on February 21, 2014 from North Carolina and March 25, 2014 from Treasury. Treasury accepted recommendations 1, 2, and 5, stating that it will verify that North Carolina has withdrawn SSBCI funds from the prohibited loan and replenished the SSBCI account. Treasury will also determine whether a general event of default has occurred as a result of the State not fully complying with lender assurance requirements or making inaccurate certifications to Treasury; and will make every effort to follow the definition of "funds used" in the *SSBCI Policy Guidelines*.

For recommendations 3 and 4, Treasury proposed alternative actions,

stating that it will change its disbursement procedures to confirm prior to making a disbursement that states are not holding excess idle cash that is not likely to be expended, obligated or transferred to small businesses within a reasonable time period. Treasury will also explain in the Summary Quarterly Reports that funds “expended, obligated, or transferred” include obligations to Venture Capital funds not yet linked to specific small business investments. Further, Treasury will describe the dollar amount of SSBCI funds expended, obligated, or transferred to Fund-of-Funds programs (which include obligations to Venture Capital funds) and the amount expended on loans and investments in small businesses reported by Fund-of-Funds programs in the most recent Annual Report.

North Carolina agreed with recommendations 1 and 2, stating that it relied on a misrepresentation from a lender about the nature and compliance of a prohibited loan, and that its annual sex offender certifications did not comply with program rules. As a result of these recommendations, North Carolina stated it has strengthened its requirements for participating lenders by requiring additional documentation before enrolling a loan, and has amended the lender participation agreements to require lenders to disclose events that render prior sex offender certifications obsolete. North Carolina acknowledged that recommendations 3, 4, and 5 were directed towards Treasury but commented that it accurately reported the \$10.3 million obligation to 4 Venture Capital firms. North Carolina believes its reporting was fully consistent with Treasury’s SSBCI *National Standards* and all applicable law, regulations, and guidance, and that the investments were matched at least 10:1 by private investment funds.

We believe that Treasury’s planned actions are fully responsive to all of the recommendations. Formal written responses from Treasury and the state of North Carolina are included in Appendix 2. Because North Carolina’s written responses included exhibits that contained personally identifiable information, they were not included 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

The objective of our audit was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. As of December 31, 2012, the state of North Carolina had received its first two disbursements totaling approximately \$30.4 million and had obligated or spent \$28 million. Of the \$28 million, \$579,168 went to 243 loans enrolled in the North Carolina Capital Access Program, approximately \$15.9 million went to 63 loans enrolled in the North Carolina Loan Participation Program, and approximately \$10.3 million went to 16 investments enrolled in the North Carolina Fund-of-Funds Program.

To test compliance, we reviewed a random sample of 45 loans/investments (31 from the North Carolina Capital Access Program, 9 from the North Carolina Loan Participation Program, and 5 from the North Carolina Fund-of-Funds Program) that were enrolled as of December 31, 2012. We performed testing to ensure all of the sampled loans and investments complied with the requirements and prohibitions of the Act and associated Treasury guidelines. During May 2013, we conducted an on-site review of loan and investment files at the North Carolina Rural Economic Development Centre (NCREDC) and compared the documentation to specific requirements and prohibitions of the Act and associated Treasury guidelines. In October 2013 we obtained updated statistics on the amount of SSBCI fund commitments that the State had made to Angel Funds as of September 30, 2013.

We interviewed management and staff designated by the state of North Carolina and the NCREDC that were responsible for administering, managing, accounting for, and reporting on the SSBCI programs. We reviewed policies, procedures, and other written guidance provided by North Carolina and the NCREDC. We also reviewed the State's administrative costs charged against SSBCI funds to ensure they were reasonable, allowable and allocable in accordance with the *SSBCI Policy Guidelines*, and Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*.¹

We conducted our audit between April 2013 and March 2014, in accordance with *Government Auditing Standards*. Those standards require that we plan

¹ Office of Management and Budget Circular Number A-87, revised May 10, 2004.

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

March 25, 2014

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 *State Small Business Credit Initiative: North Carolina'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 appreciate the Report's finding that North Carolina generally used State Small Business Credit Initiative (SSBCI) funds appropriately and that all but one of the sampled loans complied with SSBCI program requirements. The OIG transmitted a copy of the Report to North Carolina program officials on February 4, 2014. The OIG asked North Carolina to provide a narrative response describing measures it has taken or plans to take to address the deficiencies noted in the Report.

In its reply, enclosed, North Carolina expresses its appreciation of the opportunity to review and respond to the Report. North Carolina agrees with the finding that the state relied on a misrepresentation from a lender about the nature and compliance of a prohibited loan. Based on this reply, Treasury accepts recommendation 1 that Treasury verify that North Carolina has withdrawn SSBCI funds from the prohibited loan and replenished its SSBCI account. Furthermore, North Carolina accepted the finding that its annual sex offender certifications did not comply with program rules. North Carolina says it has amended the lender participation agreements to require lenders to disclose events that render prior sex offender certifications obsolete. Treasury accepts recommendation 2 and will determine if a general event of default has occurred as a result of any of these actions or the state's certifications to Treasury.

Treasury understands the concerns that motivate the OIG's recommendations 3, 4 and 5 regarding funds "obligated" to venture capital programs. Treasury shares the OIG's belief that it is essential to follow the language and intent of the Small Business Jobs Act.

The OIG report correctly notes that obligating funds on a multi-year basis is an accepted practice in the private sector. Furthermore, Treasury agrees with North Carolina's observation that, "Once a State signs a formal, highly detailed commitment letter with a venture capital firm, then those obligated funds may not be used for any other purposes." Treasury is aware that some states' budget rules require the state to have cash on-hand to sign multi-year obligations. With this context in mind, Treasury believes that states have met the definition of SSBCI funds "obligated" when they sign detailed and binding commitments with venture capital funds.

To address recommendation 3, Treasury will change its disbursement procedures to confirm prior to making a disbursement that states are not holding excess idle cash that is not likely to be expended, obligated or transferred to small businesses within a reasonable time period.

To address recommendation 4, Treasury will explain in the Summary Quarterly Reports that funds "expended, obligated, or transferred" includes obligations to venture capital funds not yet linked to specific small business investments. For the states that operate venture capital fund of funds programs, Treasury will describe the dollar amount of SSBCI funds expended, obligated, or transferred to fund of funds programs (which include obligations to venture capital funds) and the amount expended on loans and investments in small businesses reported by fund of funds programs in the most recent Annual Report.

Treasury accepts recommendation 5. When using the term "funds used" Treasury will make every effort to follow the definition of "funds used" in the Policy Guidelines. The Summary of States' Quarterly Reports will refer specifically to funds "expended, obligated, or transferred."

Thank you once again for the opportunity to review the Report. Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,



Cliff Kellogg
Director of the State Small Business Credit
Initiative

Enclosure



**North Carolina
Department of Commerce**

Pat McCrory, Governor
Sharon Allred Decker, Secretary

Scott R. Daugherty, Commissioner

February 21, 2014

Mr. Don Graves, Jr.
Deputy Assistant Secretary
Small Business, Community Development, and Affordable Housing Policy
Department of Treasury
Washington, D.C. 20220

Dear Mr. Graves:

We received the audit report from the Treasury Office of the Inspector General (OIG) entitled "State Small Business Credit Initiative: North Carolina's Use of the Federal Funds for Capital Access and Other Credit Support Programs (Report)." We appreciate the opportunity to review and comment on the Report.

As requested, we have closely reviewed the Report prepared by OIG on the State Small Business Credit (SSBCI) Program in the State of North Carolina. Our response has been prepared in close consultation with the North Carolina Rural Economic Development Center (NCREDC), which administers the SSBCI Program in North Carolina under the supervision of the North Carolina Department of Commerce.

The State of North Carolina and its contractor, NCREDC have embraced a culture of compliance as they have undertaken the rollout of the State's Small Business Credit Initiative. NCREDC's well managed and successful state-funded Capital Access Program served as a model for implementation of the SSBCI Program in North Carolina. NCREDC has taken several steps to foster a culture of compliance, including:

- Drafting operating agreements to ensure regular reports, internal audits, and active continuous oversight by the NC Department of Commerce;
- Staffing the program to include personnel with SBA lending and compliance experience and former bank business lending officers;
- Requiring compliance managers to have paralegal or bank compliance experience; and
- Hiring an external consultant with federal government compliance management experience to perform a thorough internal audit of all programs.

North Carolina was the second state to receive funds under the SSBCI Program and has consistently been amongst the top state performers in terms of deployment of SSBCI funds. Since NCREDC was initially engaged to participate in the rollout of the SSBCI program in North Carolina, its leadership team has continuously collaborated and communicated with Treasury as the SSBCI Program rules have been developed and evolved over time. In addition to the internal audit referenced above, NCREDC fully participated in Treasury's spot audits confirming compliance prior to the disbursement of the second and third tranches of SSBCI funds to North Carolina.

We appreciate the positive feedback we received from the Office of Inspector General during the audit process including compliments on the quality of our files, the responsiveness to their information requests, and the strength of the relationships we have established with our lending and investing partners.

Thrive NC

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North Carolina has reviewed the Audit Report and the Small Business Jobs Act of 2010 (Act), SSBCI Policy Guidelines, and SSBCI FAQs to respond to the conclusions made by OIG.

Our response addresses the five recommendations set forth in the Report on pages 14—15 .

1. **OIG's Recommendation that the Treasury "[v]erify that \$6,690 in SSBCI funds has been withdrawn from the prohibited loan and that the SSBCI account has been reimbursed for the same amount."**

The Report notes that "of the 45 SSBCI transactions under North Carolina's Capital Access and Loan Participation Programs and Fund of Funds Program totaling \$4.9 million, 44 were in compliance with program use of proceeds requirements." One of the Capital Access loans, however, was not in compliance because it refinanced a loan previously made to the borrower by the same lender, which constituted an impermissible use of proceeds.

As OIG states in its Report, North Carolina relied on misrepresentations made by the lender as to the nature and compliance of the loan with program requirements. OIG found that North Carolina's misuse of funds was not "intentional" or "reckless" because "the lender certified that the funds were not being used for a prohibited purpose, which State accepted." The Report further states that North Carolina "followed the established guidance and standards in accepting lender's assurances about its use of funds on the loan" and that North Carolina's acceptance of the lender's representation was not an unreasonable departure from the standards of ordinary care.

Response: North Carolina agrees with OIG's findings that North Carolina relied on misrepresentations made by its participating lender; that North Carolina followed Treasury's "established guidance and standards;" and that North Carolina's misuse of funds was not "intentional" or "reckless."

Corrective Action Taken By North Carolina: North Carolina has un-enrolled the loan at issue and has replenished the SSBCI Program account for the \$6,690 in misused funds and the matching borrower and lender fees. Documentation evidencing such corrective action is attached as follows: Exhibit 1 (email from NCREDC to Treasury identifying the loan at issue, corrective action to be taken, additional procedures to be implemented, and the lender participation agreement and loan application at issue) and Exhibit 2 (bank statement evidencing the return of SSBCI funds to NCREDC).

As the Report indicates, North Carolina has also strengthened its requirements for participating lenders by requiring additional documentation before enrolling a loan in the Capital Access Program. The additional documentation includes, the borrower's loan application if available; the lender's credit memo showing the use of loan proceeds; and the note between the borrower and lender, and if it involves any refinanced debt of the lender, the refinanced note showing that the debt has matured, additional funds have been advanced, and all other SSBCI guidelines have been satisfied.

2. **OIG's recommendation to Treasury to "[d]etermine whether there has been a general event of default under North Carolina's Allocation Agreement resulting from the State's failure to fully comply with the lender assurance requirements and for inaccurate reporting of venture capital investment amounts. If such an event has occurred and has not been adequately cured, determine whether it warrants a reduction, suspension, or termination of future funding to the State."**

Response: Since OIG's Recommendation pertains to two separate findings, each issue is addressed individually as follows:

- A. **OIG's Finding that North Carolina failed to "fully comply with the lender assurance requirements."**

The Report states that “[a]lthough North Carolina chose the annual certification option, its written agreements with lenders neglected to include a positive requirement that the lenders notify the State when an event occurs that would render the prior assurance certifications obsolete.” OIG found that North Carolina was not fully compliant with its lender sex offender assurance obligations for June, September, and December of 2012. Thus, OIG concluded that the State’s certifications, indicating that it was fully compliant, were materially inaccurate.

Response: As the Report notes, North Carolina has chosen the annual sex offender certification, which was an option made available by Treasury in its May SSBCI Policy and Guidelines. At the time of the audit review North Carolina did not include a requirement for participating lender to notify the State should an event occur that renders the prior certification obsolete. As a practical matter, we would note that the subsequent annual sex offender certification affirms that there have been no events that have occurred since the last certification.

Corrective Action Taken By North Carolina: North Carolina has reviewed its lender participation agreements and confirmed that all active loan files are compliant with respect to the sex offender certification requirement. North Carolina has amended its participation agreements with lenders to impose an affirmative duty on lenders to disclose events that render their prior sex offender assurance certifications obsolete. As of today, February 21, 2014, the state has received confirmation by 24 of 25 participating lenders that the amended participation agreement has been signed. Documentation evidencing such corrective action is attached as follows: Exhibit 3 (sample amendment to lender participation agreement). In addition, no participation submission from the remaining lender, which has not yet signed the amended lender participation agreement, will be considered for approval until its amended agreement is received.

B. OIG’s Finding that North Carolina inaccurately reported of venture capital investment amounts.

The Report notes that “[o]n three occasions North Carolina made minor inaccuracies in reporting to Treasury the total amount of an enrolled investment.” The Report further states that, “[i]n total, the reporting inaccuracies resulted in an approximately \$10,000 understatement of total investments made in the State’s 2012 annual report.” OIG found that the State’s reporting errors were “minor” and that “In all instances, the misreporting occurred because (1) fund managers reported preliminary numbers for private investors’ contributions from investment documents before receiving the final executed agreements, and (2) information was miscommunicated between fund managers and NCREDC.” OIG also points out that “[a]ccurate reporting by states is imperative to ensure that Treasury can effectively monitor each state’s performance and achievement of private leverage ratios.”

Response: As the Report indicates, the State correctly reported its own contributions of SSBCI funds. The reporting discrepancies at issue related to venture capital firms’ reporting of coincident and subsequent private investment. OIG’s Report describes these reporting inaccuracies as “minor” on both pages 10 and 11. North Carolina identified the reporting inaccuracies while working with Treasury. At that time, Treasury told North Carolina that the reports, containing the minor discrepancies, could not be corrected until OIG’s audit was complete.

As indicated in OIG’s Report, the three reporting discrepancies are “minor.” These minor discrepancies, in total, are de minimus and in no way undermined Treasury’s ability to monitor either performance or private leverage ratios. As the Report indicates, the State’s reporting error led to an “understatement” of \$10,000. In addition, in regards to OIG’s concern about private sector leverage ratios, North Carolina may be unique in requiring its participating venture funds to demonstrate an upfront 10:1 ratio of private capital leverage to State SSBCI funds for its Fund of Funds Program.

Additionally, the reporting inaccuracies occurred at a time when Treasury's reporting tool was in its infant stages. Treasury has been proactive in seeking State input to improve its SSBCI reporting tool and North Carolina has collaborated with Treasury to make significant improvements to the reporting process.

Corrective Action Taken By North Carolina: North Carolina has already taken steps to ensure that its reports to Treasury will only include final investment funds committed by venture funds at the closing of each investment round. North Carolina's participation agreements with venture capital firms already require participating firms to accurately report subsequent private investments. Furthermore, North Carolina has sent its participating investment firms a standardized reporting form that will require the participant to certify the final funds committed by both private investors and the State for each investment closing.

3. OIG's recommendation to Treasury to "[r]evise the definition of funds obligated for venture capital programs to include only funds that have been designated for specific investees."

Response: While OIG's recommendation 3, 4, and 5 are directed at Treasury, the State would like to provide its response. As a preliminary matter, North Carolina accurately reported the obligation of \$10.3 million, in total, to four venture capital firms. The State's reporting was fully consistent with Treasury's SSBCI National Standards for Compliance and Oversight and all applicable law, regulations, and guidance.

The reporting of "obligated funds" as "funds used" is consistent with standard venture fund investment practices. Once a State or private entity signs a formal, highly detailed commitment letter with a venture capital firm, then those obligated funds may not be used for any other purposes. As a result, funds that have been committed to an investment firm constitute "used funds" for all intents and purposes.

Corrective Action Taken By North Carolina: There is no corrective action that needs to be taken by State.

4. OIG's recommendation to Treasury to "[r]equire participants to distinguish in their quarterly reports the venture capital funds previously reported as obligated to specific investees from that obligated to angel funds but not yet disbursed to investees."

Response: Please see response to OIG's Recommendation 3 above. In addition, North Carolina's written response to OIG's initial draft report included a chart detailing the amount of SSBCI funds actually invested in investee firms. These investments were matched at least 10:1 by private investment funds. See Exhibit 4 (SSBCI Investment Chart)

Corrective Action Taken By North Carolina: There is no corrective action that needs to be taken by State.

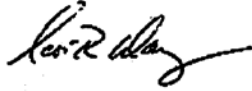
5. OIG's Recommendation to Treasury to "[a]dopt a standard definition of 'funds used' for all program reporting purposes instead of defining 'funds used' differently for different purposes."

Response: No response provided

Corrective Action Taken By North Carolina: There is no corrective action that needs to be taken by State.

In summary, North Carolina has addressed all issues that OIG has indicated in its Report. North Carolina appreciates the opportunity to respond to OIG's Report and looks forward to ongoing collaboration with Treasury in support of the continuing success of the SSBCI Program in our state.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott R. Daugherty". The signature is written in a cursive style with a long horizontal flourish extending to the right.

Scott R. Daugherty
Commissioner

Appendix 3: Major Contributors

Debra Ritt, Special Deputy Inspector General

Lisa DeAngelis, Audit Director

Andrew Morgan, Audit Manager

Diane Baker, Program Analyst

Safal Bhattarai, Auditor

Robert Oliveri, Auditor

Anita Visser, 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