

**OKLAHOMA CAPITAL
INVESTMENT BOARD**

PERFORMANCE AUDIT

JULY 1, 1993 THROUGH JUNE 30, 2005



STATE OF OKLAHOMA
OFFICE OF THE AUDITOR AND INSPECTOR

JEFF A. McMAHAN
State Auditor and Inspector

March 21, 2006

**TO THE HONORABLE BRAD HENRY
GOVERNOR OF THE STATE OF OKLAHOMA**

Transmitted herewith is the performance audit over the Oklahoma Capital Investment Board. The procedures we performed were at the request of Governor Henry in accordance with 74 O.S., § 213.2. In accordance with *Government Auditing Standards*, the views of responsible officials are presented throughout the report in green text. If applicable, an auditor's response immediately follows in blue text. In addition, management has provided an overall response to the audit which can be seen at Appendix A.

We wish to take this opportunity to express our appreciation for the assistance and cooperation extended to our office during the course of the engagement.

The Office of the State Auditor and Inspector is committed to serving the public interest by providing independent oversight and issuing reports that serve as a management tool to the state to ensure a government which is accountable to the people of the State of Oklahoma.

Sincerely,


JEFF A. McMAHAN
State Auditor and Inspector

TABLE OF CONTENTS

	Page
Audit Summary.....	3
Background, Scope, and Objectives	5
Observations and Recommendations	
Objective I - To determine the risk imposed on the state by the Venture Investing Program (VIP) and the Capital Access Program (OCAP).....	8
Objective II - To determine the effectiveness of the VIP and the OCAP programs as they relate to the OCIB's mission.....	20
Objective III - To determine if the OCIB is in compliance with applicable state statutes.....	24
Other Items Noted.....	28
Closing Comments.....	30
Appendix A.....	32

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OKLAHOMA CAPITAL INVESTMENT BOARD

PERFORMANCE AUDIT SUMMARY

JEFF A. McMAHAN, CFE

**OFFICE OF THE STATE
AUDITOR & INSPECTOR**

Why the audit was performed

This performance audit was conducted at the request of Governor Henry in accordance with 74 O.S. 2001, § 213.2.

The objectives of the audit were:

- 1) To determine the financial risk imposed on the state by the Venture Investing Program (VIP) and the Capital Access Program (OCAP);
- 2) To determine the effectiveness of the VIP and the OCAP programs as they relate to the OCIB's mission;
- 3) To determine if the OCIB is in compliance with applicable state statutes.

- The Venture Investing Program (VIP) was created with the premise that proceeds from investments made with monies guaranteed by \$100 million in OCIB tax credits would cover the costs to operate the program. To date, this has not proved to be the case as evidenced by over \$31 million in debt attributable to the VIP with the debt increasing an average of \$2.4 million each year. To date, no tax credits have been sold; however, OCIB trustees are considering selling credits to cover the debt. – pages 13-16
- The investments and debt of the VIP are accounted for on the financial statements of the Oklahoma Capital Formation Corporation (OCFC) rather than the financial statements of OCIB. As a state entity, OCIB's financial statements were readily available to anyone; however, as a private corporation, OCFC's financial statements were not available other than on a confidential basis. As a result, the transparency of the VIP is limited making it difficult to get a clear indication of the financial condition of the VIP. – pages 15-16
- The potential financial risk to the State at June 30, 2005 is \$56,107,494. This includes \$31,154,440 in debt, \$23,994,112 in unfunded commitments pledged to venture capital firms, and \$958,942 related to the Oklahoma Capital Access Program. An attempt was made to put this risk in perspective by comparing tax credits issued under two other state tax credit programs, the Small Business Venture Capital Formation Incentive Act and the Rural Venture Capital Formation Incentive Act. However, it was determined that no comparison could be made as the reporting by the Oklahoma Tax Commission to the Legislature pursuant to 68 O.S., § 2357.65 and 68 O.S., § 2357.76 was not being performed. This reporting included identifying the credits allowable, credits claimed, and unused credits carried forward to future years under these two programs. – pages 17-18
- Since inception of VIP, OCIB has had an interest in 162 different companies with 18 of the companies either headquartered in Oklahoma or having an Oklahoma presence. The remaining 144 companies were located outside of Oklahoma. Approximately \$99.8 million has been invested in the 18 Oklahoma companies. Of this amount, only a portion was provided by OCIB with the remaining funds provided by other investors. The portion provided by OCIB is unknown as this is a measure not tracked. – page 20
- OCIB's primary measure of the economic impact of the VIP is the amount of funds invested in Oklahoma. This alone does not appear sufficient to measure the economic impact the VIP has on the State. Without sufficient economic performance measures, there is no assurance that the economic benefits associated with the VIP outweigh the financial risk borne by the State. Of the 18 companies discussed in the preceding paragraph, seven have gone out of business or left the state. These seven companies account for close to one-half of the total dollars invested in Oklahoma; therefore, it is unlikely these companies had any long-term economic impact on the State. – page 21
- The Oklahoma Capital Access Program (OCAP) aids borrowers in obtaining loans. This program stipulates that at least 50% of the employees or assets of the business or project financed by the loan be located in Oklahoma. The OCAP program has approximately 1,250 enrolled loans. Without this program, it appears many of these loans would not have been made. – pages 22-23
- The OCIB appears to be in compliance with 74 O.S., § 5085.8.B. requiring \$2 to be invested in Oklahoma business for every \$1 of principal guaranteed by OCIB. However, we disagree with OCIB including OCAP loans as part of their calculation to determine compliance with this statute. – page 24
- The OCIB was part of a group of investors instrumental in bringing the NBA's New Orleans Hornets to Oklahoma City-page 28
- Venture capital investing in Oklahoma lags behind other parts of the country. OCIB created Oklahoma Equity Partners (OEP) to provide additional venture capital to Oklahoma companies – page 28-29

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TERMS

Venture Capital (VC) - Money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. The investment may be made in either start-up companies or companies in the early stages of development.

Venture Capital Fund – Those who invest money into the VC fund are known as limited partners, while those who invest the fund’s money into companies are known as general partners. As returns are made on the fund’s investments, proceeds are distributed to the partners. An investment into a VC fund is a long-term commitment, often as long as 10 years. During this time, the VC fund goes through four stages of development. The first stage is fundraising, during which time the general partners of the fund obtain capital commitments from the limited partners. The second stage is researching, performing due diligence, and making investments. The third stage is helping the companies, in which an investment is made, grow. By making an investment in a company, the venture capital firm that manages the VC fund is provided the opportunity to ensure that the fund’s interests are considered in the management of the company. The fourth stage of the VC fund is liquidation. From roughly the middle of the life of the fund through the end, the investments are liquidated through a variety of methods including: Initial Public Offering; recapitalization transactions; sales of the companies to third parties; reorganizations; bankruptcies; and asset disposition among others.

Co-Invested Funds – Multiple investors investing in the same portfolio company. For example, VC Fund A, VC Fund B, and VC Fund C each invest into the same portfolio company at the same time and under the same terms.

Leveraged Funds - Multiple investors that pool their money in a VC fund that invests in companies which have the potential to grow and return dividends on investments. For example, ten different investors each invest \$100,000 in a VC fund. The VC Fund then invests the \$1 million pool into a portfolio company or companies.

Commitment - The amount of money committed to a VC fund. The commitment is generally long term (e.g., ten years) with actual cash provided to the VC fund throughout the term of the commitment.

Equity Capital - Capital invested in common or preferred stock, royalty rights, limited partnership interests, and any other securities or rights that evidence ownership in private businesses.

Near-equity capital - capital invested in unsecured, undersecured, subordinated, or convertible loans, or debt securities.

Tax credits - credits that may be used to reduce the tax liability of a person, firm or corporation.

Distributions – returns received on investments funded through the VC fund. The distributions are typically in the form of cash or stock which is then sold.

Oklahoma Futures - A planning and oversight board formed in 1987 and created to be the central economic development policy planning and oversight board for all economic development activities in Oklahoma. Futures was abolished in 2001.

**OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT**

BACKGROUND

The Oklahoma Capital Investment Board's (OCIB or the Board) enabling legislation, the Oklahoma Capital Formation Act (the Act), was passed in 1991. According to this Act, its mission "shall be to mobilize equity and near-equity capital for investment in a manner that will result in a significant potential to create jobs and diversify and stabilize the economy of the State of Oklahoma."

The Board is a public trust of the State and consists of five trustees appointed by the Governor with the advice and consent of the Senate. According to the Act, the trustees are to be "selected based upon outstanding knowledge and leadership and shall possess experience in the management of investments similar in nature and in value to those of the Board." The trustees serve for a term of five years with terms set up to allow one trustee to rotate off of the Board each year. However, as noted in the listing of trustees below, some members have served past their term expiration pending reappointment or replacement by the Governor with consent of the Senate.

<u>Trustee</u>	<u>Term Expiration</u>
Gerald G. Austin Executive Vice President, retired Fleming Companies, Inc.	December 2007
John A. Brock Owner, Rockford Exploration	December 2008
John R. Elmburg Owner, Relco	December 2006
Jean McGill President, Noble Investments, Inc.	December 2004
Michael Mitchelson Attorney	December 2005

The Board was managed under contract by the Department of Commerce until 1994. From 1994 through 2000, the Board employed a small staff. In January 2001, management of the Board was privatized. According to correspondence from the Board, the basis for privatization was that "the board currently operates under a structural impediment that will...make it impossible to retain and employ top quality management. That structural impediment is the annual salary cap legislation that limits the salary of the chief executive officer to \$76,000 per year." In an effort to combat this situation, the OCIB solicited proposals from prospective companies to provide management services. OCIB eventually entered into a management services agreement with Institutional Equity Associates, LLC (EDGE or OCIB management) on January 1, 2001, to perform all management functions of the Board. Therefore, since this date, the Board has had no employees. The annual fee of the agreement with EDGE is \$443,500 with the term of the agreement being 15 years. In addition to the annual fee, the agreement provides for other performance-based fees discussed later in this report.

OCIB COMMENT - The annual fee to Edge fell within the amount previously budgeted by the Board for its FY2001 operations prior to the decision of the Trustees to privatize the management of the Board.

EDGE manages three programs on behalf of the Board:

- Venture Investing Program
- Oklahoma Capital Access Program
- New Program Development Initiatives – Although Oklahoma Equity Partners is a New Program Initiative, it will be reviewed as a part of the Venture Investing Program. Other activity related to New Program Initiatives appears to be minimal and will not be addressed further in this report.

The following timeline indicates key events in the OCIB's history:

- **1986**- The initial business plan and legislation for OCIB is drafted.
- **1987**- OCIB is created in HB 1444 as a division of the Oklahoma Development Finance Authority. \$50 million of tax credits were transferred to the Board.
- **1988**- Attorney General Robert Henry issues Opinion Number 88-20, confirming that the granting of tax credits to the Board, the transfer of tax credits by the Board, and the extensions of guarantees by the Board are constitutional.
- **1991**- Legislature passes HB 1697 authorizing OCIB to function as an independent trust.
- **1992**-Oklahoma Futures approves the Board's first business plan as an independent trust. The OCIB business plan is reviewed and approved each year until Oklahoma Futures is abolished in 2001.
- **1992**-OCIB engages the Capital Resources Division of the Oklahoma Department of Commerce as its manager.
- **1992**- OCIB launches the Oklahoma Capital Access Program (OCAP), enrolls its first participating banks and its first OCAP loans.
- **1992**-OCIB distributes its first request for proposal for venture funds.
- **1992**-OCIB elects to support the raising and investing of capital through an intermediary corporation. The Board solicits bids and selects Baker Capital to establish and operate the Oklahoma Capital Formation Corporation (OCFC).
- **1993**-OCIB launches the Venture Capital Investing Program.
- **1994**-OCIB employs staff as direct employees of the Board.
- **2000**-The Legislature passes HB 1375 to increase the Board's authorization level to \$100 million in tax credits.
- **2000**-OCIB elects to engage private managers, solicits bids, and selects Institutional Equity Associates, LLC (EDGE).

OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT

- **2004**-The Oklahoma Tax Commission and other state agencies (including OCIB) are sued. The suit challenges the state's use of tax credits. The Supreme Court accepts original jurisdiction and denies all relief.
- **2004**-OCIB creates Oklahoma Equity Partners, a special fund to accelerate Oklahoma investments.
- **2005**-OCIB joins with the City of Oklahoma City and private investors to support an investment in the National Basketball Association's New Orleans Hornets.

SCOPE

This audit was conducted pursuant to 74 O.S., § 213.2 and was performed in accordance with *Government Auditing Standards*. The audit period is July 1, 1993 through June 30, 2005.

OBJECTIVES

We identified the following as our objectives:

- 1) To determine the financial risk imposed on the state by the Venture Investing Program (VIP) and the Capital Access Program (OCAP);
- 2) To determine the effectiveness of the VIP and the OCAP programs as they relate to the OCIB's mission;
- 3) To determine if the OCIB is in compliance with applicable state statutes.

I. To determine the financial risk imposed on the state by the Venture Investing Program (VIP) and the Capital Access Program (OCAP)

METHODOLOGY

Internal controls in place were considered through interviews with OCIB management. In addition, the following procedures were performed:

- We reviewed the statutes applicable to OCIB.
- We interviewed OCIB's external auditors.
- We reviewed OCIB and OCFC audited financial statements and other documentation.
- We interviewed economists from the University of Oklahoma, Oklahoma State University, and the University of Central Oklahoma.
- We interviewed the trustees of the OCIB.

OBSERVATIONS

An Overview of the Venture Investing Program (VIP)

Venture capital is defined by the National Venture Capital Association as money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. The VIP is designed to support the funding of venture capital pools.

The key component of the VIP is the \$100,000,000 in Oklahoma tax credits authorized by 74 O.S., § 5085.7. The OCIB is authorized to sell the credits only upon a legitimate call on a Board guarantee with no more than \$20,000,000 in tax credits sold annually. Four entities have signed agreements to purchase up to an aggregate of \$8,000,000 per year of the tax credits through July 1, 2015.

The tax credits are purchased dollar for dollar. As of June 30, 2005, no credits have been sold.

Using the tax credits as a guarantee, OCIB secures a line of credit (LOC) with a local lender. Draws made against the LOC are then used by a third party, the Oklahoma Capital Formation Corporation (OCFC), to make investments in venture capital (VC) funds. A VC firm then invests the funds, along with other leveraged and co-invested funds, into companies that represent the opportunity for a high rate of return within five to seven years. OCIB management states they attempt to invest in VC funds looking to invest in Oklahoma companies; however, there is no requirement that the VC fund do so.

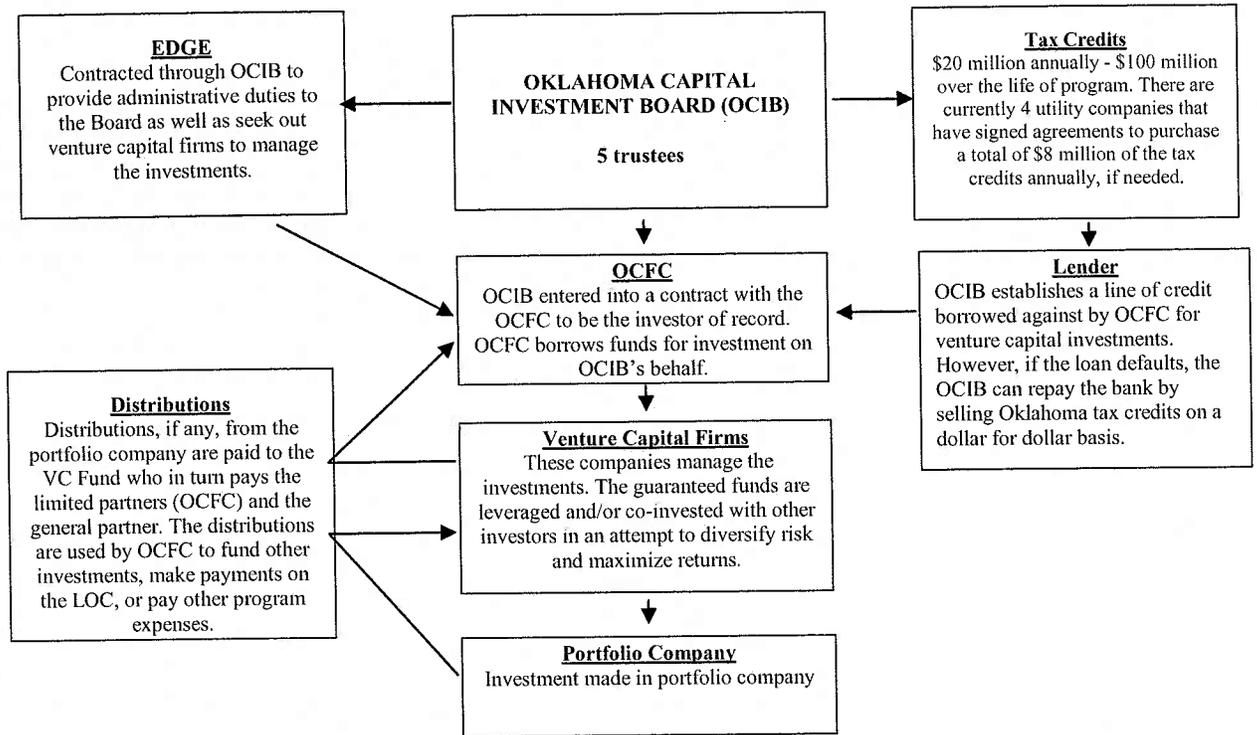
OCIB COMMENT - Across its portfolio of investments the Board is obligated to ensure at least \$2 is invested in Oklahoma for \$1 it guarantees. Through experience the Board has learned the best way to achieve this is to select experienced, professional firms that work hard to invest in the State on a best efforts basis. OCIB only invests in VC funds that have a strong plan for identifying qualified Oklahoma companies for investment. OCIB obligates its portfolio funds to expend significant time, effort and energy working hand in hand with local entrepreneurs and investors. The result of this approach has been a level of investment in Oklahoma projects that far exceeds the amounts invested by OCIB in funds.

When the VIP was created, there was some question as to whether the OCIB could directly invest in private companies as Article 10, Section 15 of the Constitution prohibits the State from directly investing in a private entity. Because of this, the OCIB elected to use an intermediary as part of its structure and entered into a contractual relationship with the OCFC in 1992. Under this relationship, OCFC borrows against OCIB's LOC with a local lender, invests the funds with a venture capital firm, and serves as the investor of record. Therefore, the investment is made in the name of the OCFC rather than the OCIB even though the OCIB is guaranteeing the funds used to purchase the investment.

OCIB COMMENT - OCFC was selected through a public bid to serve this role.

It should be noted that VIP and venture capital investing is not unique to Oklahoma. Numerous states have used the OCIB model to implement venture investing programs designed to spur economic development. Iowa, Arkansas, South Carolina, Michigan, Montana, Utah, Ohio, and Hawaii all have programs modeled after Oklahoma. Other states such as Louisiana, Florida, Missouri, Wisconsin, New York, and Colorado use a CAPCO (Certified Capital Company) program. Under this program, a state provides upfront tax credits to insurance companies in exchange for the companies providing cash to the CAPCO's. The CAPCO's then use the funds to invest in qualifying businesses. Other states such as Connecticut, Maryland, and Massachusetts have the ability to directly invest in a private company. The following chart summarizes the VIP:

**OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT**



OCIB COMMENT - OCIB holds all assets for the benefit of the State. All profits from the portfolio of investments go to OCIB and ultimately the State.

AUDITOR'S RESPONSE- Although the program is intended to return profits to the State, to date, this has not occurred. All profits have been used to satisfy the debt of the program and/or other operating costs. The only time profits would be returned to the State is when the program is operating debt free.

Fees associated with OCIB / OCFC relationship

The following briefly describes the fees associated with the OCIB /OCFC relationship:

- **Guarantee Origination Fee** - The OCFC is charged a guarantee fee by OCIB each time they close on a commitment to a venture fund. This fee is based upon the size of the commitment and the life of the fund. For example, the commitment fee is 2% of the commitment amount times the life of the fund in terms of years (e.g., 13 years). For example, the guarantee origination fee on a \$5 million commitment would be as follows:

$$\$5,000,000 * 2\% * 13 = \$1,300,000$$

The origination fee and supplemental fee together is meant to compensate the OCIB for the risk it bears in guaranteeing the investment. The total guarantee fees since inception of the program total \$15,822,183; however, only \$5,392,288 has been paid to OCIB by OCFC. The difference of \$10,429,895 is reflected as an accounts receivable on the OCIB financial statements.

When asked why the receivable continues to grow each year, management of the OCIB stated that the Board only requires payment when it needs to cover expenses.

- **Supplemental Fee** – A fee received by OCIB that is generally equal to all of OCFC’s net income, as defined in the advisory agreement between OCFC and OCIB.

The following table illustrates the guarantee origination and supplemental fees since the program’s inception.

Table 1 – OCIB/OCFC Fees	
Year	Guarantee Origination and Supplemental Fees
1994	\$1,120,000
1995	960,000
1996	572,000
1997	2,430,568
1998	260,000
1999	780,000
2000	-0-
2001	3,517,658 ¹
2002	3,838,435
2003	1,545,913 ²
2004	2,495,217
2005	1,300,000
Total	\$18,819,791

SOURCE: OCIB and OCFC financial statements 1993-2005

As discussed later in the report, should the relationship between OCIB and OCFC dissolve, the fees identified in Table 1 would no longer exist.

OCIB COMMENT - The purpose of the Origination and Supplemental Fees is to assure that profits from the Board’s programs go to OCIB and ultimately the State.

AUDITOR’S RESPONSE- Although the program is intended to return profits to the State, to date, this has not occurred. All profits have been used to satisfy the debt of the program and/or other operating costs. The only time profits would be returned to the State is when the program is operating debt free.

Fees associated with the management agreement and venture capital firms

The following briefly describes the fees associated with the EDGE management agreement and the venture capital firms:

- **Management Service Agreement** – A flat fee of \$443,500 is paid annually to EDGE by OCIB. (A small portion of this fee may be attributable to the OCAP.) The following two fees are also included in the agreement:

¹ This total is comprised only of a supplemental fee. To date, this is the only supplemental fee recorded during the life of the program. There were no guarantee origination fees received during 2001.

² Net of a \$390,000 reduction in 2003.

**OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT**

- Variable Fee equal to .35% of the amount of each commitment by OCFC to a new fund;
- Participation fee of an amount equal to 10% of the amount of: (i) the aggregate amount of cash distributions to OCFC from all new funds, **less** (ii) the aggregate amount of capital contributed by OCFC to all new funds, **less** (iii) the aggregate amount paid as annual base fees during the lives of new funds, **less** (iv) the aggregate amount paid as variable management fees with respect to new funds, **less** (v) interest on the OCFC line of credit to the extent allocable to amounts drawn to fund capital contributions to new funds and variable management fees paid with respect to new funds.

OCIB COMMENT - As a point of reference, OCIB believes it should be noted that some states pay as much as \$300,000 to groups to manage capital access programs. Massachusetts would be one example.

- **Venture Capital Firms** – A management fee is typically charged by VC firms to cover the costs of managing the fund’s committed capital. The fees associated with each of the funds are not known.

Other general operating expenses such as legal fees, accounting fees, travel, etc. are also incurred in operating the VIP and OCAP. Table 2 presents the various fees and operating costs incurred with operating the programs administered by OCIB.

Table 2 – Fees and Operating Costs			
Year	Management Fees	Other Operating Expenses	Total
1994	\$-0-	\$369,372	\$369,372
1995	-0-	343,174	343,174
1996	-0-	362,896	362,896
1997	-0-	420,162	420,162
1998	-0-	373,382	373,382
1999	-0-	350,353	350,353
2000	-0-	335,723	335,723
2001	221,750	182,681	404,431
2002	467,563	115,903	583,466
2003	496,000	59,088	555,088
2004	539,192	114,555	653,747
2005	561,156	121,253	682,409
Total	\$2,285,661	\$3,148,542	\$5,434,203
VC Fund Level Fees			\$4,000,000 ³
Total Fees and Operating Costs			\$9,434,203

Source: OCIB and OCFC financial statements 1993-2005, with the exception of the VC Fund Level Fees explained in the footnote below.

OCIB COMMENT - The increase in fees from 2002 through 2005 is investment related. Over this period the Board more than doubled its investment activity,

³ The exact amount of fees charged by the VC firms is not known. OCIB indicates that over the first 3 to 4 years of the fund’s life, a firm typically charges 2.5% of the amount committed. The fee then reduces over the remainder of the term based on the negotiated terms of the contract. We have estimated the fee assuming a fee of 2.5% of the amount committed for the first three years of the term of the commitment. Therefore, the amount presented is a conservative estimate of the fees charged by these firms.

which resulted in more variable management fees, legal expenses and other deal related costs.

In addition to the fees and operating costs above, OCFC has also incurred \$8.3 million in interest expense as of June 30, 2005.

Debt Created by the VIP

When the VIP program was created, it was done so with the premise that the proceeds from investments made with the VC funds would cover the costs to operate the program without the issuance of tax credits. This means the investment proceeds would be enough to satisfy both the debt created by borrowing against the LOC and the fees and operating costs of the program. While no tax credits have been issued, this does not mean the investment proceeds have been sufficient to support the VIP.

As previously discussed, the investments made in the VIP are generally funded with draws made against a LOC with a local lender. As of June 30, 2004, OCIB had a guaranteed LOC of \$30 million. At this time, the debt on the LOC was \$26.9 million and was due on January 30, 2006. Also, the VIP had commitments at that time of \$22.8 million. Because the debt was approaching the LOC limit, only \$3.1 million remained to fund future commitments. As a result, the OCIB approved an increase in the borrowing limit to \$55 million during fiscal year 2005. The additional borrowing capacity allowed OCIB to obtain a term note for \$25 million, and use the proceeds of the note to pay down the LOC. This freed up additional funds on the LOC that OCFC could then borrow against. Table 3 shows borrowing capacity and the balance of the debt by fiscal year.

Table 3 – Schedule of Long Term Debt				
Date	Type of Debt Instrument	Borrowing Capacity	Balance of Debt	Due Date
6-30-93	LOC	\$3,140,000	\$670,350	7-15-95
6-30-94	LOC	3,140,000	1,636,000	7-15-95
6-30-95	LOC	10,000,000	3,912,857	7-15-97
6-30-96	LOC	10,000,000	6,844,346	7-15-97
6-30-97	LOC	17,500,000	10,487,137	12-31-98
6-30-98	LOC	17,500,000	15,911,095	11-30-99
6-30-99	LOC	25,000,000	17,451,732	11-30-99
6-30-00	LOC	25,000,000	13,193,912	11-28-00
6-30-01	LOC	30,000,000	14,252,564	11-28-01
6-30-02	LOC	30,000,000	18,796,648	11-28-03
6-30-03	LOC	30,000,000	23,234,380	11-28-03
6-30-04	LOC	30,000,000	26,931,622	1-30-06
6-30-05	LOC/Term Note	\$55,000,000	\$31,154,440	7-31-06/07 ³

Source: OCFC financial statements 1993 - 2005

We noted that the due date for the LOC was extended frequently. However, management states this is a result of the banks providing a better interest rate for short term finance. As a result, the LOC is periodically refinanced to extend the due date.

³ The due date for the LOC is July 31, 2006, while the due date for the term note is July 31, 2007.

**OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT**

Since fiscal year 1993, OCFC has borrowed \$56.7 million against the LOC while repaying \$25.6 million. These borrowed funds were used to make investments and pay fees and operating costs of the program. The following table illustrates the amounts borrowed and payments made against the LOC and the term note:

Table 4 – Borrowings and Payments Made			
Year Ended June 30,	Amount Borrowed	Payments	Outstanding Balance
1993	\$670,350	\$ 0	\$670,350
1994	965,650	0	1,636,000
1995	2,276,587	0	3,912,587
1996	3,621,946	690,187	6,844,346
1997	4,110,833	468,042	10,487,137
1998	6,549,953	1,125,995	15,911,095
1999	6,405,845	5,102,208	17,214,732
2000	4,738,730	8,759,550	13,193,912
2001	3,438,087	2,379,435	14,252,564
2002	8,962,451	4,418,367	18,796,648
2003	4,437,732	0	23,234,380
2004	5,221,045	1,523,803	26,931,622
2005	5,380,629	1,157,810	\$31,154,441
TOTAL	\$56,779,838	\$25,625,397	

Source: OCFC financial statements 1993 – 2005

Note that in addition to the \$31,154,441 in debt outstanding, the OCIB has an additional \$23.9 million committed but unfunded as of June 30, 2005. While dependant upon the distributions received from OCIB's current investments, it is likely that a large portion of these commitments will be funded through borrowing against the LOC. Therefore, unless the distributions from current investments are greater than the commitments funded, the outstanding debt balance will continue to increase.

We recognize that it is not possible to predict the success or failure of the VIP's current portfolio of investments; however, based solely on the amount of distributions received to date from the VIP, the question arises as to whether the VIP will generate enough distributions to service the outstanding \$31.1 million debt. The following table illustrates the distributions received by OCFC from amounts invested:

Table 5 – Cash Proceeds from Limited Partnerships	
Financial Statement Date	Cash Proceeds
6-30-93	\$0.00
6-30-94	0.00
6-30-95	0.00
6-30-96	690,187
6-30-97	468,042
6-30-98	979,846
6-30-99	5,102,208
6-30-00	8,759,551
6-30-01	2,379,434
6-30-02	918,367
6-30-03	816
6-30-04	1,571,975
6-30-05	1,137,833
TOTAL	\$22,008,259

SOURCE: OCFC financial statements 1993 – 2005

Cash proceeds represent cash distributions and proceeds from sale of investment securities.

If the future distributions are not sufficient and the debt is called by the lender, OCIB has no recourse other than to sell tax credits to service the debt. During our interviews with OCIB trustees, all five indicated the Board is considering selling tax credits to reduce the debt.

Transparency of the VIP Appears Limited

The OCIB and the OCFC prepare separate financial statements and both receive separate, independent audits. As an entity of the State of Oklahoma, OCIB’s annual financial statements are made available to anyone upon request. However, as a private corporation, the OCFC financial statements have not been provided by OCIB to outsiders other than on a confidential basis. For example, at the onset of our audit, we were asked to sign a confidentiality agreement with OCIB management to obtain copies of the OCFC financial statements. After obtaining the OCFC financial statements, we determined that by viewing only the OCIB financial statements, it is difficult to get a clear indication of the financial condition of the VIP since the debt and investments of the VIP are carried on the OCFC financial statements.

OCIB COMMENT - There are statutory restrictions on how OCIB is to treat confidential information. Title 105, Subchapter 1-3-4 of the Rules which govern the Board provides the following guidelines.

“Confidential or commercially sensitive information

Any information submitted to or compiled by the Oklahoma Capital Investment Board with respect to the marketing plans, financial statements, trade secrets, research concepts, methods or products, or any other proprietary information of firms, persons, associations, partnerships, agencies, corporations, or other entities shall be confidential except to the extent that the person or entity that provided such information or that is the subject of such information consents to disclosure. [74:5085.6]”

OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT

During the course of our audit, OSF requested and obtained a copy of the OCFC June 30, 2005 audited financial statements from OCIB management. After reviewing the report and analyzing the relationship between OCIB and OCFC, OSF made the determination that the two entities should be blended together for financial statement presentation in the State of Oklahoma's CAFR. The CAFR is prepared by OSF and serves as the annual financial report for the State of Oklahoma. The report is provided to legislative leaders and other groups, including bond rating agencies that use the CAFR to assess the creditworthiness of the State. A blended presentation is one in which the governmental unit's financial results (OCIB) are combined with those of another entity (OCFC), so that only the combined results are presented. Based on Governmental Accounting Standards Board Statement No. 14, OSF concluded that a blended presentation is appropriate as it would be misleading to exclude OCFC due to the nature of its relationship with OCIB. In effect, OCFC is in existence solely because of the OCIB.

We believe the lack of transparency for the VIP is a significant issue as legislative leaders and decision makers should be made aware of the financial risk to the state. The financial risk and the amount of potential tax credits to be issued would also appear to be important to the State Board of Equalization as the issuance of the tax credits would have an impact on State tax revenue and therefore impact the monies available for appropriations to fund State operations and programs.

OCIB COMMENT - It has been the Board's belief and the understanding of OCIB's external auditors that OCIB's past financials have included all the relevant OCFC information in footnote form. However, we understand how a reader may find the information difficult to understand. In an effort to avoid confusion, OCIB has taken steps to eliminate the issue.

Counsel to OCIB researched the possibility of OCIB acquiring OCFC and concluded, with the benefit of recent case law, that an acquisition is possible. The Board, in its meeting of December 8, 2005, resolved to acquire OCFC and thereby roll it into the OCIB. It is intended that the future financial statements of OCIB and OCFC will be presented on a consolidated basis.

An Overview of the Oklahoma Capital Access Program (OCAP)

The OCAP provides a tool for lenders to make commercial loans to borrowers that may not have qualified to borrow the funds under a typical loan agreement. The lender submits between 3% and 7% of the enrolled portion of the loan to OCIB and OCIB matches this portion 150%. The match drops to 100% after the lender has enrolled \$3,000,000 in the program. These funds are held in a reserve account that may be paid to the lender should the lender suffer a loss on an enrolled loan. The payment from the reserve account is paid to assist the lender to recover a portion of their loss. If the loan does not suffer a loss, the reserve will continue to build as additional loans are enrolled into the program. OCIB is authorized to sell tax credits to cover an OCAP loss as well.

OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT

Since the inception of the OCAP program, the following has been received by and paid from the reserve account as of June 30, 2005:

Fees received from lenders	\$1,067,093
OCIB fees paid into reserve	<u>\$1,524,424</u>
Total fees received	\$2,591,517
Claims paid	<u>\$1,632,575</u>
Total reserve account	\$958,942

Source: OCIB financial statements 2005

The claims paid out under the OCAP program constitute a legitimate call on an OCIB guarantee. Therefore, OCIB has the right to sell tax credits in the future to reimburse itself for the \$1,632,575 in cash paid out. However, to date no tax credits have been sold.

Potential Financial Risk to the State Created by VIP and OCAP

Based on conversations with OCIB's external auditors and review of the OCIB and OCFC financial statements, we determined the following to be the potential risks to the State:

- **\$23,994,112** – This is the amount of unfunded commitments pledged by OCIB to certain venture capital firms. These commitments will be funded through either borrowing against the line of credit or through distributions on the Board's investments. However, the more likely scenario would be borrowing against the line of credit. While the commitments have yet to be paid, it is OCIB management's position that once a commitment is made, an attempt to breach it would likely result in 50% or more of the funds being lost.
- **\$31,154,440** – This is the outstanding debt associated with the line of credit and the term note payable to the lender. It should be noted that \$1,632,575 in claims were paid under OCAP. As stated previously, OCIB has the authority to sell tax credits to reimburse itself for cash paid out under OCAP. The 1.6 million is not identified separately under the assumption that the funds were paid from borrowing against the LOC.
- **\$958,942** – This the total of the reserve account in the OCAP program. Should this account be paid to lenders, it would create a legitimate call on an OCIB guarantee and tax credits could be sold to cover the amount paid.

When considered in the aggregate, it appears the potential monetary risk to the State at June 30, 2005, is **\$56,107,494**.

Some or all of \$32,113,382 (31,154,440 + 958,942) of the risk may be minimized through the investments the OCFC currently holds. According to the June 30, 2005 financial report, the investments held by OCFC have a value of \$13,617,585; however, because the nature of these investments is that they are long-term, the ultimate value of the investments will not be known until exiting the investment in the portfolio company. The \$23,994,112 is not included in this comparison because the commitments will be used to purchase future investments of which the value is not known at this time.

OCIB COMMENT - It may be helpful to state the **net contingent cost**, which reflects the carrying value of both assets and liabilities. The Auditor reflects a liability of \$56,107,494. Of this total \$55,148,552 represents liabilities of the

Board, \$958,942 of the risk total is exposure under the OCAP and, per OCIB's external auditors, is not a recognized liability of the Board. The corresponding value of assets is the unfunded commitment of \$23,994,112 plus the reported value of \$13,617,858, or a total of \$37,611,697. **The net contingent cost is therefore the difference of \$17,536,855.** In the judgment of the Board, this is the most accurate way of understanding the extent to which the Board's portfolio is at risk. About half this amount can be attributed to the Board's new, or third, portfolio, built since 2001. When the Board builds a new portfolio it holds the assets past the trough of the "J Curve" cycle, the time in the early life of venture funds when costs are incurred while revenues are absent. The other half can be attributed to losses sustained by the Board in its second portfolio, which suffered through the internet crash. The Board may elect to provide for the latter through the sale of tax credits. Or, the Board may elect to continue to absorb these losses until the final performance of the second portfolio becomes known. All funds in the second portfolio are actively harvesting investments and the final values are not yet known. These matters are regularly reviewed by OCIB Trustees.

Other State Tax Credit Programs

Once the potential financial risk created by VIP and OCAP were determined, we attempted to put this risk in perspective by comparing the risk created to tax credits issued under two other tax credit programs, the Small Business Capital Formation Incentive Act and the Rural Venture Capital Formation Incentive Act. These programs were created by 68 O.S., § 2357.60 and 68 O.S., § 2357.71, respectively. Both programs provide a tax credit equal to a percentage (20% for small business and 30% for rural) of the cash amount invested in a qualified small business capital company or qualified rural small business capital company. Both acts require the Oklahoma Tax Commission to annually submit a report to the Speaker of the House of Representatives and President Pro Tempore of the Senate regarding the amount of credits actually claimed and allowed and the amount of credits likely to be claimed and allowed for the following year (the credits can be used over a ten year period). We asked OTC to provide the reports submitted; however, we were told no reports have been submitted.

As a result, we attempted to determine the following:

- Investments provided to small business capital companies
- Actual investments made in Oklahoma companies
- Total credits allowable
- Actual credits claimed
- Unused credits carried forward to future years

Small business capital companies must file a Form 527, *Small Business Capital Company Information Report*. This report indicates the amount provided by each investor to the small business capital company and the amount subsequently invested in an Oklahoma company. Form 527-A, *Small Business Capital Company Report for Investors*, is filed by the investor with their annual state tax return. This form indicates the amount invested, the credit allowable in the current year, the credit claimed in the current year, and the credit carried forward to future years.

We asked OTC to provide the two forms submitted for the years 1998 through 2004. OTC provided the forms for the years 2002 through 2004; however, no forms were provided for other years. After reviewing the forms provided, we

determined that we could not satisfy ourselves as to whether we had obtained all forms. Because we did not believe our information to be complete, we were not able to determine the investments provided to small business capital companies, the actual investments made in Oklahoma companies, the total credits allowable, the actual credits claimed, or the unused credits carried forward to future years.

RECOMMENDATION

As shown above, the potential risk to the State created by VIP and OCAP is significant, especially the risk associated with VIP. However, given the type of investment activity in the VIP, it would be unlikely that a program of this type would be entirely free of financial risk. The question then arises as to how much risk the State is willing to bear. In order to answer this question, one must be aware of the financial risk involved and also know the economic impact the VIP is having on the State. Performance measures relating to the economic impact of the VIP are discussed in Objective II of this report.

In order for the Governor, legislature, and citizens to have the information to determine the potential financial risk, we recommend the VIP become more transparent. In order to accomplish this, we recommend the OCIB consider ending their relationship with OCFC. As stated previously, OCFC's involvement in the VIP was due to a question as to whether OCIB could directly invest in a private entity. We have reviewed correspondence between OCIB and their legal counsel addressing the issue of whether OCIB could directly invest in a private entity. OCIB's legal counsel concluded they did in fact have such authority. We have read the basis for their conclusion, and believe the conclusion has merit. However, we are not making any legal determination on this conclusion and would recommend the OCIB obtain an Attorney General's opinion on the matter.

Should the relationship with OCFC be eliminated, OCIB would become the investor of record and all financial activity related to the VIP would be reported in OCIB's annual financial statements, which would be a matter of public record. In addition, fees between the two entities such as guaranty origination fees, supplemental fees, fee rebates, and general operating costs of the OCFC would be eliminated from the VIP. The guaranty origination fees, supplemental fees, and fee rebates are payable between OCIB and OCFC, so eliminating these would not necessarily be a reduction in costs related to operating the VIP. However, eliminating the general operating costs of the OCFC would appear to be a savings to the overall operation of VIP. Since inception of the program, \$734,852 in operating costs has been incurred by OCFC. In addition, as a private corporation, OCFC is subject to state and federal taxes. As a result of eliminating OCFC from the VIP, distributions from investments would be received directly by OCIB thereby eliminating potential tax liability. This would in turn reduce the costs of operating the VIP.

OCIB COMMENT - Due to the structure of the past relationship between OCIB and OCFC, OCFC has not incurred any state or federal income tax liability. Origination and Supplemental Fees charged by OCIB have eliminated this exposure. It should also be stated that to simplify this relationship OCIB will be acquiring OCFC and rolling it into OCIB. Future financials will be presented on a consolidated basis.

In addition, we recommend the OTC prepare and submit the reports related to the Small Business Capital Formation Incentive Act and the Rural Venture Capital Formation Incentive Act required by 68 O.S., § 2357.65 and 68 O.S., § 2357.76.

AUDITOR'S COMMENT - OTC management was given the opportunity to provide a response to the last recommendation and declined to respond.

II. To determine the effectiveness of the VIP and the OCAP programs as they relate to the OCIB's mission

METHODOLOGY

Internal controls in place were considered through interviews with personnel from OCIB. In addition, the following procedures were performed:

- We reviewed the fiscal year 1993 through 2005 OCIB and OCFC financial statements.
- We reviewed schedules provided by venture capital firms noting amounts invested into Oklahoma.
- We researched the portfolio companies in which the venture funds invested to determine if they had Oklahoma operations.
- We reviewed 74 O.S., § 5085.1 through 11.
- We interviewed economists from the University of Oklahoma, Oklahoma State University, and the University of Central Oklahoma.
- We selected a sample of loans enrolled in the OCAP to ensure the borrowers were eligible to participate.
- We sent a survey to 16 lenders asking their opinion of the OCAP.
- We interviewed the trustees of the OCIB.

OBSERVATIONS

OCIB Direct Investments into Oklahoma Should be Tracked

Since the inception of the VIP and through June 30, 2005, approximately \$99.8 million has been invested in 18 companies based in Oklahoma or with an Oklahoma presence. This amount is comprised of OCIB's direct investment, leveraged funds, and co-invested funds. Of the \$99.8 million invested in these companies, \$73.8 million was provided by co-investors. The remaining \$26 million includes OCIB's direct investment plus other leveraged funds. We inquired of OCIB management regarding how much of the \$26 million was OCIB's direct investment (i.e., the amount guaranteed by the state) and were told this was a measure they did not track. They believe that the more important measure is the total investment made in Oklahoma companies regardless of the source of the investment. Because the amount of direct investments is not tracked on a company-by-company basis, this also precludes us from determining the amount of OCIB investments that went to out-of-state portfolio companies. However, we noted that throughout the life of the VIP, OCIB has had an interest in 162 portfolio companies. As previously stated, 18 of these companies were Oklahoma based or had an Oklahoma presence. The remaining 144 were located outside of Oklahoma. The Oklahoma based portfolio companies represents 11% (18/162) of the total portfolio companies OCIB has had an interest in.

OCIB COMMENT - The Board believes the most meaningful number to track is the volume of venture capital that ends up in the hands of Oklahoma companies, whether that comes from a Board-supported venture fund or a co-investor fund (a venture fund recruited to an Oklahoma deal by a Board-supported fund). OCIB's capital represents less than 6.5% (62/965) of the total capital that has been raised by Board supported venture capital funds, while 11% of all companies have been in Oklahoma. As of June 30, 2005 the Board had

committed \$62 million to fund managers that raised \$965 million in total capital. By only representing 6.5% of the total capital pool, the Board is able to mitigate risk by creating a diversified pool of investments. As well, this approach has enabled OCIB to leverage its resources by attracting both capital and professional investment talent to Oklahoma.

RECOMMENDATION

While determining the amount of direct investments on a company-by-company basis is not considered significant to OCIB, we believe this is an important measure for the state's leadership and its citizens to have a clear indication of OCIB's direct involvement in Oklahoma companies. Therefore, we recommend the Board determine a mechanism for tracking their direct investments (less leveraged funds) into Oklahoma companies and include this information in OCIB's annual report provided to the Legislature in accordance with 74 O.S., § 5085.9.

OBSERVATIONS

Measures to Assess Economic Impact of VIP Should be Developed

OCIB's primary measure of the economic impact of the VIP is the amount of funds invested into Oklahoma. 74 O.S., § 5085.3 defines the mission of the Board as "...to mobilize equity and near-equity capital for investment in such a manner that will result in a significant potential to create jobs and diversify and stabilize the economy of the State of Oklahoma." Based on this mission, it appears the Board was established to be an economic development vehicle. The amount invested into Oklahoma as a result of the VIP program is an important measure; however, it alone does not appear sufficient to measure the economic impact the program has on the State.

We interviewed economists from the University of Oklahoma, Oklahoma State University, and the University of Central Oklahoma to determine if, in their opinion, dollars invested is a sufficient measurement of the effectiveness of this program. All agreed that this measurement by itself is not an adequate indicator of economic development.

OCIB COMMENT - Based upon the need for an in depth analysis the Board hired Applied Economics of Phoenix, Arizona to perform an economic impact analysis of the Board's programs. OCIB selected Applied Economics based upon the recommendation of the Oklahoma City Chamber of Commerce. The report showed the following:

- The OCIB has had a total economic impact of \$881.3 Million on the Oklahoma economy over the past 13 years as a result of the venture capital and capital access programs. These programs assisted over 780 companies during this time period.
- The largest component of the impact is from the venture investment program. The 19 companies in this program, each of which participated for multiple years, supported 7,100 jobs over the multi-year period and \$157.8 million in payroll.
- As a result of the multiplier effect, the total impact of the companies in the venture investment program on the State of Oklahoma was \$695.7 million in increased economic activity, 10,600 jobs and \$252.5 million in payroll. This includes jobs and payroll at participating companies as well as jobs and payroll at other local businesses.

**OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT**

- The capital access program has assisted 760 small and medium sized companies since its inception in 1992. Of these 760 companies, 331 provided enough information to calculate impacts. These 331 companies created 1,175 new jobs and \$33.1 million in payroll.
- The total economic impact of the capital access program, including additional supported jobs and payroll at other local businesses was \$185.6 in increased economic activity, 2,100 jobs and \$61.3 million in payroll.

Source: Applied Economics/Economic Impacts of the Oklahoma Capital Investment Board's Venture Investment Program and Oklahoma Capital Access Program, February 2006. <http://ocib.org>

As previously stated, since 1993 the VIP invested close to \$100 million dollars in 18 Oklahoma companies or companies with an Oklahoma presence. Of these 18, two have ceased operations while five others have moved their Oklahoma operations out of state. Table 6 provides information regarding the amounts invested in these companies.

Table 6 – Dollars Invested In Oklahoma					
	Companies that went out of business	Companies that left the state	Total	Total Portfolio Companies Receiving the Investment	Percentage of Total
Number	2	5	7	18	38%
VC Fund Investment	\$10,871,222	\$5,535,985	\$16,407,207	\$26,028,682	63%
Co-Investment	\$25,033,911	\$7,526,979	\$32,560,890	\$73,748,422	44%
Total invested and co-invested	\$35,905,133	\$13,062,964	\$48,968,097	\$99,777,104	49%

*Source: VC Firm confirmation statements provided by OCIB management
The VC Fund Investment amounts include both the OCIB direct investment plus leveraged funds.*

This table is further evidence why only the amount invested is not a sufficient measure of the success or failure of the VIP. As shown above, close to one-half of the dollars invested in Oklahoma companies appear to have failed to have a long-term impact on the State as they are no longer in operation or have left the state.

OCIB COMMENT - The rate of business success of 49% reflected in this chart compares favorably to the national success rate of 39.5% as reported by the U.S. Census Bureau's Business Information Tracking report. This rate covered the period of 1989-1998.⁴

OCAP Aids Borrowers in Obtaining Loans

As of June 30, 2004, there have been approximately 1,250 loans enrolled in OCAP. We judgmentally selected 75 of these loans to ensure the lender signed the OCAP filing form. By signing this form, the lender is stating the borrower is eligible to participate in the program and that they have complied with Section 2.3 of the Oklahoma Capital Access Agreement (OCA) which includes a statement that "the proceeds and the loan will be used for an Oklahoma business

⁴ Headd, B., 2001, Business Success: *Factors Leading to Surviving and Closing Successful*, Discussion Paper, CES 2001-01. Washington, D.C.: Bureau of the Census, Center for Economic Studies.

purpose and that at least 50% of the employees or assets of the business or project financed by the loan will be located in Oklahoma.”

Of the 75 loans tested, we noted all OCAP filing forms were signed by the lender. In addition, we sent a survey to the 16 lenders that had made the 75 loans asking their opinion of the program and to confirm the loan data provided by OCIB. Of the ten lenders that responded, all confirmed the loan data to be correct. The following table is a summary of two of the survey questions asked:

Table 7- Summary of OCAP Survey Responses			
	Yes	No	Did Not Answer
1. Would your bank have made the loan if OCAP were not available?	1	8	1
2. In your experience with the program, do you feel it provides the potential to create jobs and diversify the economy in Oklahoma?	6	2	2
<p>3. We also asked the lenders to provide any other information that would help us in evaluating the OCAP program. Following were the responses provided:</p> <p style="text-align: center;">-----</p> <p>“The program has been simple in its implementation and effective in providing an alternative method in which to extend credit to local Oklahomans.”</p> <p>“This program has been useful for the bank. It has helped to provide opportunities to our customers whose margins are somewhat tight without compromising the bank’s lending integrity.”</p> <p>“Although our bank has not made a huge number of loans enrolled in the OCAP, all of the enrolled would not have been made otherwise, and we would probably not have pursued an SBA guarantee because of the complexities involved.”</p> <p>“We have been with the program for many years and use it consistently throughout the year. We think the program makes us a more competitive bank and it allows us to keep credit flowing in our community. The program is easy to use and easy to understand.”</p>			

Source: OCAP Lender Surveys

RECOMMENDATION

As discussed in the preceding objective, the question was raised as to how much risk the state was willing to bear under the VIP. One of the key components in making this determination is having knowledge of the economic impact the VIP has on the State. As stated, \$99.8 million has been invested in Oklahoma through the VIP. While this likely had a positive economic impact, the level of the impact is unknown as no performance measures exist to make this determination. Without adequate performance measures, it is not possible to make a judgment about whether the results of the program are worth the financial risk to the state.

According to the Governmental Accounting Standards Board, “Performance measures are meant to provide more complete information

about an entity's performance than do traditional budgets or financial statements and schedules. Primarily, performance measures are concerned with the *results* of the services delivered by the government. Subsequently, they help to provide a basis for assessing the economy, efficiency, and effectiveness of those services."

We recommend the OCIB develop performance measures to aid the Governor, legislature, citizens, and the Board itself in determining the effectiveness of the VIP. The Board may consider seeking input from The Oklahoma Academy for State Goals to aid in this endeavor.

OCIB COMMENT – The Board agrees more comprehensive performance measures are needed and commits to producing these. The Board believes the economic impact achieved to date is dramatic in relation to the risks borne by the State in delivering the program. The Board believes entrepreneurs hold enormous potential to build new businesses and whole new industries in Oklahoma. A process for selecting the very best entrepreneurs, and supporting these with investment capital and business building talent, is the best strategy for producing high-quality economic development. The Board believes the Legislature understands this bargain and the risks assumed by the State when adopting the program in 1991 and doubling the Board's authority in 1999.

III. To determine if the OCIB is in compliance with applicable state statutes.

METHODOLOGY

Internal controls in place were considered through interviews with personnel from OCIB. In addition, the following procedures were performed:

- We reviewed 74 O.S., § 5085.1 through .11.
- We reviewed schedules provided by venture capital firms identifying amounts invested into Oklahoma.
- We interviewed OCIB's external auditors.

OBSERVATIONS

\$2 to \$1 Requirement Appears To Have Been Met

We reviewed 74 O.S., § 5085.1 through .11, and analyzed the significance of each statute to the overall mission of OCIB. While there were various statutes related to OCIB we determined that, from a compliance aspect, many were relatively insignificant in relation to the overall mission of the Board. We did note one compliance issue that we considered significant. 74 O.S., § 5085.8 B. states in part "...The Board shall ensure that at least Two Dollars (\$2.00) will be invested in Oklahoma businesses or projects for every One Dollar (\$1.00) of principal guaranteed by the Board." As of June 30, 2005, the OCIB has guaranteed through VIP \$48,334,932 since the inception of the program. This statute would require at least \$96,669,864 (\$48,334,932 X \$2) be invested in Oklahoma businesses. We were provided a schedule prepared by OCIB representing the Oklahoma investments. We agreed the investments presented on the schedule to confirmations of the invested amounts provided by the venture capital firms to OCIB's independent auditor. Based on this information, \$99.8 million has been invested in Oklahoma-based companies or companies with a presence in Oklahoma. Therefore, based on this analysis, the Oklahoma investments exceeded the requirement by \$3.1 million.

OCIB COMMENT - The calculation used to achieve the \$3.1 million figure does not take into account the Board's OCAP program or debt that has been

attracted to Oklahoma companies supported by the Venture Investing Program. The legislature adopted governing language in the form of rules that describe its intent. This language is presented below.

We did note during discussions with OCIB management that they also consider the loans made under the OCAP to determine compliance with this requirement. Although open to interpretation, it is our position that the purpose of this requirement is to ensure that a portion of the investments guaranteed by the Board through the VIP are made in Oklahoma companies. We believe the requirement would apply to VIP investments only, as evidenced by use of the term “invested” in the statute. Under the OCAP program, loans are made by lenders and as discussed in Objective II, the Board is guaranteeing only a small percentage of the amount loaned. We do not believe loans made under the OCAP were intended to be included in the determination of compliance with this requirement.

RECOMMENDATION

In determining compliance with 74 O.S., § 5085.8 B, we recommend the OCIB include only investments guaranteed by the Board through the VIP.

OCIB COMMENT - The above recommendation does not take into consideration the Rules 105:1-5-3 (Rules) that were adopted to guide the Board in the calculation of the \$2 to \$1 requirement. The governing Rules provide the following:

“The Board shall ensure that at least Two Dollars (\$2.00) will be invested in Oklahoma businesses or projects for every One Dollar (\$1.00) of principal guaranteed by the sale of tax credits by the Board (The Standard) [74:5085.8]. This Standard shall be applied as a portfolio, or a program-wide Standard to be achieved at least once by July 1, 2015 and applies only to Board guarantees backed by tax credits issued to the Board pursuant to 74 O.S. 1991, Section 5085.7 and not to guarantees backed by cash, securities or other assets of the Board. **Such dollars invested in Oklahoma businesses or projects includes capital mobilized directly through the use of an OCIB guarantee and that capital invested by others along with such directly mobilized capital in Oklahoma businesses or projects as equity, near-equity or debt.** Accomplishment of this Standard shall be a cumulative measure of all such dollars and shall not be reduced by the liquidation or reduction in value of investments in Oklahoma businesses or projects. The fact that the Board at any one point in time may not have yet achieved the Standard shall not invalidate or affect the enforceability of any Board guarantee backed by the sale of tax credits. The Board shall seek to negotiate investment agreements that include standards required of individual investments which shall be appropriate to the investment and that enable the Board to outperform this Standard.”

The OCAP is a program that utilizes the Board’s guarantee to bring debt finance to hundreds of companies. As noted in Table 7, approximately 90% of the lenders that responded stated they would not have made the loan without OCIB’s support. It is the Board’s opinion, that by definition and in terms of merit, the OCAP’s results should be included in the \$2 to \$1 calculation. In addition, the Board’s external auditors review this calculation on an annual basis. They concur with OCIB’s calculation and interpretation of the governing Rules. OCIB has attached a letter from Nate Atchison, Partner at Finley and Cook, which provides his agreement with the Board’s procedures.

AUDITOR’S RESPONSE: As previously stated, the 2 to 1 requirement is open to interpretation and the administrative rules previously cited by OCIB management are based on their interpretation. However, we believe the intent of this law was to ensure two dollars was invested into an Oklahoma company

for every dollar guaranteed by OCIB through the VIP. Since there is not a requirement specifying how much of the VIP must be invested into Oklahoma companies, we believe the intent was to ensure that at least a portion of the investments stayed in state.

By including the cumulative loans of the OCAP, OCIB is including an additional \$37 million (as of June 30, 2005) in the calculation to determine compliance with this statute. For example, under OCIB's method, an additional \$20 million could be drawn on the LOC and invested in the VIP; however, they would still be in compliance with this statute even with all of the \$20 million in investments going outside of Oklahoma.

Bidding of Management Services Contract

During the course of our audit, questions were raised regarding compliance with state purchasing procedures in the selection of EDGE as the Board's management function. We reviewed April 30, 1999, correspondence from OCIB to the Department of Central Services (DCS) stating that OCIB is exempt from the Central Purchasing Act because of its status as a public trust of the State. We also reviewed attorney general opinion 1984 OK AG 135 which addresses the question "Are state beneficiary public trusts required to comply with the Central Purchasing Act?" In response to this question, the Attorney General responded in part, "Clearly, trustees of a state beneficiary public trust, *as public officers*, fall within the definition of "agency" and "state agency" in 85.2 of the Central Purchasing Act. They are officers of the executive branch of state government and are not excluded from the Central Purchasing Act's requirements...Therefore, we conclude that state beneficiary public trusts are subject to the Central Purchasing Act." In addition, 74 O.S., § 85.12 outlines types of purchases and/or state agencies exempt from the provisions of the Central Purchasing Act. The OCIB is not mentioned in this statute.

While the previously mentioned Attorney General's opinion and 74 O.S., § 85.12 would appear not to exempt OCIB from the Central Purchasing Act, there is still some question because of 74 O.S., § 5085.8.B and 74 O.S., § 5085.8.D. 74 O.S., § 5085.8.B states, "The Board shall have the right to contract freely to protect the interests of the State of Oklahoma." 74 O.S., § 5085.8.D. states, "The Board shall have the power to make any contract, execute any document, perform any act or enter into any financial or other transaction necessary in order to carry out its mission." These two statutes appear to give the OCIB broad purchasing power and may be interpreted as an exemption from the Central Purchasing Act, although not specifically stated.

While it is unclear as to whether OCIB is exempt from the Central Purchasing Act, we did note that OCIB submitted internal purchasing procedures to DCS in accordance with 74 O.S., § 85.39 which states, "Each state agency shall develop internal purchasing procedures for acquisitions by the state agency. Procedures shall, at a minimum, include provisions for the state agency's needs assessment, funding, routing, review, audits, monitoring, and evaluations. Following development, the state agency shall submit the procedures to the State Purchasing Director." The internal procedures were approved by the Director of Central Purchasing effective May 7, 1999.

To evaluate the awarding of the management services contract against OCIB's internal purchasing procedures, we inquired of OCIB management about the process used to select EDGE. According to correspondence from the Board's legal counsel dated July 18, 2000, the OCIB was having difficulty retaining top

management because of salary stipulations imposed by the state on the chief executives of agencies. As a result, OCIB's retiring president suggested privatizing the management functions of the Board, which would allow them to provide a salary necessary to be competitive in this field. This recommendation was reviewed and approved by legal counsel as a viable option for the Board. The trustees agreed it was the option the Board should pursue. On August 15, 2000, a "request for proposal" (RFP) was sent by OCIB to 32 potential bidders. Five proposals were received in response to the RFP. All responses were mailed to the Board's legal counsel for handling. Two OCIB trustees evaluated the bids and applied a scoring system to each bid. After the score of each bid was tabulated, the bid with the highest score was selected as the winning bidder. This bidder was EDGE. In order to verify the bid process as previously described was followed, we discussed the process with the two OCIB trustees involved in the bid evaluation and both trustees confirmed the process. In addition, we obtained and reviewed the following documents:

- Request for Proposal
- Contact sheet for 32 potential bidders sent RFP
- Proposals received
- Score sheet used to evaluate the proposals

Based on our review of documentation, it appears OCIB followed their internal purchasing procedures in the selection of EDGE as its management group.

RECOMMENDATION

As discussed previously, it is unclear as to whether OCIB is exempt from the Central Purchasing Act. Therefore, we recommend the Legislature consider OCIB's status under the Central Purchasing Act and if necessary amend 74 O.S., § 85.12.

OCIB COMMENT - OCIB does not hold itself out to be exempt from the Central Purchasing Act. Contrary to the implication in the audit, OCIB is in complete compliance with the Central Purchasing Act. As noted in the audit, state agencies are authorized to develop internal purchasing procedures for acquisitions at 75 O.S. Section 85.39.A.1. The statute also requires the State Purchasing Director to review the agency procedures. See 75 O.S. section 85.39.A.2. This procedure was followed as evidenced by the correspondence from Devon Sauzek to Tom Jaworsky dated April 30, 1999 and the letter from Pamela M. Warren to Devon Sauzek dated May 7, 1999. Ms. Warren's letter states the OCIB's internal purchasing procedures are in compliance with the Central Purchasing Act. The Board's Chairman stated that "OCIB was authorized by Oklahoma law to contract for management services under the Central Purchasing Act. Further, OCIB followed its approved internal purchasing procedure in seeking bids for management services, in evaluating bids and awarding the contract."

AUDITOR'S RESPONSE: The intent of the procedures performed was not to imply that OCIB was or was not in compliance with the Central Purchasing Act (Act), it was to identify that while attorney general opinion 1984 OK AG 135 states that public trusts are subject to the Act, OCIB has specific statutory authority to contract outside the guidelines of it. If the intent of the Legislature is for the OCIB "...to make any contract, execute any document, perform any act or enter into any financial or other transaction necessary in order to carry out its mission" as stated in 74 O.S., § 5085.8.D, they may wish to consider amending 74 O.S., § 85.12 to specifically exclude OCIB acquisitions from the Act as stated in the recommendation.

IV. Other Items Noted

Oversight of OCIB Operations Could Be Strengthened

As previously stated, management operations of the Board were privatized in 2001 and as such, the Board has no employees. We discussed the oversight of the operations of the Board with OCIB management who stated they feel the oversight is adequate because the board members are appointed by the Governor with the advice and consent of the Senate and the annual OCIB report is sent to the state's top officials. Based on conversations with the five board trustees, they have no involvement in the day-to-day operations of OCIB. However, they do approve all OCIB-sponsored investments.

OCIB COMMENT - The previous statement could leave the impression the Trustees are not engaged. In fact, the Trustees approve all contracts, all budgets, all expenditures, asset allocations and business plans. A Trustee co-signs all OCIB checks. Two Trustees serve on the financial audit committee and they require that 100% of the payments to the manager be audited for compliance with the management contract.

We reviewed a report from the Government Accountability Office (GAO) titled *Privatization: Lessons Learned by State and Local Governments*. We noted the following excerpt from the report in which GAO noted:

When a government's direct role in the delivery of services is reduced through privatization, a need is created for enhanced monitoring and oversight that evaluates compliance with the terms of the privatization agreement and evaluates performance in delivering services to ensure that the government's interests are fully protected.

RECOMMENDATION

Due to the privatization of the OCIB operations, we recommend the Legislature consider amending 74 O.S., § 5085.6 to provide additional oversight by the State. Possibilities may include having an executive branch state official serve as a trustee (Director) in a non-voting capacity or two executive branch state officials in a voting capacity.

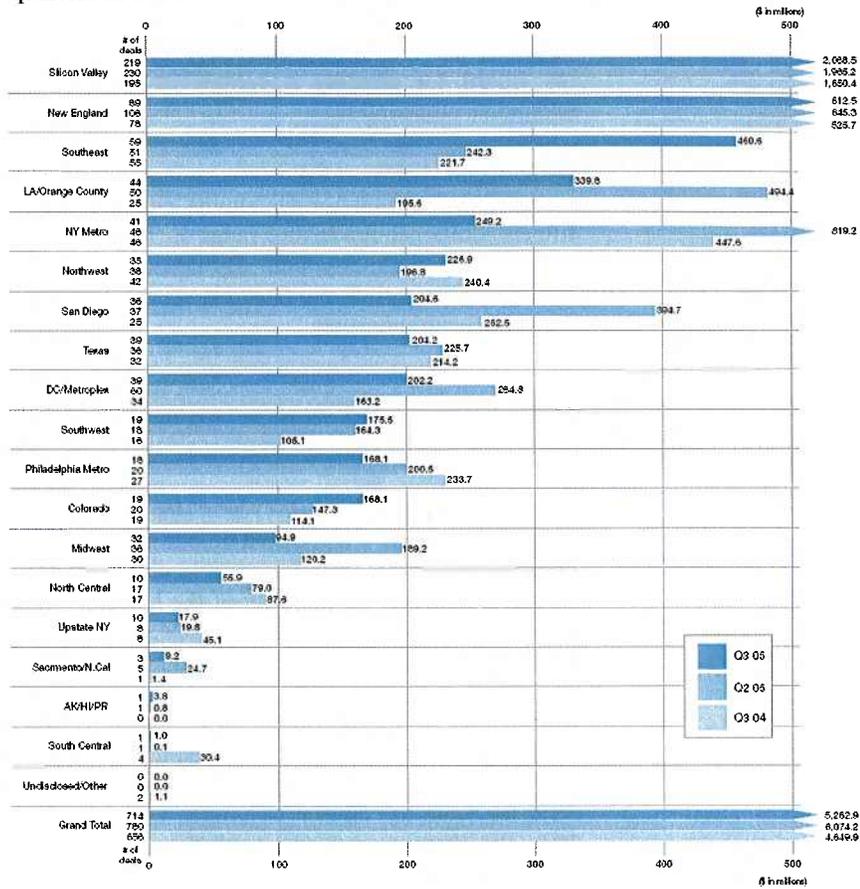
New Orleans Hornets Basketball

The New Orleans Hornets were displaced from their home city as a result of Hurricane Katrina. In late September of 2005, the National Basketball Association announced that Oklahoma City would be their temporary home. As an inducement, the City of Oklahoma City assembled a group to help ensure a minimum level of revenues to the team. The City of Oklahoma City, private investors, and OCIB each share 1/3 of a \$10 million commitment that may be called if revenues for the season fall short of a \$40 million goal. We commend the OCIB's effort in boosting the state's economy with their commitment.

Oklahoma Equity Partners

Based on research conducted during the audit and conversations with both OCIB management and OCIB trustees, Oklahoma is not known for venture capital investing. To illustrate Oklahoma's involvement in venture capital in relation to other regions of the country, the following chart is provided showing venture

capital investing for the second quarter of 2004 and the second and third quarters of 2005.



Source: PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association, Money Tree Survey Q3 2005 Results US Report

Oklahoma is included in the South Central region with Kansas, Arkansas and Louisiana. As can be seen, the venture capital investing in this region lags far behind other regions of the country.

OCIB COMMENT - For the decade ending 2004, Oklahoma, 27th in size among the states, ranked 30th in the amount of venture capital invested.⁵

The OCIB seeks to increase the amount of equity capital and near-equity capital made available to Oklahoma businesses. They have attempted to accomplish this by establishing Oklahoma Equity Partners, LLC (OEP). This venture capital fund makes investments strictly in Oklahoma companies. As of June 30, 2005, OCIB had committed \$7.5 million to OEP and has funded \$740,500 of this commitment.

OCIB is the manager of the fund but has delegated its responsibilities as manager to EDGE. As the manager, EDGE is responsible for overseeing the fund and the operating company, OKCapAdvisors, which is responsible for the day-to-day work of the fund such as identifying, evaluating, screening, and packaging Oklahoma investment opportunities. Outside of the fees outlined

⁵ PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association, Money Tree Survey. 1995 to 2004 Results by State.

under the management services agreement discussed earlier, EDGE is not entitled to any additional compensation from Oklahoma Equity Partners for the services it provides. OKCapAdvisors is paid a base fee of approximately \$200,000 per year for the services provided under this contract. We commend the Board for creating a vehicle to provide additional venture capital to Oklahoma companies.

OCIB COMMENT - OEP is one example of an investment supported by OCIB to mobilized capital for Oklahoma entrepreneurs. The Board has supported fifteen additional funds that range in focus from pre-seed technology to later stage growth and mezzanine. By investing in a number of funds, each with its own special expertise, the Board is able to recruit a wide range of talent to serve Oklahoma entrepreneurs.

Closing Comments

As discussed throughout this report, the OCIB primarily operates two programs: the OCAP and the VIP. Based on our audit, it appears the OCAP is effective in providing a vehicle for businesses to obtain loans. As evident from our survey of OCAP lenders, the majority of the lenders would not have made these loans without the OCAP. In addition, the OCAP poses a relatively small financial risk to the State when compared to the VIP.

Through its ability to issue \$100 million in tax credits, the State is making an investment in the VIP and no investment is risk free as evidenced by the \$55 million in risk created by the VIP. Therefore, through its decision to operate the VIP, the State has chosen to assume this risk. However, as an investor in the VIP, the State must understand the relationship between the risks and the rewards generated by the VIP. Herein lies the greatest weakness with the VIP: the rewards to the State are not known. While the investments made in companies located within the State of Oklahoma have undoubtedly had a positive economic impact, the mere fact that an investment was made should not be the only reward recognized by the State.

While the investments in Oklahoma companies are extremely important, they should be considered only the first step in the evaluation of the overall economic development program. In order for the State to truly evaluate its risk versus its reward, we believe it is important for the State to know whether the companies are successful long term, as that is when the State will truly see its rewards. To measure the companies' long-term success, the State would need information such as:

- how many employees do these companies have?
- what are the average salaries for these employees?
- what impact are the companies having on the State's tax base?
- have the companies spawned any other subsidiary or start up companies?
- are the companies still in business?
- have the companies gone public?

All of these things would be important in evaluating the effectiveness of the VIP as an economic development program.

We believe these types of measures will especially be important if the OCIB sells tax credits to satisfy debt for the VIP. It is likely at this time that questions regarding the rewards generated by the VIP will surface. State leadership and taxpayers alike will be asking the question, "What did we get in return for the tax credits we issued?" The lack of economic development performance measures does not allow a comprehensive answer to this question.

OCIB Comment: Readers are invited to refer to the full economic impact study prepared by Applied Economics. The report along with other information related to OCIB activities can be found at the OCIB web site, <http://www.ocib.org>.

**OKLAHOMA CAPITAL INVESTMENT BOARD
PERFORMANCE AUDIT
APPENDIX A**

March 13, 2006



Mr. Jeff A McMahan
Office of the State Auditor and Inspector
2300 North Lincoln Boulevard, Room 100 State Capitol
Oklahoma City, OK 73105-4801

Honorable Jeff McMahan:

Thank you for the service you have provided to the Oklahoma Capital Investment Board in the production of this performance audit.

The audit demonstrates:

- The Board has supported investment in professionally managed venture capital funds, which in turn have attracted \$99.8 million of venture capital to Oklahoma projects. You cited Oklahoma Equity Partners as one example of an effective investment.
- The Board's Oklahoma Capital Access Program has been effective in catalyzing a large volume of development loans to small businesses.
- The Board's commitment to the NBA Hornets has had a demonstrable impact on Oklahoma.
- The Board has accomplished its statutory requirement to mobilize at least \$2 for every \$1 it guarantees. To our knowledge, this is the highest statutory requirement of all State of Oklahoma economic development programs.
- The Board has implemented its programs at no out-of-pocket cost to the State, while holding all its assets for the benefit of the State. On its 6/30/05 balance sheet the Board carries a net contingent cost of only \$17.5 million.

During the course of the audit you recommended the Board consider combining the financial reporting of its funding vehicle, the Oklahoma Capital Formation Corporation (OCFC), with the financial reporting of the Board. This was a valuable suggestion and will help make our reporting more easily understood. The Board has taken this action and will begin reporting on a consolidated basis with this fiscal year.

Also during the course of the audit you recommended the Board create a way to report on the development impact of its programs. This was good advice. With the help of the Oklahoma City Chamber, the Board engaged the professional economic consulting firm, Applied Economics, to perform an analysis of the economic impact of the Board's programs on the Oklahoma economy. The results of this study demonstrated a total historical economic impact of \$881 million. This is a conservative estimate. It does not include the impact of the Hornets investment, or the impact of 429 companies that received OCAP loans but for which information was insufficient to conduct an analysis. This impact, relative to the actual cost and the contingent cost, is dramatic. In the future the Board will update this report on a regular basis.

OKLAHOMA CAPITAL INVESTMENT BOARD

301 N.W. 63rd Street, Suite 520 • Oklahoma City, Oklahoma 73116 • Telephone: (405) 848-9456 • Fax: (405) 842-6389

You sought to compare the impact of OCIB programs with the risk to the State created by tax credits issued under two other tax credit programs, the Small Business Capital Formation Incentive Act and the Rural Venture Capital Formation Incentive Act. We were disappointed you were unable to gather the needed data to complete the comparison. A March 10, 2006 story in The Oklahoman reports these other programs, similar to CAPCO programs in some states, will cost the State \$66 million in calendar 2005, and apparently an even higher number in calendar 2006. These programs "designed to stimulate job growth [are] being abused by investors who are realizing millions of dollars in gains without providing the intended economic development benefits to Oklahoma, officials said Wednesday [March 10, 2006]."

You questioned whether the Board is subject to the Central Purchasing Act. We assert we are and are in compliance with the Act. You analyzed whether the current management contractor was selected appropriately and concluded the process was appropriate. You recommend the Board could benefit from more oversight. Throughout its life the Board has benefited from many forms of oversight from the Oklahoma Department of Commerce, Oklahoma Futures, the Office of State Finance, and the Economic Development Committees of the Senate and House. The Board has undergone full financial audits since inception. The Board has been managed with great care by its trustees, all appointed by a Governor and confirmed by the Senate. We appreciate thoughtful oversight and welcome continued oversight in the future.

You acknowledge OCIB has been adopted as a model by at least eight other states. In our experience this has been good for Oklahoma and demonstrates the vision, creativity, and discipline of State leaders dating back to the Board's inception.

We look forward to implementing your valuable suggestions and to continuing our important service to the State of Oklahoma.

Regards,



The Trustees of the Oklahoma Capital Investment Board

1. Jenkins, Ron, "Officials Say Oklahoma Investment Tax Credit Being Abused," The Oklahoman, (March 10, 2006).

