



October 23, 2008

Mr. Glenn Stober, Director
California Business, Transportation, and Housing Agency
980 Ninth Street, Suite 2450
Sacramento, CA 95814

Dear Mr. Stober:

Final Report—Hancock Small Business Financial Development Corporation, Agreed-Upon Procedures

The Department of Finance, Office of State Audits and Evaluations (Finance), has completed its agreed-upon procedures review of the Hancock Small Business Financial Development Corporation's (Hancock) compliance with the Small Business Loan Guarantee Program for the period July 1, 2006 through June 30, 2007.

The enclosed report is for your information and use. Hancock's response to the report findings are incorporated into this final report. Hancock agreed with our findings and we appreciate its willingness to implement corrective actions. The findings in our report are intended to assist management in improving the effectiveness and efficiency of its operations. In accordance with Finance's policy of increased transparency, the final report will be placed on the Finance website.

We appreciate the assistance and cooperation of Hancock's staff during the review. If you have any questions regarding this report, please contact Kimberly Tarvin, Manager, or Rich Hebert, Supervisor, at (916) 322-2985.

Sincerely,

Original Signed by:

David Botelho, Chief
Office of State Audits and Evaluations

Enclosure

cc: Ms. Karen Kawada, Program Analyst, California Business, Transportation, and Housing Agency
Mr. Edward Lee, President, Hancock Small Business Financial Development Corporation

AGREED-UPON PROCEDURES

Hancock Small Business Financial
Development Corporation

Small Business Loan Guarantee Program
For the Period July 1, 2006
Through June 30, 2007

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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This report is also available on our website at <http://www.dof.ca.gov>

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INDEPENDENT ACCOUNTANT'S REPORT ON APPLYING AGREED-UPON PROCEDURES

Mr. Glenn Stober, Director
California Business, Transportation, and Housing Agency
980 Ninth Street, Suite 2450
Sacramento, CA 95814

The Department of Finance, Office of State Audits and Evaluations (Finance), performed the procedures enumerated below, which were agreed to by the California Business, Transportation, and Housing Agency (BT&H) to assist in evaluating Hancock Small Business Financial Development Corporation's (Hancock) compliance with the Small Business Loan Guarantee Program (SBLGP). Hancock management is responsible for compliance with these requirements. This review covers the period July 1, 2006 through June 30, 2007.

This agreed-upon procedures engagement was conducted in accordance with the *Statements on Standards for Attestation Engagements* published by the American Institute of Certified Public Accountants. These standards require that we report all findings identified during the application of the agreed upon procedures. For findings that include questioned costs, materiality was defined as errors or omissions of \$1,000 or more. The sufficiency of these procedures is solely the responsibility of the BT&H. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Background

The SBLGP was created by the Legislature to encourage lenders to provide funds to small businesses and farming enterprises that need additional collateralization in the form of a loan guarantee. The loan guarantees provide the following:

- Encourage the development of small business opportunities for minority, women, and disabled persons.
- Alleviate unemployment.
- Allow participation in state public works contracts by small and emerging contractors.

The SBLGP was established within the California Technology, Trade, and Commerce Agency (CTTCA) and administered by the Office of Small Business Loan Guarantee Program. The CTTCA created a Loan Guarantee Trust Fund (Fund) to collateralize the guarantees on loans to small businesses made by local lending institutions. Under a contractual agreement with the CTTCA, which was subsequently transferred to BT&H, program administration and direction of certain Fund account transactions were assigned to eleven regional financial development

corporations. Each corporation issues guarantees on behalf of the state and manages its share of the Fund and portfolio of outstanding guarantees.

Hancock was established in 1983 and is one of the eleven regional financial development corporations. Hancock's mission is to create and retain jobs and promote economic development within communities by assisting small businesses obtain financing through local banks in the Southern California area. During the period July 1 2006 through June 30, 2007, Hancock claimed \$466,100; which consists of \$125,000 for personnel, fringe benefits, and rent; and \$341,100 for loan guarantee fees.

Procedures Performed and Findings

1. Verification of Allowable Costs

a. Operational Expenses

Hancock claimed \$125,000 in reimbursement for operational and administrative costs. To determine whether the costs claimed were allowable as stipulated in the contract, we performed the following procedures:

- Reviewed the grant agreement to identify authorized positions and allowable salary rates.
- Verified personnel expenses claimed were supported by timesheets and paychecks, and that expenses claimed did not exceed the actual salaries paid.
- Analyzed the fringe benefits claimed to ensure that the percentage of personnel expenses claimed did not exceed the allowable rate.
- Verified that rent expenses were supported by the rental agreement and canceled checks.

Based on the procedures performed, the rent costs claimed are allowable. However, Hancock claimed \$2,390 in ineligible salary and fringe benefits. See Finding 3 in the *Findings and Recommendations* section of this report for further details.

b. Loan Guarantee Fees

Hancock claimed and was paid \$341,100 for guarantee fees based on the issuance of 100 new loans at \$3,250 per loan and 7 renewal loans at \$2,300 per loan. To verify that the loan guarantee fees claimed were allowable, we performed the following procedures:

- Identified the loan guarantees issued from the Monthly Loan Guarantee Registration Report.
- Reviewed a sample of borrower files to confirm the loan was made and determined whether it was a new loan or a renewal. Additionally, we reviewed the promissory notes and the Board of Directors and Loan Committee meeting minutes.
- Recalculated the variable fees to determine whether the loan guarantee fees were accurately claimed.

Based on the procedures performed, we determined that the loan guarantee fees claimed were accurate and allowable.

2. Contracting Practices

We verified that contracting practices were appropriate by determining whether related-party relationships existed with subcontractors. Specifically, we performed the following procedures:

- Interviewed Hancock staff to gain an understanding of contracting practices.
- Reviewed the Statement of Economic Interest forms completed by Hancock's staff and officers.
- Determined whether any of Hancock staff or officers reported any economic interest in any of the subcontractors.
- Reviewed the subcontract agreements, general ledger, and cancelled checks to identify any transactions that indicate the existence of related-party relationships.

Based on the procedures performed, we determined that Hancock's contracting practices are appropriate and did not identify any related-party relationships.

3. Cost Allocation

To determine whether Hancock's cost allocation plan methodology was reasonable and appropriately applied, we interviewed staff and reviewed financial records to determine whether Hancock had any other programs in addition to the SBLGP that would require allocation of costs between programs.

We determined that Hancock only operates the SBLGP program. Therefore, Hancock is not required to have a cost allocation plan to distribute costs among programs.

4. Record Maintenance

To verify all required records are maintained, we performed the following:

- Interviewed Hancock staff to obtain an understanding regarding the records maintained.
- Reviewed the general ledger, Loan Guarantee Program Database, Board of Directors and Loan Committee minutes, loan portfolio records, and subcontract agreements.

Overall, Hancock maintained the required records, except the Loan Guarantee Program Database has not been updated since 2000. See Finding 2 in the *Findings and Recommendations* section of this report for further details.

Collection Costs

We interviewed staff and reviewed the general ledger and the Loan Guarantee Program Database to determine whether:

- Collection costs are charged correctly.
- Out-of-pocket costs were paid for each collection effort with the monies received by a single successful collection.

Based on the procedures performed, Hancock did not charge collection costs or pay out-of-pocket costs for collection efforts.

5. Timely Deposit of Recovery Funds

To determine the length of time between the receipt of recoveries and when funds are forwarded to the state or trustee for deposit, we interviewed staff and reviewed the Loan and Guarantee Program Database and the general ledger.

Based on the procedures performed, we determined that Hancock did not promptly forward receipt of recoveries to the state or trustee for three of the four recoveries remitted. See Finding 1 in the *Findings and Recommendations* section of this report for further details.

6. Accuracy and Reconciliation of Loan Guarantee Portfolio Records

To determine whether the loan guarantee approval process is adequately documented and whether the portfolio records are accurate and reconcile with bank records, we performed the following procedures:

- Interviewed Hancock staff to obtain an understanding of the loan guarantee approval process and records maintained.
- Reviewed a sample of loan guarantee files to evaluate the adequacy of the loan guarantee approval process documentation.
- Reviewed the Loan Guarantee Program Database to determine whether it was updated when an extension was granted to a matured line of credit.
- Determined whether the loan guarantee portfolio records were accurate and reconciled with bank records.

Based on our review, the loan guarantee approval process is adequately documented in the loan guarantee files. Additionally, the Loan Guarantee Program Database is updated when a mature line of credit is granted an extension. Furthermore, Hancock receives periodic confirmation reports from lenders on the status of loans and reconciles this information with the Loan Guarantee Program Database. Any variances identified during the reconciliation process are resolved with the lender and reported to BT&H.

7. Monitoring of Collateral Holdings

To determine whether Hancock communicates the status of the collateral holdings and to identify Hancock's monitoring efforts, we performed the following procedures:

- Interviewed Hancock staff to identify communication and monitoring procedures.

- Reviewed lender confirmation reports to determine whether the information is reconciled to the Loan Guarantee Program Database.

Hancock regularly communicates with the lenders and receives monthly updates on loan status, compares the information to the Loan Guarantee Program Database, investigates variances on loan status changes, and updates the Loan Guarantee Program Database accordingly.

8. Accounting Procedures

To determine whether Hancock's accounting procedures are designed to prevent double billings and ensure the separation of duties are adequate, we performed the following procedures:

- Interviewed Hancock staff regarding accounting processes.
- Reviewed Hancock's organization chart.

Because Hancock did not have an accounting procedures manual, we relied upon Hancock's description of its accounting procedures. Hancock uses QuickBooks Pro 2006 to record the accounting transactions. The accounting procedures incorporate separation of duties and are adequately designed to prevent double billing.

9. Review of Independent Auditor's Report

We reviewed the single audit reports prepared by Hancock's Certified Public Accountant (CPA) for the fiscal periods ending June 30, 2006 and June 30, 2007, and the CPA's working papers reviewed to identify internal control weaknesses in the accounting procedures.

The CPA's report and working papers did not identify any internal control weaknesses.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on compliance with SBLGP requirements. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of BT&H, and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

Original Signed by:

David Botelho, CPA
Chief, Office of State Audits and Evaluations
(916) 322-2985

June 20, 2008

FINDINGS AND RECOMMENDATIONS

FINDING 1 Untimely Deposit and Inaccurate Reporting of Recovered Funds Resulted in a Loss of \$5,525 in Interest and the Use of Working Capital to the Small Business Loan Guarantee Program

Condition: Hancock did not promptly forward receipt of recoveries to the state or trustee for three of the four recoveries remitted, and inaccurately reported the borrower for some recoveries as follows:

- Hancock received \$110,000 from one entity on November 26, 2003. Of this amount, only \$44,640 was remitted to the trustee on November 30, 2003. The remaining amount of \$65,360 and interest of \$1,000 was not remitted until nearly three years later on September 19, 2006. Furthermore, at least \$5,525¹ in interest would have been earned by the Small Business Loan Guarantee Program had the funds been remitted timely.
- Recovery deposits received from two companies in the amounts of \$3,200, and \$5,000 on November 15, 2005 and June 30, 2005, respectively, were not remitted until September 9, 2006.
- Recoveries of \$80,169 in defaulted loans from three borrowers were inaccurately reported to the trustee as belonging to one borrower. As a result, some of the payments were not credited to the correct borrower. Furthermore, additional funds owed may not be collected from a borrower that was erroneously credited for the recovery.

Criteria: Small Business Loan Guarantee Contract Agreement, Exhibit D, Section 17 (D) states that all funds received by the contractor totaling \$10,000 or more pursuant to a guarantee default shall be remitted to the State within ten working days. The contract agreement also stipulates that funds totaling less than \$10,000, pursuant to the same guarantee default or payoff shall be remitted to the state at least quarterly.

Recommendations: Implement procedures to ensure that recoveries are timely deposited and accurately recorded. The Business, Transportation, and Housing Agency (BT&H) will make the final determination regarding the resolution of the unpaid interest.

¹ Interest was calculated using the simple interest calculation method and the average surplus Money Investment Fund interest rate for the period. If the compounded interest calculation was applied, the interest lost amount would be greater.

FINDING 2 Loan Guarantee Program Database Has Not Been Updated for Recoveries since the Year 2000.

Condition As a result, the BT&H was not aware of the undeposited funds discussed in Finding 1 because the database was not updated. Therefore, BT&H was unable to monitor the remittance of these funds. The lack of updating the recoveries in the Loan Guarantee Program Database is a significant internal control weakness that increases the risk that loan recoveries could be misappropriated or fraud could occur without timely detection.

Criteria: According to the SBLGP Policies and Procedures Manual, Section III, page 27 information pertaining to any recoveries must be entered into the Loan Guarantee Program Database.

Recommendation: Hancock management should ensure that data from recovery funds is properly maintained to enable timely monitoring and proper crediting of recovery funds.

FINDING 3 Ineligible Personnel Costs of \$2,390 Were Paid Due to Claiming Budgeted Amounts Instead of Actual Costs Incurred

Condition: Hancock claimed and was paid \$13,029 for a Senior Loan Officer's salary when the actual salary expenses incurred were \$11,190 resulting in ineligible costs claimed of \$1,839. Because the fringe benefits are calculated based on 30 percent of salaries, \$551 (\$1,839 x 30 percent) in related fringe benefits are ineligible.

Criteria: Small Business Loan Guarantee Contract Agreement, Exhibit B, Section 3 (C) indicates that the state agrees to compensate the contractor for actual expenditures incurred in accordance with the budget line item amounts.

Recommendation: Develop procedures to ensure that only actual costs incurred are claimed. BT&H will make the final determination regarding the resolution of the ineligible costs.



SMALL BUSINESS FINANCIAL
DEVELOPMENT CORPORATION

September 24, 2008

Mr. David Botelho, Chief
Office of State Audit and Evaluations
915 L Street
Sacramento, CA 95814-3706

Re: Draft Report – Hancock Small Business Financial Development

Mr. Botelho,

Hancock would like to thank your staff for the professional way in which they conducted the audit. They were extremely courteous and very helpful. It was a pleasure in working with them. In response to the audit we would like to make the following comments:

Finding #1

Untimely deposit and inaccurate reporting of recovered funds.

Response:

Hancock acknowledges the error in its reporting. However, it must be noted that the transaction occurred while the corporation was under Mr. Sam Kim who is now deceased. In the transition, the error was discovered later. Procedures have been implemented to ensure that recoveries are reported on timely bases.

Finding #2

Loan Guarantee Program database has not been updated for recoveries since the year 2000.

Response:

Hancock acknowledges the finding and has instituted procedures that will ensure that this error will not be repeated.

Finding #3

Ineligible Personnel Cost of \$2,390 were paid claiming budget amount instead of actual costs incurred.

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Response:

Hancock acknowledges the finding and now fully understands the criteria used to determine personnel cost. Procedures have been developed to ensure that this error is not repeated.

Hancock is also preparing an accounting procedure manual that will ensure that it's procedures will prevent double billing and to make sure the separation of duties are adequate.

If you have any questions, please call me at (213) 382-4300.

Thank you again for the professionalism shown to our staff.

Sincerely,

Original Signed by:

Edward Lee,
President and Chairman of the Board