

**AUDIT OF SBA'S FY 2001 FINANCIAL STATEMENTS**

**MANAGEMENT LETTER**

**AUDIT REPORT NUMBER 2-17**

**APRIL 12, 2002**

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U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
WASHINGTON, D.C. 20416

<b>AUDIT REPORT</b>
<b>Issue Date: April 12, 2002</b>
<b>Number: 2-17</b>

**To:** Thomas A. Dumaresq  
Chief Financial Officer

Cory Whitehead  
Assistant Administrator for Administration

Lawrence E. Barrett  
Chief Information Officer

**From:** *Robert G. Hultberg*  
for Robert G. Seabrooks, Assistant Inspector General for Auditing

**Subject:** Audit of SBA's FY 2001 Financial Statements - Management Letter

Pursuant to the Chief Financial Officers Act of 1990, attached is Cotton & Company LLP's management letter. It identifies issues related to: (1) personal property and equipment, (2) foreclosed property records and valuation, (3) loan accounting records and servicing, (4) analysis of account balances and transactions, (5) credit card use, (6) sensitive loan sale information, (7) new transaction codes, (8) Master Reserve Fund reporting, and (9) disaster loan cash flows. The conditions were identified during the audit of SBA's Fiscal Year 2001 financial statements, but were not required to be included in the Auditor's Report on Internal Control.

**The findings in this report are based on the auditors' conclusions and the report recommendations are subject to review, management decision and action by your office, in accordance with existing Agency procedures for follow-up and resolution. Please provide us your proposed management decisions within 30 days on the attached SBA Forms 1824, Recommendation Action Sheet.**

Should you or your staff have any questions, please contact Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-7577.

Attachments

# COTTON & COMPANY LLP

auditors ♦ advisors

DAVID L. COTTON, CPA, CFE, CGFM ♦ CHARLES HAYWARD, CPA, CFE, CISA ♦ MICHAEL W. GILLESPIE, CPA, CFE ♦ CATHERINE L. NOCERA, CPA  
MATTHEW H. JOHNSON, CPA, CGFM ♦ SAM HADLEY, CPA, CGFM ♦ COLETTE Y. WILSON, CPA

February 20, 2002

## MANAGEMENT LETTER COMMENTS INDEPENDENT AUDIT OF FISCAL YEAR 2001 FINANCIAL STATEMENTS

Inspector General  
U.S. Small Business Administration

We have audited the U.S. Small Business Administration's (SBA) financial statements as of September 30, 2001, and for the year then ended, and have issued our reports, dated February 20, 2002, to SBA under separate cover. These documents included our reports on SBA's internal control structure and compliance with laws and regulations.

The purpose of this management letter is to communicate nonreportable findings to SBA management.

This letter is intended solely for the information and use of SBA management.

We would like to express our appreciation to the SBA representatives who assisted us in completing our audit. They were always courteous, helpful, and professional.

Very truly yours,

COTTON & COMPANY LLP

By: 

Matthew H. Johnson, CPA

C&C

established 1981

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**INDEPENDENT AUDIT OF FISCAL YEAR 2001  
FINANCIAL STATEMENTS  
U.S. SMALL BUSINESS ADMINISTRATION  
NONREPORTABLE FINDINGS**

Certain nonreportable findings came to our attention during the audit of the U.S. Small Business Administration's (SBA) Fiscal Year (FY) 2001 financial statements, and they are discussed in this report. Findings 1 through 3 were also reported in our FY 2000 management letter. All findings are related to SBA's internal control.

**1. Personal Property and Equipment**

SBA continues to lack proper control over its personal property and equipment. In the FY 1999 and FY 2000 management letters, we reported that SBA field offices were not consistently conducting annual physical inventories of personal property and equipment. We also reported that SBA's property accountability system, Fixed Asset Accounting System (FAAS), did not fully meet the needs of all field offices. As a result, much of the information FAAS contains is duplicated in ad-hoc systems or is not being used at all.

During our FY 2001 audit, we found that both of the above conditions still existed. For example, 4 of 12 field offices and 3 of 5 headquarters' offices tested had not conducted physical inventories during FY 2001. SBA's Standard Operating Procedure (SOP) 00-13-4 requires annual physical inventories.

In FY 2000, we recommended that the Assistant Administrator (AA) for Administration in coordination with the Chief Financial Officer (CFO) and Chief Information Officer (CIO):

- Notify all field offices of the need for and importance of conducting annual physical inventories.
- Evaluate the adequacy of FAAS to meet field office needs, and modify the system as appropriate.

In response to these recommendations, the AA for Administration issued a procedural notice on November 16, 2001, emphasizing the need for and importance of conducting annual physical inventories. Additionally, the AA for Administration met with the CFO and CIO on October 31, 2001, and will hold subsequent biannual meetings to evaluate the adequacy of FAAS to meet field office needs and modify the system as appropriate.

With the above actions by SBA occurring in FY 2002, this finding is closed.

**2. Foreclosed Property Records and Valuation**

Property that SBA acquires through enforcing payment under secured loans is referred to as "collateral purchased" (COLPUR), or foreclosed property. SBA should be recording COLPUR-related transactions, such as sales and purchases, in the Liquidation/Litigation Tracking System (LLTS) and Loan Accounting System (LAS). Statement of Federal Financial Accounting Standard (SFFAS) No. 3 requires agencies to record property acquired on loans approved before 1992 at cost, adjust for the lower of cost or net realizable value, and carry any difference in a valuation allowance. SFFAS No. 3 also requires property acquired on loans approved from 1992 forward to be valued at the net present value of projected future cash flows associated with the property.

In FY 2000, we reported that SBA did not always record the disposition of foreclosed property in a timely manner, and it did not always calculate the net realizable value properly. Similar conditions existed in FY 2001. For example, in a sample of 7 items, we found that one item valued at approximately \$58,000 was sold during FY 2001, but was still on SBA's records at year-end. Further, SBA had incorrectly calculated the net realizable value by about \$139,000 for one item sampled. We also found that SBA had recorded ownership for two sampled items actually owned by participating lenders.

In FY 2000, we recommended that the CFO coordinate with the Office of Capital Access and the Office of Field Operations to:

- Record COLPUR-related transactions in LLTS and LAS within one month of transaction dates.
- Ensure that all field office liquidation staff receive training and guidance on requirements for valuing foreclosed property and entering complete and accurate data into LLTS and LAS.
- Periodically reconcile field office property documentation and LLTS and LAS entries to ensure that property is properly valued and accurately entered in LLTS and LAS.

In response to these recommendations, the Office of Financial Assistance (OFA) issued an information notice on November 6, 2001, to all employees advising of the need to report transactions in a timely manner and calculate the net realizable value properly. In addition, SBA's basic liquidation training course is being revised to emphasize proper valuation and procedures for entering complete and accurate data into LLTS and LAS. The training material is expected to be revised by March 2002.

Also, SBA added elements to its Quality Service Reviews (QSR) in December 2001. QSR teams are required to determine if:

- Assets acquired in SBA's name are booked at their net realizable value.
- Information pertaining to net realizable value was entered accurately in the LLTS within 30 days of property acquisition.
- LLTS information accurately reflects property data contained in the loan file.

With the above actions by SBA occurring in FY 2002, this finding is closed.

### **3. Loan Accounting Records and Servicing**

LAS does not always reflect current borrower information. We first reported this in our FY 2000 audit based upon results of loan confirmations received from borrowers. In FY 2000, we sent 288 confirmations, and 22 were returned with incorrect addresses, or about 8 percent. For the FY 2001 audit, we sent 234 confirmations, and 37 of these, or 16 percent, were returned with incorrect addresses. Confirmations with incorrect addresses were generally associated with non-performing loans, which require substantially more servicing by SBA or the servicing bank than performing loans.

Accurate and complete loan file information is critical for providing proper service to the debtor, pursuing collection of delinquent debt, and, in the case of guaranteed loans, obtaining claim payment. In discussing this matter with SBA, we learned that there is no centralized database for the purpose of maintaining borrower's current addresses, and that the LAS does not have sufficient field input capacity

to record both historical and current addresses. SBA, however, stated that the respective field and district offices maintain this information.

**Recommendation 3A:** We recommend that the CFO in conjunction with the Office of Capital Access evaluate the LAS to determine whether it alone provides convenient and efficient access to borrower contact information necessary for servicing loans and financial reporting or whether an additional centralized data source should be made available. The evaluation should include an assessment of whether the LAS is capable of containing additional address fields so that updated addresses can be entered without deleting original addresses.

#### 4. Analysis of Account Balances and Transactions

SBA's Office of Chief Financial Officer (OCFO) does not perform adequate analyses of accounts and transactions to determine reasonableness and appropriateness. During the FY 2001 financial statement audit, we found two specific items that should have been identified during an analysis:

- SBA has reported \$8.1 million in Account 1150, Advance to Subcontractors 8a, for several years. When asked by the auditors if this amount was still outstanding, SBA determined that the balance was uncollectible and should be written-off. As a result, SBA overstated advances on its balance sheet by \$8.1 million. SBA procedures should have been in place to analyze the balance before preparing financial statements and submitting them to the auditors.
- As part of our confirmation process, we identified three loans with payments made during FY 2001, but not recorded by SBA in LAS until October 2001 (FY 2002). As a result, we projected errors in loan balances of \$3.5 million. Although SBA has procedures in place requiring transactions to be recorded in the correct fiscal year, it does not have a procedure in place to determine if this actually occurs.

*Standards for Internal Control in the Federal Government (GAO/AIMD-00-21.3.1)* requires that internal control provide reasonable assurance over the reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use. SBA's lack of procedures in the above areas lessens its ability to fully achieve this requirement.

**Recommendation 4A:** We recommend that the CFO develop and implement procedures for analyzing account balances and transactions. We recommend that procedures include evaluating the reasonableness and validity of account balances, ensuring that transactions are recorded in the correct fiscal year, and determining if an adjustment to the financial statements is necessary.

#### 5. Credit Card Use

SBA is not adhering to its policies governing monitoring of credit card use. Approving officials are required to oversee and review credit card purchases and associated documentation and ensure that items purchased are authorized by a Form 2 and are appropriate (SOP 00-12-01, The Government Credit Card Program). SOP-00-12 requires a Form 2 to show evidence of budget approval and approval by an approving official. SOP-00-12 also requires that a cardholder reconcile and annotate statements of account and provide them to the approving official within 5 working days of receipt from the Denver Finance Center.

We tested credit card use at five headquarters' offices and noted the following:

- In a sample of 25 credit card transactions, we found that for three of the transactions, SBA was unable to provide either a Form 2 or supporting receipts. Also in that same sample, 11 of the Form 2s did not have an approving official's signature and 5 of the 11 did not have a budget officer's initials.
- For three of the five offices visited, credit card statements contained no evidence of review by the cardholder or approving official.

Without evidence of required review and approval, SBA cannot be certain that credit card purchases are for legitimate business-related items and that amounts invoiced are correct. Further, SBA is not complying with its policies and procedures governing credit card monitoring.

**Recommendation 5A:** We recommend that the AA for Administration issue a procedural notice to all cardholders and approving officials emphasizing the SOP requirements.

## 6. Sensitive Loan-Sale Information

SBA is not properly limiting and controlling intra-agency access to sensitive borrower information, thus allowing unauthorized individuals to view and download borrowers' tax returns, banking information, and Social Security Numbers.

SBA's Office of Chief Information Officer (OCIO) established an intranet web site for its network administrators from which they could download and install specialized software. The software was intended to permit loan sale bidders to access necessary borrower documents for loans to be sold, and the bidders were required to sign confidentiality statements. The software was also intended to give SBA field office loan officers access to borrower information so they could service a loan until the file was sent to the due diligence contractor and forwarded to the successful bidder. The web site included instructions on how to download the software and provided a universal username and password to access the software.

In conducting our audit, we were able to access this web site from within the agency, download the software, obtain the universal password and user name, and access sensitive borrower information without authorization.

Federal Financial Management System Requirements for Core Financial Systems require that system administrators restrict access to sensitive data elements such as social security numbers and banking information. Although SBA had the ability to limit access to the web site, it did not do so in this circumstance. Upon notification of this condition, however, OCIO restricted user access to that portion of the network.

**Recommendation 6A:** We recommend that the CIO determine if other information systems containing confidential, sensitive information are protected from unauthorized access.

**Recommendation 6B:** We further recommend that the CIO establish procedures to periodically monitor software installed at workstations to assure proper licensing and authorized access to data.

## 7. New Transaction Codes

OCFO does not have policies or procedures for communicating new transaction codes and general ledger accounts. Without such procedures, LAS data, used to populate SBA's database for analyzing cash flows, may not be complete; and unknown transaction codes and general ledger accounts that should be included in the database may have been excluded. For example, in FY 2001, new loan

expense codes were established, and they were unknown to the Office of Financial Analysis. As such, when the Office of Financial Analysis initially prepared the subsidy rate calculation cash flow models, it did not reflect the new transaction codes or expenses accumulated under those codes for the year.

*Standards for Internal Control in the Federal Government* requires that internal control provide reasonable assurance over the reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use. SBA's lack of procedures to communicate changes in transaction codes and general ledger accounts lessens its ability to fully achieve this requirement.

**Recommendation 7A:** We recommend that the CFO develop, document, and implement policies and procedures for ensuring the timely communication of new transaction codes and general ledger accounts. This would not only include updating the applicable SOP but also specifically notifying users of the establishment of a new transaction code or general ledger account and the appropriate use of such code or account.

#### 8. Reporting the Master Reserve Fund

In FY 2001, SBA changed the manner in which it presents its ownership in earnings from the Master Reserve Fund (MRF). The change, an improvement over past practices, could be enhanced with additional disclosure. Statement of Federal Financial Accounting Standards (SFFAS) No. 7 requires that funds "...similar in nature to trust funds, and those funds within the Federal universe (inside or outside the budget) that are fiduciary in nature..." must disclose, among other items, condensed information about assets and liabilities showing investments, other assets, liabilities, and fund balance. Although SBA's note shows much of this information, additional disclosure, in accordance with SFFAS 7, would be an improvement.

**Recommendation 8A:** We recommend that the CFO determine if the MRF should be treated in a nature similar to a trust fund for financial reporting purposes and as appropriate, determine what additional disclosures in accordance with SFFAS 7 are necessary for future reporting.

#### 9. Disaster Loan Cash Flows

Sophisticated analytical software programming for the disaster loan program is used to model cash flows, the results of which are then entered into a spreadsheet for uploading into the OMB calculator. In FY 2000, programming errors resulting in insignificant cash flow errors were identified. SBA did not correct these errors in FY 2000, because they did not significantly impact cash flow. SBA stated, however, that it would correct the errors before the FY 2001 process. These errors remained uncorrected in FY 2001 because SBA does not have a process to monitor and track changes.

**Recommendation 9A:** We recommend that the CFO develop, document, and implement procedures over the disaster cash flow models for ensuring that identified errors are tracked, monitored, and corrected.

#### Management's Response

SBA management generally concurred with the findings in the draft report with the exception of finding 3 (see Appendices A and B). Officials from the Office of Capital Access noted that most of the loans associated with the returned confirmations were in liquidation or charged off. Loans in liquidation status would indicate that the businesses that received these loans are no longer operating. As the LAS does not have the capability to capture multiple addresses, i.e., it only contains the borrower's original



business address, it makes sense that the auditor's confirmations were returned. Although lenders do not have the ability to enter data into the LAS, liquidation plans provided to the district offices generally contain current borrower contact information and are the primary vehicles from which the loans are serviced. For charged off loans, the remaining balances have been written off and contact with the borrowers is no longer necessary. Officials from the Office of Capital Access agreed that loans in regular servicing status should have current addresses in the LAS, but noted that an insignificant number of these loans had returned confirmations.

**Evaluation of Management's Response**

We revised Finding 3 and reduced the number of recommendations from three to one as a result of management's response to the draft report.



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, D.C. 20416

DATE: APR 04 2002

TO: Robert Seabrooks  
AIG/Auditing

FROM: Thomas A. Dumaresq  
Chief Financial Officer

Cory Whitehead  
Assistant Administrator for Administration

Lawrence E. Barrett  
Chief Information Officer

Calvin Jenkins  
Associate Administrator for Field Operations

SUBJECT: Response to Draft Management Letter

Thank you for your March 15, 2002, DRAFT Management Letter regarding the audit of SBA's FY 2001 financial statements by Cotton and Company, LLP. As discussed in the meeting with your staff and staff from Cotton on March 14, 2002, we are in general agreement with findings and recommendations. We appreciate the changes made to the original DRAFT letter issued on March 11, as a result of that meeting.

The Management Letter contains 9 findings and 10 recommendations. Two of these findings have already been closed, and this is acknowledged in the Management Letter. This is a clear reflection of the level of attention that SBA pays to these issues, and to our commitment in implementing corrective actions in a timely manner. We expect a similar response to the remaining recommendations resulting in these being closed prior to next year's audit report.

The Office of Financial Assistance and the Office of Lender Oversight will respond separately to the draft management letter. We look forward to working with you to reach agreement on the management actions addressing these findings, once the final Management Letter and required Form 1824's are issued.

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Appendix B  
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DATE: April 10, 2002

TO: Robert G. Seabrooks  
Assistant Inspector General for Auditing

FROM: Jeanne M. Sclater *Jeanne Sclater*  
Deputy ADA for Capital Access

Janet A. Tasker *Janet Tasker*  
Associate Administrator for Lender Oversight

SUBJECT: Response to Audit of SBA's FY2001 Financial Statements -- Amended Draft Management Letter

Thank you for your March 15, 2002, Draft Management Letter regarding the audit of SBA's FY 2001 financial statements by Cotton and Company, LLC. This memo responds to Item 3 of the Management Letter relating to Loan Accounting Records and Servicing.

The finding in Item 3 was that the Loan Accounting System (LAS) does not always reflect current borrower information. Specifically, there was concern regarding the number of confirmations returned with incorrect addresses that were generally associated with non-performing loans. The finding states that non-performing loans require substantially more intensive servicing thus increasing the importance of having a current borrower address. One of the recommendations to address this finding was for the Office of Lender Oversight (OLO) to establish procedures to validate borrower information to ensure that addresses and other personal information are accurate and current for loans maintained by lenders under SBA's Guaranteed, Certified, and Preferred Lender programs.

Neither the Office of Capital Access nor the Office of Lender Oversight believe that the recommendation relating to OLO is appropriate and both offices question whether the finding itself is necessary. This determination is based upon analysis of those loans with returned confirmations and our understanding of the follow-up action taken to obtain current addresses for these borrowers. A table with relevant details on the loans in question is attached. The following items summarize our analysis and assessment of the situation

1. The 37 loans whose confirmations were returned from the following programs:

<u>TYPE OF LOAN</u>	<u>NUMBER OF LOANS</u>
PLP LOANS	12
OTHER 7(a) LOANS	13
DISASTER LOANS	4
SBIC	4
OTHER LOANS	4
TOTAL LOANS	37

Lender Oversight provides policy guidance for reviews of 7(a) lenders and actually conducts reviews of 7(a) lenders that are PLP lenders. PLP reviews are required annually while non-PLP 7(a) lenders are conducted by district offices once over a three period. Given that only 12 of the loans with returned confirmations were PLP loans (2 of which were charged off, see number 2 below for discussion of this issue), Lender Oversight's ability to impact any change in results in future years is limited. In the same light, with 13 of the loans being regular 7(a) loans the ability to impact any change in results in future years is also limited given that only a third of the lenders are being reviewed by District Offices in a given year.

The reviews of 7(a) lenders currently conducted are compliance reviews, not data quality reviews. To implement this recommendation, OLO would have to expand the nature of its reviews from compliance with SBA program regulations to include data quality reviews and validation. Resources and expertise to expand compliance reviews to validate data quality are not available, and we believe, based on the findings, not required and not an effective use of limited resources.

2. The 37 loans with returned confirmations are in the following status categories:

<u>STATUS OF LOAN</u>	<u>NUMBER OF LOANS</u>
In Liquidation	23
Charged Off	10
Regular Servicing	3
Paid in Full	1
Total Loans	37

A significant number of the loans whose confirmations were returned are in liquidation and we believe that should not be a surprise to any of us. Loans in liquidation status would indicate that these are loans to businesses that are no longer operating so it makes sense that if confirmations were sent to the business address in SBA's records, they would be returned. The borrowers are out of business and the assets of the business are being liquidated. There is no longer an operating business where mail would be received. It is our understanding that the current loan accounting system does not allow for multiple addresses, i.e., the operating business address and the liquidation address.

While the contact information in the loan accounting system for all loans in liquidation may not be current, that does not necessarily compromise SBA's ability to provide proper service to the debtor, pursue collection of delinquent debt, and obtain claim payment. As the Management Letter observes, loans in liquidation status are loans that require substantially more servicing. By virtue of their being in liquidation, these loans require a different, more intensive and hands-on servicing approach than current or moderately delinquent loans would require. As part of SBA's servicing requirement for loans in liquidation, written plans are required of the lender and must be filed with the District Office. The liquidation plan would generally contain current contact information for the borrower and would be the primary vehicle from which the loan was being serviced. It is our understanding, that when contacted by OCFO, the District Offices were able to provide current contact information for use in re-sending the confirmations for almost all the loans in liquidation. That fact indicates that the primary management tool being used to manage and monitor loan liquidations is effective.

Charged-off loans are loans that are no longer being actively collected by the lender or SBA. The remaining balance has been written off and there is no further proactive contact with the borrower. Under these circumstances, there is no provision for a lender or a district office to maintain a current borrower address nor is there a requirement for the former borrower to provide changes in addresses to the SBA.

Loans in regular servicing status should have current addresses in the loan accounting system and this would be of more concern if there were a substantial number of loans returned. Three returned confirmations for loans in regular servicing out of a total of 234 confirmations (or 1.3% of the total) does not appear to be a material finding. Loans paid in full would not require a current address in SBA's loan accounting system.

Given the analysis presented above, the Offices of Capital Access and Lender Oversight request that the finding and the related recommendations be removed from the Draft Management Letter. Please feel free to call either of us to discuss this issue in more detail.

Attachment

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