

illegal acts and, if management fails to report, the auditor shall report to SBA at the address listed above.

ii. *Reporting Internal Control Structure Reportable Conditions.* Reportable conditions in an SBIC's internal control structure shall be reported to SBIC management in writing and SBIC management shall immediately transmit this auditor's report to SBA. Reportable conditions and the manner of reporting such conditions are addressed in AU Section 325, *Codification of Statements on Auditing Standards*, issued by the American Institute of Certified Public Accountants.

G. Detecting Noncompliance With Laws and Regulations

i. Audits of SBICs are performed in accordance with generally accepted auditing standards. These standards require IPAs to design audit procedures which will provide reasonable assurance of detecting instances of noncompliance with applicable laws and regulations that could have a material effect on Licensees' financial statements.

ii. A GAAS audit is neither a substitute for nor a duplication of the examination of an SBIC performed by SBA's examiners. The purpose of such examinations is to provide a comprehensive evaluation of the Licensee's compliance with laws and regulations governing the SBIC program. In contrast, IPAs perform audits in which compliance issues are viewed in the context of the possible effects of noncompliance on the financial statements.

iii. As part of the audit planning process, all IPAs shall be responsible for reviewing and becoming familiar with the laws and regulations applicable to SBICs. Auditors must have sufficient knowledge of such laws and regulations to be able to design appropriate audit procedures for an SBIC, and to recognize instances of noncompliance which may become evident in the course of performing such procedures. The laws and regulations governing the SBIC program include the following:

1. *Small Business Investment Act of 1958, as amended (Act).* The Act (15 U.S.C. 681 et seq.) provides a statement of the public purpose of the SBIC program and establishes the legislative framework upon which the regulations are based. Licensees are permitted to engage in activities contemplated by the Act, and in no other activities. Provisions of the Act governing SBICs are found primarily in Title III.

2. *Code of Federal Regulations, title 13, parts 107 and 121 (13 CFR 107 and 121).* Part 107 contains the regulations governing the SBIC program, and auditors should become familiar with this part in its entirety. Part 121 contains small business size regulations which apply to various SBA programs; particular attention should be given to the definition of "Affiliation" (§ 121.401) and the SBIC size standard (§ 121.802).

iv. In addition to the Act and regulations themselves, SBA has various materials available which may assist auditors in developing an overall understanding of the SBIC program. These include basic informational brochures about the program; the preambles to final rules published in the

Federal Register, which provide rationales for and interpretations of new regulations; and a regulatory compliance checklist for small business financings.

v. Preparation for an SBIC audit should include a review of AICPA Statement on Auditing Standards No. 54 (SAS 54). This statement discusses the consideration an auditor should give to the possibility of illegal acts by a client in a financial statement audit performed in accordance with GAAS. As defined in the statement, "illegal acts" include violations of laws or government regulations.

vi. In addition to any specific audit procedures deemed necessary which may relate to compliance issues, the IPA shall obtain representation from the Licensee regarding its lawful operation as contemplated by the Act.

V. Accounting Policies and Procedures

A. Generally Accepted Accounting Principles

i. As a general rule, Licensees shall follow generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board, its predecessors (such as the Accounting Principles Board), and the AICPA. Sources of information concerning specialized accounting and reporting principles for investment companies include the AICPA publication, "Audits of Investment Companies", as well as this accounting guide. In the event of any conflict between this appendix and other sources, this appendix shall govern for purposes of financial reporting to SBA.

ii. Licensees and their IPAs should be aware that some of the specialized GAAP promulgated for investment companies is oriented towards companies which do not share many of the characteristics of SBICs. Appendix A of "Audits of Investment Companies" discusses some of the distinctive characteristics of venture capital companies in general, and of SBICs in particular, relative to other types of investment companies. These characteristics may include active rather than passive investment, illiquid portfolios with no public market, relatively long holding periods for investments, and the existence of significant debt in the case of SBICs.

iii. Appendix A includes the following statement: "Though all venture capital investment companies should prepare their financial statements in conformity with generally accepted accounting principles and are subject to audit as are other investment companies, the statement presentation of some companies may need to be tailored to present the information in a manner most meaningful to their particular group of investors." SBA, as the regulator and major creditor of the SBIC industry, has tailored Form 468 to provide financial information in a format which will satisfy SBA's analytical and regulatory requirements. An IPA should exercise professional judgment in determining whether reporting on Form 468 requires a material departure from GAAP for a particular SBIC. If such a departure exists, the Independent Auditors' Report should be modified accordingly.

B. Accrual Basis of Accounting

Books of account shall be maintained on an accrual basis. All accruals are to be entered in the records and posted at the end of the fiscal year, and as of the closing dates of any other fiscal periods to be covered by interim or special financial report to SBA.

C. Reporting Entity

i. For most SBICs, the reporting entity is the Licensee only. Application of this general rule and certain exceptions to it are discussed in this paragraph C.

ii. Investment in Management Services Company. The provisions of § 107.501(c) permit a Licensee to organize a wholly-owned corporation solely to provide management services. The regulation states that reports submitted to SBA shall reflect the consolidated results of the Licensee and its subsidiary.

iii. Investment in Section 301(d) Licensee. Under § 107.712, a Section 301(d) Licensee may be licensed to operate as the subsidiary of one or more Licensee companies ("Participant Licensees"), with or without non-Licensee participation. Each Participant Licensee shall own at least twenty percent of the voting securities of the Section 301(d) Licensee. Such an investment should be reported on the equity method, under the caption "Investment in 301(d) Licensee" on the Statement of Financial Position. SBA recognizes that this accounting treatment may constitute a departure from GAAP if the Participant Licensee is the majority owner of the Section 301(d) Licensee. The independent public accountant may wish to express a qualified opinion if the departure is considered material.

iv. Temporary Control. Under certain circumstances, as described in § 107.801, a Licensee may temporarily own more than a 50 percent interest in a small business concern. These investments shall be classified in the appropriate category of Loans and Investments on the Statement of Financial Position (generally, this will be "Operating Concerns Acquired"), and shall be reported at their fair value. This treatment is consistent with FASB Statement No. 94, which provides an exception to the general rule of consolidating majority-owned subsidiaries when control is likely to be temporary.

D. Fair Value of Loans and Investments

i. In accordance with generally accepted accounting principles for investment companies, SBICs shall report Loans and Investments (presented on lines 1 through 10 of the Statement of Financial Position, page 2 of SBA Form 468) at fair value. To the extent possible, fair value shall be represented by quoted market prices (appropriately discounted for such factors as restrictions on marketability or large holdings relative to daily trading volume). In the absence of quoted market prices, fair value shall be an estimate determined in good faith by the Board of Directors or General Partner(s), based on the application of valuation policies which are consistent with SBA guidelines.

ii. In response to new statutory requirements concerning valuations, SBA