

**AUDIT OF
SBA'S OVERSIGHT OF THE
FISCAL TRANSFER AGENT
FOR THE 7(A) LOAN PROGRAM**

AUDIT REPORT NUMBER 3-08

JANUARY 30, 2003

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U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416


AUDIT REPORT
ISSUE DATE: January 30, 2003
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From: 
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Assistant Inspector General for Auditing

Subject: Audit of SBA's Oversight of the Fiscal Transfer Agent for the 7(a) Loan Program

Attached is a copy of the subject audit report. The report contains three findings and three recommendations addressed to the Chief Financial Officer, nine recommendations to the Associate Deputy Administrator for Capital Access, two recommendations to the Acting Assistant Administrator for Administration, and two recommendations to the General Counsel. The Chief Financial Officer's response is synopsised in the report and included in its entirety at Appendix D. Responses provided by the Associate Deputy Administrator for Capital Access, Acting Assistant Administrator for Administration, and General Counsel did not address the recommendations made to them and they will be resolved during the audit resolution process.

The recommendations in this audit report are based on the conclusions of the Auditing Division. The recommendations are subject to review, management decision and action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide us your management decision for each recommendation within 30 days. Your management decisions should be recorded on the attached SBA Forms 1824, "Recommendation Action Sheet," and show either your proposed corrective action and target date for completion, or explanation of your disagreement with our recommendations.

Any questions or discussion of the findings and recommendations contained in the report should be directed to Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-7204.

Attachment

**AUDIT OF SBA’S OVERSIGHT OF THE FISCAL
TRANSFER AGENT FOR THE 7(A) LOAN PROGRAM**

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SUMMARY

The secondary market of SBA's 7(a) loan program assists lenders in making long-term loans to small business. Since 1989, Colson Services Corporation has been SBA's Fiscal Transfer Agent (FTA). The FTA serves as a central registry of owners of guaranteed interests and of all SBA guaranteed interests sold or resold in the secondary market. The Master Reserve Fund (MRF) was created to facilitate operation of loan pooling in SBA's 7(a) secondary market program by holding both the principal paid from borrowers and due to investors, as well as accumulated interest earnings. SBA's Office of Capital Access oversees the Colson contract and the operations of the FTA.

The audit objectives were to determine whether: 1) the MRF was properly accounted for in accordance with Federal regulations; 2) the FTA was properly performing its fiscal transfer agent functions; and 3) the FTA contract was properly awarded, administered and monitored.

The audit disclosed the following:

- The results of MRF operations were not properly accounted for in accordance with Federal accounting regulations and Federal financial management procedures. SBA neither knew the fiscal health of the MRF nor timely reported this information to Agency decision-makers. SBA has not implemented financial reporting procedures which would identify the results of loan pooling operations (surpluses and shortfalls) within the MRF, nor analyzed the MRF for future potential revenues and projected shortfalls from loan pooling operations. The MRF also has not been treated in a manner similar to a trust fund and public funds held in the MRF were not registered with symbols and titles by the Department of Treasury (Treasury) in consultation with the Office of Management and Budget (OMB).
- SBA has allowed the FTA to hold basis point fees and other fees collected on behalf of SBA although these fees are due immediately to SBA. This allows the FTA to receive approximately 23 days of float interest per month on the fees and this is the compensation for providing the collection services. An estimated \$527,000 over two years was paid to the FTA. This practice is an inappropriate augmentation to SBA's appropriation as SBA had the FTA use the float collected on the fees as compensation for collecting these fees rather than paying the compensation from appropriated funds.
- SBA did not award, administer, and monitor the FTA contract in a manner that fully protected the interests of the Federal government or ensured that the government received the best services for the least cost. Specifically, (1) the FTA contract was improperly extended beyond five years, (2) the legality of float compensation payments to the FTA was unclear and an unsound business practice, (3) accurate FTA contract costs were not tracked or maintained, (4) Federal regulations for administering the MRF do not exist, and (5) there were discrepancies in the terms and conditions for auditing the FTA by its Independent Public Accountant including meeting FOIA requirements and the need to conduct Statements on Auditing Standards (SAS) 70 reviews.

We made recommendations to the Chief Financial Officer to:

- Report the financial results of MRF operations in the nature of a trust fund.
- Statistically reconcile the source and application of funds in the MRF to more properly identify the public funds from the MRF principal amounts.
- Work with Treasury and the OMB to establish Treasury titles and symbols for the MRF.

We made recommendations to the Associate Deputy Administrator for Capital Access in conjunction with the Assistant Administrator for Administration to:

- Direct the FTA to submit basis point fees collected to the Federal government by the end of each business day when the depository receipts total over \$1,000.
- Negotiate for a fixed compensation rate for the FTA to collect basis point fees and compensate the FTA through SBA's appropriation.
- Determine whether any other remedies are needed concerning the inappropriate augmentation of SBA's appropriation.
- Begin the process of initiating a new procurement action for FTA services.
- Eliminate float interest compensation to the FTA for both the front-end and back-end float compensation periods in all future contracts with an FTA.
- Review FTA activities and identify contract costs of providing services and establish a fee structure sufficient to cover such services.
- Ensure that contract provisions for audits performed by Independent Public Accounting firms working for the FTA include access rights to audit reports and working papers by OIG and the General Accounting Office.

We made recommendations to the Associate Deputy Administrator for Capital Access to:

- Ensure that future audits of the Fiscal Transfer Agent by Independent Public Accounting firms include a Statement on Auditing Standards (SAS) 70 review of internal controls, and computerized system controls.
- Develop and publish regulations and SBA procedures governing the operation and functioning of the MRF.

We made recommendations to the Acting Assistant Administrator for Administration to:

- Instruct SBA contracting officers to obtain OGC review for legal sufficiency and not to extend contracts beyond five years in the future.
- Move the Contracting Officers Technical Representative (COTR) duties for the current and future FTA contracts to the Office of Chief Financial Officer and maintain a Technical Point of Contact (TPOC) within the Office of Financial Assistance.

We made recommendations to the General Counsel to:

- Provide a legal opinion as to whether float interest compensation is legal and allowable in FTA contracts.

- Determine whether any other remedies are needed concerning the use of float interest compensation to the FTA.

The Chief Financial Officer generally agreed with the recommendations addressed to him. Comments provided by the Associate Deputy Administrator for Capital Access, Acting Assistant Administrator for Administration, and General Counsel did not state whether they agreed or disagreed with the recommendations addressed to them and actions to address the findings and recommendations will be evaluated during the audit resolution process.

INTRODUCTION

A. Background

The secondary market of SBA's 7(a) loan program is intended to assist lenders to make long-term loans to small business and provide liquidity which may be used to make additional loans. In the secondary market a lender sells the SBA guaranteed portion of a loan to an investor. The investor as a registered holder receives an unconditional guarantee from the SBA which is backed by the full faith and credit of the United States. The SBA guaranteed portion of loans can also be pooled. The advantage of pooling is that in cases of delayed payments by originating lenders on individual loans, the investors would still be paid timely.

The SBA initially contracted with Colson Services Corporation as the Fiscal Transfer Agent (FTA) for the secondary market in 1989. Colson was awarded a second contract in April 1994 and the contract can be extended through June 2011, if all options are exercised. The FTA serves as a central registry of owners of guaranteed interests and of all SBA guaranteed interests sold or resold in the secondary market. It also receives remittances from lenders in respect to guaranteed interests, makes appropriate payments to each registered holder of a certificate along with a statement of account, and furnishes SBA with reports on program activity. As of September 30, 2002, the secondary market portfolio consisted of 48,492 loans, valued at approximately \$11,113,856,491 in 4,628 loan pools.

The Master Reserve Fund (MRF) was created to facilitate operation of loan pooling in SBA's 7(a) secondary market program. The MRF includes both the principal paid from borrowers and due to investors, as well as accumulated interest earnings which is intended to ensure timely payments to investors if there is a shortfall in borrower payments from monthly loan collections. As of September 30, 2002, the MRF totaled \$1.2 billion which included the initial principal payment to secondary market investors of around \$665 million and \$536 million in accumulated interest earnings which had been determined to be Federal funds.

SBA's Office of Capital Access oversees the Colson contract and the operations of the FTA. The FTA is currently compensated by the collection of fees (e.g., issuance, service, transfer, origination, etc). The FTA earns additional revenue on float interest from the investment and reinvestment of funds between the date payments are received from lenders and the date payments are received by the registered holders or SBA's MRF for loans included in loan pools. The MRF also is charged for services provided by other contractors selected by the FTA and approved by SBA including management and custodial fees, commissions, broker expenses, and trustee fees for managing the public funds in the MRF. These various fees and expenses are for investing the MRF in Treasury securities and other cash equivalent securities that contain no market risk.

B. Objectives and Scope

The objectives of the audit were to determine whether: (1) the MRF was properly accounted for in accordance with Federal regulations, (2) the FTA was properly performing its fiscal transfer agent functions, and (3) the FTA contract was properly awarded, administered and monitored.

We reviewed the contract with the FTA and reviewed internal accounting statements and documents from the FTA regarding the MRF. We analyzed 7(a) borrowers' payments to the FTA and disbursements of loan pool amounts to investors to determine an approximate amount of dollar earnings for float income due to the FTA. We met with Office of Financial Assistance officials (OFA) to discuss secondary market, and FTA operations. Interviews were conducted with Office of the Chief Financial Officer officials (OCFO) to discuss potential MRF financial reporting issues of the FTA. We also reviewed the basis point fees collected by the FTA for the SBA.

Audit fieldwork was performed from November 2000 through March 2002 and included tests that we considered necessary to answer our audit objectives. The audit was performed in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

FINDING 1 SBA Needs to Incorporate Proper Federal Accounting and Financial Management Procedures for Its Master Reserve Fund

SBA neither knew the fiscal health of the MRF nor timely reported this information to Agency decision-makers. This occurred because SBA did not reconcile the MRF as agreed to by SBA in our previous audit report issued in 1993. Additionally, while SBA receives monthly reports on the balance of the MRF from the FTA, SBA has not implemented financial reporting procedures which would identify the results of loan pooling operations (surpluses and shortfalls) within the MRF, nor analyzed the MRF for future potential revenues and projected shortfalls from loan pooling operations. Specifically, we found that: (1) the MRF has not been treated in a manner similar to a trust fund, and (2) the public funds held in the MRF were not registered with symbols and titles by Treasury in consultation with OMB. As a result, the true status of the MRF is unknown and a potential liability may exist in the MRF.

a. The MRF needs to be treated in a manner similar to a trust fund

The MRF earns investment income to ensure timely payment to pool investors when shortfalls arise in loan pooling operations. This investment income is derived from the “float” interest collected from investing borrower payments between time of receipt and the time those payments are then paid to loan pool investors. The MRF is, therefore, a fund held for later use in a fiduciary capacity. Currently, SBA does not require that its financial statements fully disclose the fiscal health and well-being of the MRF. Specifically, condensed balance sheet and income statement information does not exist for the MRF. As a result, SBA has insufficient information to know how the MRF is performing as a fiscal entity and is unable to make projections about its future performance.

According to Statements of Federal Financial Accounting Standards (SFFAS) No. 7, Section 83, a reporting entity may be responsible for funds financed with dedicated collections that are held for later use in a fiduciary capacity. Special accountability is required for the sake of contributors who expect to benefit from the fund’s future expenditures. Such funds are similar in nature to other Federal trust funds (inside or outside the budget) that are fiduciary in nature. SFFAS No. 7, Section 84, requires separate financial information about dedicated collections that should be provided if they are material either to the reporting entity, the beneficiaries or the contributors.

SFFAS No. 7, Section 85, includes the following reporting requirements for these funds:

- A description of each fund’s purpose;
- The sources of revenue or other financing for the period and an explanation of the extent to which the funds are inflows to the Government;

- Condensed information about assets and liabilities showing investments in Treasury securities, other assets, liabilities due and payable to beneficiaries, other liabilities, and fund balance;
- Condensed information on net cost and changes to fund balance showing revenues by type, program expenses, other expenses, other financing sources and other changes in fund balance; and
- Any revenues, other financing sources, or costs attributable to the fund under accounting standards.

SBA's FY 2001 financial statements reported that the MRF had accumulated interest earnings totaling \$490 million. The OCFO estimated that of the \$490 million, \$169 million was a contingent liability that would potentially be needed to cover shortfalls to investors in the future, \$253 million had been utilized to cover shortfalls in loan pooling operations in the past, and that the remaining \$68 million were earnings from pool operations (SBA equity). However, these estimates were based on analyzing the income and losses on five loan pools. These estimates were not based on a valid statistical sample of closed and open pools. In the April 2002 management letter from the independent auditors who audited SBA's financial statements, the auditors recommended that SBA determine whether the MRF should be treated in a nature similar to a trust fund for financial reporting purposes. In this audit, the auditors concluded that the MRF was in the nature of a trust fund and to properly comply with SSFAS No. 7, the MRF needed to be treated in a nature similar to a trust fund.

Since the inception of the MRF in 1986, SBA has not required the recognition of revenue or losses on loan pools in the MRF and, therefore, does not know the current financial condition of the MRF. SBA, therefore, needs to statistically reconcile the MRF for loan pools that have been fully paid since the beginning of the fund and for other transactions that have affected the MRF. This would establish SBA's equity position within the MRF. SBA also needs to analyze the MRF for future projected cash flows to identify potential future funding (if any) the MRF may need to ensure the solvency of the fund.

Additionally, as loan pools are paid-off, surpluses and shortfalls have not been recognized on loan pool operations in the MRF. These surpluses or shortfalls have not been netted against current investment income to provide the basis for condensed income statement information for the MRF in SBA's financial statements. A previous OIG audit (3-2-H-007-0036) issued in June 1993 recommended that the MRF be reconciled on a periodic basis to include funds due, funds received, funds disbursed and the amount of deficiency assessed to the MRF. Although SBA agreed with this recommendation, SBA took no action and the MRF has never been reconciled.

b. Public funds held within the MRF have not been registered with symbols and titles by Treasury in consultation with OMB

Government funds held within the MRF, estimated at \$536 million as of September 30, 2002, were not registered with symbols and titles by Treasury as required by Federal regulations. This occurred because SBA did not originally set up the MRF

correctly when the fund was established in 1985. As a result, the estimated \$536 million in government funds have not been properly accounted for with Treasury.

The GAO Policy and Procedures Manual, Title 7, Chapter 2.1.A and 2.1.B, requires that all public funds shall be deposited in and/or spent from a Federal fund or trust fund managed by Treasury. Account symbols are assigned by Treasury in consultation with OMB, and in compliance with the principles, standards, and related requirements prescribed by the Comptroller General.

[FOIA Exemption 5

] In discussions with OMB, SBA had not established Treasury symbols to properly account for the public funds held within the MRF. Since 1986, SBA has held the public funds in a non-government trust fund. In 1993, Treasury performed a Cash Management Review and determined that interest earnings in the MRF should be reported on SBA's Statement of Transactions (SF-224). To comply with this requirement, SBA should have worked with OMB to set up the required Treasury symbols to ensure correct reporting of interest earnings held within the MRF.

Recommendations

We recommend that the Chief Financial Officer in conjunction with the FTA:

- 1A. Report the results of MRF operations in compliance with SFFAS No. 7. This would include the creation of those financial statements or reports which would identify and report on the fiscal health of the MRF.
- 1B. Statistically reconcile the MRF as to the different amounts that make up the MRF to more properly identify the public funds from the MRF principal amounts. This would include: initial borrower payments held by the MRF, accumulated revenues and/or liabilities from loan pool operations, administrative fees and interest earnings.
- 1C. Work with the Office of Management and Budget (OMB) and Treasury officials to properly establish symbols and titles for the SBA Master Reserve Fund.

Management Comments

The Chief Financial Officer agreed to include the information required by SFFAS No. 7 in a footnote to SBA's financial statements and to work with the FTA to develop a plan for obtaining a complete accounting of the MRF. He also stated that while SBA believed reporting of the MRF has been consistent with past Treasury and OMB guidance, the MRF may be impacted by a new Treasury reporting requirement on Cash and Investments Held Outside of Treasury (CIHO) and an OMB mandate that the MRF be included in the reporting requirements under the Federal Credit Reform Act (FCR). The Chief Financial Officer further stated that SBA will work with OMB and Treasury to implement the reporting requirements of CIHO and FCR as they relate to the MRF.

Evaluation of Management's Comments

The Chief Financial Officer's comments are responsive to our recommendations.

FINDING 2 Fees Due to SBA are not Timely Remitted and are an Inappropriate Augmentation to SBA's Appropriation

The FTA collects, on behalf of SBA, certain fees from borrowers and lenders who participate in SBA loan programs around the 6th of each month. These fees are collected to reduce the subsidy rate for SBA loan programs and other loan program expenses. These fees are due immediately to SBA; however, SBA has allowed the FTA to hold this amount until around the 29th of each month before it remits the funds to SBA. This allows the FTA to receive approximately 23 days of float interest per month on the fees and this is the compensation for providing the collection services. An estimated \$527,000 over two years was paid to the FTA. This practice is an inappropriate augmentation to SBA's appropriation as SBA had the FTA use the float collected on the fees as compensation for collecting these fees rather than paying the compensation from appropriated funds.

31 USC 3302 identifies that an agent of the US Government having custody or possession of public money shall keep the money safe without using the money and shall deposit the money in the Treasury as soon as practicable without deduction for any charge or claim. The GAO Policy and Procedures Manual, Title 7 Chapter 5.3B requires the frequency of deposits of funds will depend upon the amount of funds received. Receipts of \$1,000 or more shall be deposited daily. 15 USC 636 identifies that basis point fees shall be paid to the SBA and used to reduce the subsidy on loans guaranteed to small business concerns.

As an example of the cost of the float income lost to SBA, we obtained the amounts from the largest fee payments made to SBA from the FTA for FY 2000 and FY 2001. These fees included the 50 basis point fees and loan accrual fees. These fees are collected around the 6th of the month and paid to SBA around the 29th of the month. We also obtained the actual money market (Vista) rate as a conservative example of the interest float that the FTA earned in FY 2000 and FY 2001. We computed an estimation of the FTA's earnings from float (See Appendix A). We estimated that the FTA made \$527,000 in float income for FY 2000 and FY 2001.

The enabling legislation for collection of basis point fees (15 USC 636) did not allow the FTA specific authority to use the float interest of the basis point fees as the compensation mechanism for collecting these fees. SBA, therefore, should be compensating the FTA from its own appropriation for the collection of these fees. Additionally, the FTA is SBA's fiscal agent and according to the above Federal fiscal procedures, it is the responsibility of the FTA to make deposits of funds owed to the SBA daily when receipts are \$1,000 or more.

Recommendations

We recommend that the Associate Deputy Administrator for Capital Access in conjunction with the Acting Assistant Administrator for Administration:

- 2A. Direct the FTA to submit basis point fees collected to the Federal government by the end of each business day when the depository receipts total over \$1,000.
- 2B. Negotiate for a fixed compensation rate for the FTA to collect basis point fees and compensate the FTA through SBA's appropriation.
- 2C. Determine whether any other remedies are needed concerning the inappropriate augmentation of SBA's appropriation.

Management Comments

The response provided by the Associate Deputy Administrator for Capital Access did not specify whether he agreed or disagreed with the finding and recommendations.

Evaluation of Management's Comments

The comments provided by the Associate Deputy Administrator for Capital Access were not responsive to the recommendations and actions to address the finding and recommendations will be evaluated during the audit resolution process.

FINDING 3 Contract Administration Weaknesses do not Fully Protect the Interests of the Federal Government

The FTA contract does not fully protect the interests of the Federal government or ensure that the government receives the best services for the least cost. Specifically, we found: (1) the FTA contract was improperly extended beyond five years, (2) the legality of float compensation payments to the FTA was unclear and an unsound business practice, (3) accurate FTA contract costs were not tracked or maintained, (4) Federal regulations or procedures for administering the MRF do not exist, (5) the terms and conditions for auditing the FTA by its Independent Public Accountant need to be changed to include meeting FOIA requirements and performing audits in accordance with Statements on Auditing Standards (SAS) 70 requirements.

a. The Contract was Improperly Extended Beyond Five Years

In 1996, SBA improperly extended the contract with the FTA (Contract No. SBAHQ-94-C-8114) scheduled to expire in 1999 for seven additional years and included two additional 30-month options which, if exercised, would ultimately cause the contract to be effective from April 1994 through June 2011. This occurred because SBA believed that the maximum time provisions in the Federal Acquisition Regulations (FAR) for contractor services did not apply since the contractor was not being compensated with appropriated Federal funds. As a result, the contract with the FTA did not terminate in 1999 and a new FTA contract was not fairly competed. Potentially, a different contractor could have been selected that would have afforded SBA the opportunity to seek the best value through open competition for FTA services and which could have resulted in less cost to the Federal government.

41 USC 353(d) limits Federal service contracts to five years. Additionally, 41 USC 253 requires full and open competition through the use of competitive procedures such as sealed bids and competitive procedures on new contract proposals that are best suited under the circumstances of the procurement.

SBA initially tried to extend a previous 1989 contract with the same FTA in 1992 for a term beyond five years. [FOIA Exemption 5

] In 1996, SBA extended the current contract [FOIA Exemption 5].

CICA allows for seven exceptions that can be utilized as justification whereby other than competitive procedures are authorized 41 USC 253(a)(1)(c). During our review of FTA contract files, we did not find documentation by SBA supporting that any of these seven exceptions were relied upon for extending the FTA contract extension and justifying additional option periods.

By improperly extending the existing contract with the FTA in 1996, SBA negated any possibility that a new contract could have been written in 1999 when the 1994 contract should have expired. This prevented full and open competition of the existing contract with the FTA. Additionally, the methods of compensation in the existing contract along with a lack of accounting for the costs of the contract prevent SBA from judging whether it is receiving the best services at the least cost to the Federal government (See b and c below). Given the history of the FTA contract extension issues and the financial issues regarding financial statements (Finding 1), SBA should move Contracting Officers Technical Representative duties to the Office of Chief Financial Officer. Additionally, SBA should retain the current COTR as the Technical Point of Contact for day-to-day operational oversight of the FTA contract.

b. Float Compensation Payments to the FTA are an Unsound Business Practice and Need to be Eliminated

SBA pays “float” interest compensation as a part of its compensation package to the FTA for its services. It is unclear whether this practice is prohibited by law or regulation, however this form of compensation should be eliminated from future FTA contracts due to the unknown and potentially large amounts of compensation that could occur during periods of high interest rates. Because of the open-ended form of this compensation method, the FTA was compensated an estimated \$7.49 million for its services in FY 2000 and FY 2001 in float interest income, exclusive of other SBA approved fees. This amount could be over compensation given the work that was performed by the FTA at that time.

According to the legislative history relating to the Secondary Markets Improvement Act of 1984 (P.L. 98-352), in cases of delayed payments by originating lenders on individual loans, the agent would still continue to make timely payments to pool investors, covering the shortfall with fees charged and profits made from the interest on monies in the custody of the agent during the float between payments received and payments made. Additionally, the FTA could only charge such fees as are approved by SBA to cover expenses directly related to central registration and to the administration and servicing of the pools.

The FTA earns float on the front-end and on the back-end. For front-end float, the FTA receives the payments from the borrowers around the third of every month and holds the payments from the borrowers for about twelve days (the 3rd to the 15th). For back-end float, the FTA transfers the funds from the MRF on the 25th of the month and the FTA holds the funds for an estimated three days until the investors cash the checks or the funds are deposited by ACH in the investors’ accounts.

As an example of the cost of the float income lost to the MRF and to the SBA, we obtained the amount of funds paid by borrowers to the MRF (front-end float) and the funds paid to investors (back-end float). We also obtained the actual money market (Vista) rate as a conservative example of the interest float that the FTA earned in FY 2000 and FY 2001. We computed an estimation of the FTA’s earnings from float income

(See Appendix B for front-end float and Appendix C for back-end float). We estimated that the FTA received \$7.49 million over the past two years in float income.

The OIG took exception to the use of back-end float in a prior audit report (3-2-H-007-036). Treasury also performed a Cash Management review of the MRF as a result of the 1993 OIG audit. The Cash Management Review stated that the issue of whether the contractor should earn interest on the float associated with the negotiation of checks is a contractual matter to be resolved by SBA management, the Office of Inspector General and SBA General Counsel. While Treasury's Cash Management Review discussed the use of back-end float, front-end float is also an issue that is negotiable for future FTA contracts.

The legislative history of the Secondary Market Improvement Act indicates that float income is to be used to cover the shortfall between when borrowers are late making payments to the MRF and the FTA's duty to make timely payment to the investors in the secondary market. Additionally, the FTA should only be allowed to earn fee compensation that is directly related to central registration and to the administration and servicing of the loan pools. Therefore, the \$7.49 million received over the past two years may have been an improper source of compensation to the FTA since it is not a fee directly related to the central registration and to the administration and servicing of loan pools within the secondary market.

Given the stated legislative history of the Secondary Markets Improvement Act and the large amounts of funds that the FTA has received as float interest compensation, the SBA Office of General Counsel (OGC) should provide an opinion as to whether this is a legal form of contract compensation and whether financial remedies are necessary. For future FTA contracts, we believe this form of compensation needs to be eliminated to protect the MRF and the Federal government from potentially over compensating the FTA.

c. Accurate FTA Contract Costs are not tracked or maintained

The FTA contract is currently categorized as a firm-fixed-price contract with no cost to the government. However, the contract cost the government at least \$5.8 million in FY 2000 and \$6.1 million in FY 2001 for secondary market and MRF activities. These costs are either taken directly out of the MRF or from float interest compensation to the FTA. SBA did not have a mechanism to track the costs of the contract in any form. As a result, the \$5.8 and \$6.1 million in contract costs for FY 2000 and FY 2001 respectively, were not reported in SBA financial statements. This omission prevents Agency decision-makers from knowing the true costs of FTA activities.

According to FAR 16.202, a firm-fixed-price contract provides for a price that is not subject to any adjustment on the basis of the contractor's cost experience in performing the contract. Additionally, a firm-fixed-price contract is suitable for acquiring commercial items or for acquiring other supplies or services on the basis of reasonably definite functional or detailed specifications when the contracting officer can establish fair and reasonable prices at the outset. Fair and reasonable prices occur when

there are reasonable price comparisons with prior purchases of the same or similar supplies or services made on a competitive basis or supported by valid cost or pricing data and available cost or pricing information permits realistic estimates of the probable costs of performance.

SBA has maintained that since the MRF does not use appropriated funds, SBA does not have to follow the FAR when contracting for FTA services. SBA has, therefore, awarded no cost contracts with the FTA and has not tracked contract costs for FTA services. SBA has incorrectly assumed that since there were no appropriated funds expended, there was no cost to the Federal government. [FOIA Exemption 5

] A conservative estimate of the FY 2000 and FY 2001 contract costs to the Federal government includes the following:

	<u>FY 2000</u>	<u>FY 2001</u>
Management & Custodial Fees	\$ 910,708	\$1,103,325
Commission & Broker Expenses	\$ 739,622	\$1,013,873
Trustee Fees	\$ 100,000	\$ 100,000
Front-end Float Income (from 5 th to 15 th)	\$2,510,874	\$2,427,883
Back-end Float Income (from 25 th to 28 th)	\$1,320,532	\$1,233,878
Float Income on Fees Collected for SBA	<u>\$ 267,761</u>	<u>\$ 259,194</u>
Totals	<u>\$5,849,497</u>	<u>\$6,138,153</u>

The amounts listed above are the various forms of compensation paid to the FTA. The first three amounts are paid from the MRF. The front-end and back-end float are the interest amounts made by the FTA while the borrower and investor payments are held by the FTA. The float income on fees collected for SBA are the amounts that Treasury would make on the timely remission of fees to the Federal government. These amounts do not include thousands of dollars of fees charged by the FTA on transactions affecting loans in the secondary market for the 7(a) loan program. The FTA earns more compensation than is listed here and these amounts are used for comparison purposes to track the costs of FTA services to the Federal government.

It is incumbent upon SBA to obtain the best possible services for the least cost in contracting for FTA services. To do this, the SBA must develop a system to identify and track contract costs by the FTA so that when the next contract solicitation is written, SBA will have the information necessary on which to base an informed contract decision and make a cost justified award.

d. There are no Federal Regulations or Procedures for Administering the Master Reserve Fund

SBA has not promulgated Federal regulations or SBA Standard Operating Procedures for administering the Master Reserve Fund. The SBA contract with the FTA contains the only procedures for the operation of the MRF. Given that the MRF totals

over \$1.2 billion as of September 30, 2002 and that \$536 million are Federal funds, there should be procedures at SBA for how the MRF should be operated and overseen.

Section 3.B. of the Small Business Secondary Markets Improvement Act of 1984 (P.L. 98-352), requires the SBA to promulgate final rules and regulations to implement the act.

At a minimum, we believe such procedures or regulations would:

- Designate the MRF to be Federal funds and include SBA's responsibilities for managing the fund.
- Designate the date of the billing month when payments from borrowers to the MRF actually become Federal funds.
- Designate the date of the billing month when MRF funds actually become funds due to investors and are then transferred out of MRF interest bearing accounts.
- Designate the investment instruments the MRF can be invested in and the compensation mechanism for the trustee to invest MRF funds.
- Designate the amount of fees to be paid from the MRF and for what purposes.
- Designate how suspense funds (funds collected from borrowers who cannot be identified, but whose funds are ultimately due to MRF) are to be treated.
- Designate the responsibility for overseeing the reconciliation and accounting procedures the CFO must utilize to properly account for the MRF.

The issue of no Federal procedures or regulations governing the correct or complete functioning of the MRF was reported by Walker & Company, LLP (an Independent Public Accountant) hired by the Chief Financial Officer to evaluate the effectiveness of SBA's oversight of the MRF in December 2000. SBA's response to that report was to identify that this was not considered a problem. The FTA was audited by an IPA that had to meet American Institute of Certified Public Accountant (AICPA) standards. However, the provisions governing the correct and complete operation of the MRF (containing over \$500 million in Federal funds) are by an SBA contract. The audits performed by the FTA's IPA do not review SBA's operational oversight of the MRF, nor examine the long-term fiscal health of the MRF.

e. The terms and conditions for auditing the Fiscal Transfer Agent by an Independent Public Accountant need to be changed

Currently, the FTA is audited by an IPA hired by the FTA to determine the adequacy of financial and operational controls and procedures in accordance with the FTA contract. The audits performed by the IPA are not required to be in accordance with Government Auditing Standards, nor are there requirements that the IPA determine compliance with applicable laws and regulations. To ensure proper audit procedures are performed, audits of the FTA should be in accordance with Government Auditing Standards and any non-compliance with applicable laws and regulations should be timely reported to the SBA and the OIG. This would ensure the proper scope of audits of the FTA and Trustee, and as FTA and Trustee issues arise, the SBA and OIG would be fully

informed and aware of these issues. Additionally, the contract between SBA and the FTA did not contain an audit access clause that would allow OIG to review auditor working papers upon request.

f. Audit Reports on FTA financial and operational controls are subject to Freedom of Information Act requests

Letters transmitting audit reports on the performance of the FTA by its IPA contain the wording that the reports are not subject to Freedom of Information Act (FOIA) requests. 5 U.S.C. 552(a)(1) requires that each Federal agency shall make available information of the general course and method by which its functions are channeled and determined. Audits of Federal programs or Federally sponsored programs are subject to FOIA requests. The restrictions that audit reports on FTA activities are not subject to FOIA are in violation of the current FTA contract since such disclosure is required by law. This wording needs to be eliminated from transmittals of IPA reports on FTA activities specifically related to the FTA contract.

g. The FTA should be required to have audits in accordance with Statement on Auditing Standards 70

The FTA should be required to have reviews of its operations in accordance with the requirements of Statement on Auditing Standards (SAS) 70. SAS 70 requires reviews of internal controls, and system-wide areas such as computer security and trust accounting procedures. We believe that SAS 70 reviews of a proper scope would provide OIG and other auditors hired to audit SBA's financial statements reasonable assurance and therefore, could avoid duplication by the various audit organizations and reduce overall auditing of the FTA.

Recommendations

We recommend that the Associate Deputy Administrator for Capital Access in conjunction with the Acting Assistant Administrator for Administration:

- 3A. Begin the process of initiating a new procurement action for FTA activities and then terminate the existing contract with the FTA when either a new contract with the current FTA can be enacted or a new contract with a different FTA can be enacted.
- 3B. Eliminate float interest compensation to the FTA for both the front-end and back-end float compensation periods in all future contracts with an FTA.
- 3C. Review FTA activities and identify contract costs for fees and services. Report these contract costs in proposed MRF trust fund financial statements so future FTA contracts will have historical cost data for comparison purposes.

- 3D. Change the contract provision for audits of the Fiscal Transfer Agent to include access rights to audit reports and working papers by the OIG and the U.S. General Accounting Office.

We recommend that the Associate Deputy Administrator for Capital Access:

- 3E. Ensure that future audits of the Fiscal Transfer Agent by its Independent Public Accountant include a Statement on Auditing Standards (SAS) 70 review of internal controls and computer security controls.
- 3F. Develop SBA procedures and regulations governing the proper operation of the MRF. These procedures would include how to treat MRF float income and other operational aspects of the MRF.

We recommend that the Acting Assistant Administrator for Administration:

- 3G. Instruct SBA contracting officers to obtain OGC review for legal sufficiency and not to extend contracts beyond five years in the future.
- 3H. Move the Contracting Officers Technical Representative (COTR) duties for the current and future FTA contracts to the Office of Chief Financial Officer and maintain a Technical Point of Contact (TPOC) within the Office of Financial Assistance.

We recommend that the Office of General Counsel:

- 3I. Provide a legal opinion as to whether float interest compensation is legal and allowable in FTA contracts.
- 3J. Determine whether any other remedies are needed concerning the use of float interest compensation to the FTA.

Management Comments

The responses provided by the Associate Deputy Administrator for Capital Access, Acting Assistant Administrator for Administration, and General Counsel did not specify whether they agreed or disagreed with the finding and the recommendations.

Evaluation of Management's Comments

The comments provided by the Associate Deputy Administrator for Capital Access, Acting Assistant Administrator for Administration, and General Counsel were not responsive to the recommendations and actions to address the finding and recommendations will be evaluated during the audit resolution process.

APPENDIX A

ESTIMATE OF FLOAT INTEREST EARNED BY FTA ON FEE COLLECTIONS

FY 2000 Projected Totals:

Month	Money Market Rate	Days Held	Interest Factor	40/50 Basis Point Fee Collections	Loan Accrual Fee Collections	Total Collections	Estimated Float Interest
Oct	4.91%	23	0.003094	\$3,212,613	\$2,429,083	\$5,641,696	\$17,455
Nov	5.08%	23	0.003201	\$3,230,903	\$2,079,287	\$5,310,190	\$16,998
Dec	5.05%	23	0.003182	\$3,125,636	\$2,418,983	\$5,544,619	\$17,644
Jan	4.96%	25	0.003397	\$3,296,312	\$2,780,581	\$6,076,893	\$20,645
Feb	5.26%	23	0.003315	\$3,422,161	\$2,565,764	\$5,987,925	\$19,847
Mar	5.47%	23	0.003447	\$3,453,451	\$2,879,797	\$6,333,248	\$21,830
Apr	5.74%	25	0.003932	\$3,622,376	\$2,907,259	\$6,529,635	\$25,671
May	5.84%	24	0.003840	\$3,236,100	\$2,689,150	\$5,925,250	\$22,753
Jun	6.10%	23	0.003844	\$3,544,838	\$2,906,702	\$6,451,540	\$24,799
Jul	6.26%	25	0.004288	\$3,567,353	\$2,874,639	\$6,441,992	\$27,621
Aug	6.27%	23	0.003951	\$3,724,577	\$3,013,327	\$6,737,904	\$26,621
Sep	6.30%	23	0.003970	<u>\$3,603,481</u>	<u>\$2,914,844</u>	<u>\$6,518,325</u>	<u>\$25,877</u>
Totals				<u>\$41,039,801</u>	<u>\$32,459,416</u>	<u>\$73,499,217</u>	<u>\$267,761</u>

FY 2001 Projected Totals:

Month	Money Market Rate	Days Held	Interest Factor	40/50 Basis Point Fee Collections	Loan Accrual Fee Collections	Total Collections	Estimated Float Interest
Oct	6.31%	24	0.004149	\$3,724,698	\$2,968,730	\$6,693,428	\$27,771
Nov	6.34%	23	0.003995	\$3,989,552	\$3,273,229	\$7,262,781	\$29,015
Dec	6.31%	23	0.003976	\$3,744,414	\$3,329,574	\$7,073,988	\$28,127
Jan	5.80%	24	0.003814	\$3,560,783	\$3,216,558	\$6,777,341	\$25,847
Feb	5.15%	23	0.003245	\$4,417,019	\$3,425,344	\$7,842,363	\$25,450
Mar	4.94%	23	0.003113	\$3,860,267	\$3,052,760	\$6,913,027	\$21,519
Apr	4.59%	24	0.003018	\$3,903,848	\$3,237,872	\$7,141,720	\$21,554
May	3.83%	23	0.002413	\$3,854,070	\$3,227,182	\$7,081,252	\$17,090
Jun	3.64%	23	0.002294	\$3,969,658	\$3,227,856	\$7,197,514	\$16,509
Jul	3.52%	24	0.002315	\$4,059,339	\$3,362,877	\$7,422,216	\$17,179
Aug	3.41%	23	0.002149	\$4,130,472	\$3,345,567	\$7,476,039	\$16,064
Sep	2.86%	25	0.001959	<u>\$3,308,997</u>	<u>\$3,361,523</u>	<u>\$6,670,520</u>	<u>\$13,067</u>
Totals				<u>\$46,523,117</u>	<u>\$39,029,072</u>	<u>\$85,552,189</u>	<u>\$259,194</u>

Two Year Total

\$526,955

APPENDIX B

ESTIMATE OF FRONT-END FLOAT INTEREST EARNED BY FTA ON MRF

FY 2000 Estimated FTA front-end float interest:

Month	Pool Receipts Per Month	Money Mkt Rate	Days Held By FTA ¹ (5.75/365)	Estimated Float Interest Earned
Oct	\$217,131,501	4.91%	0.015753425	\$167,950
Nov	\$214,878,393	5.08%	0.015753425	\$171,962
Dec	\$279,261,510	5.05%	0.015753425	\$222,166
Jan	\$220,036,476	4.96%	0.015753425	\$171,930
Feb	\$222,580,516	5.26%	0.015753425	\$184,437
Mar	\$245,662,679	5.47%	0.015753425	\$211,691
Apr	\$230,239,350	5.74%	0.015753425	\$208,193
May	\$234,509,467	5.84%	0.015753425	\$215,749
Jun	\$247,072,911	6.10%	0.015753425	\$237,427
Jul	\$244,180,612	6.26%	0.015753425	\$240,802
Aug	\$252,565,146	6.27%	0.015753425	\$249,469
Sep	\$230,839,215	6.30%	0.015753425	\$229,100
Totals	\$ 2,838,957,774			\$2,510,874

FY 2001 Estimated FTA front-end float interest:

Month	Pool Receipts Per Month	Money Mkt Rate	Days Held By FTA (5.75/365)	Estimated Float Interest Earned
Oct	\$236,686,529	6.31%	0.015753425	\$235,276
Nov	\$248,107,586	6.34%	0.015753425	\$247,802
Dec	\$248,400,565	6.31%	0.015753425	\$246,920
Jan	\$274,156,145	5.80%	0.015753425	\$250,496
Feb	\$249,475,559	5.15%	0.015753425	\$202,400
Mar	\$289,723,850	4.94%	0.015753425	\$225,469
Apr	\$314,309,408	4.59%	0.015753425	\$227,272
May	\$293,886,365	3.83%	0.015753425	\$177,318
Jun	\$352,977,327	3.64%	0.015753425	\$202,406
Jul	\$291,400,387	3.52%	0.015753425	\$161,588
Aug	\$289,666,175	3.41%	0.015753425	\$155,606
Sep	\$211,587,662	2.86%	0.015753425	\$95,330
Totals	\$ 3,300,377,558			\$2,427,883

¹ Our calculations were based upon an estimated average of 5.75 days the FTA holds the float interest compensation per month.

APPENDIX C

ESTIMATE OF BACK-END FLOAT INTEREST EARNED BY FTA ON MRF

FY 2000 Estimated FTA back-end float interest:

Month	Pool Receipts Per Month	Money Mkt Rate	Days Held By FTA ² (3/365)	Estimated Float Interest Earned
Oct	\$274,833,787	4.91%	0.008219178	\$110,912
Nov	\$240,829,243	5.08%	0.008219178	\$100,554
Dec	\$221,296,611	5.05%	0.008219178	\$ 91,853
Jan	\$221,564,210	4.96%	0.008219178	\$ 90,325
Feb	\$251,807,655	5.26%	0.008219178	\$108,864
Mar	\$217,913,475	5.47%	0.008219178	\$ 97,972
Apr	\$227,043,439	5.74%	0.008219178	\$107,115
May	\$248,388,543	5.84%	0.008219178	\$119,227
Jun	\$228,784,542	6.10%	0.008219178	\$114,706
Jul	\$245,292,949	6.26%	0.008219178	\$126,208
Aug	\$242,743,710	6.27%	0.008219178	\$125,096
Sep	\$246,616,326	6.30%	0.008219178	\$127,700
Totals	\$ 2,867,114,490			\$1,320,532

FY 2001 Estimated FTA back-end float interest:

Month	Pool Receipts Per Month	Money Mkt Rate	Days Held By FTA (3/365)	Estimated Float Interest Earned
Oct	\$255,850,102	6.31%	0.008219178	\$132,692
Nov	\$237,115,519	6.34%	0.008219178	\$123,560
Dec	\$247,423,507	6.31%	0.008219178	\$128,321
Jan	\$249,204,345	5.80%	0.008219178	\$118,799
Feb	\$253,326,599	5.15%	0.008219178	\$107,230
Mar	\$278,427,691	4.94%	0.008219178	\$113,049
Apr	\$246,685,540	4.59%	0.008219178	\$ 93,065
May	\$293,264,811	3.83%	0.008219178	\$ 92,318
Jun	\$303,365,533	3.64%	0.008219178	\$ 90,760
Jul	\$285,761,701	3.52%	0.008219178	\$ 82,675
Aug	\$299,478,696	3.41%	0.008219178	\$ 83,936
Sep	\$287,033,280	2.86%	0.008219178	\$ 67,472
Totals	\$ 3,236,937,323			\$1,233,878


² Our calculations were based upon an average of 3 days the FTA holds the float interest compensation per month. A statistical sample of back-end float in our 1993 audit yielded a 5.5 day average for back-end float, however since ACH payments have become more prevalent, we selected a three day average to be conservative.



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

DATE: DEC 19 2002

TO: Robert G. Seabrooks

FROM: Thomas A. Dumaresq
Chief Financial Officer 

SUBJECT: Audit of SBA's Oversight of the Fiscal Agent for the 7(a) Loan Program

Your draft report dated November 19, 2002 on this subject included three recommendations on the financial reporting of the Master Reserve Fund (MRF). My responses to the recommendations follow.

IG Recommendation

1A. Report the results of MRF operations in compliance with SFFAS No. 7. This would include the creation of those financial statements or reports which would identify and report on the fiscal health of the MRF.

CFO RESPONSE

We agree to report the MRF financial status in the SBA's FY 2002 financial statements using the guidance provided by the Federal Accounting Standards Advisory Board (FASAB) in the Statement of Federal Financial Accounting Standard Number 7 (SFFAS No. 7). SFFAS No. 7 in paragraph 83 requires the following information be reported for under the "Accountability for Dedicated Collections:"

- (a) *A description of each fund's purpose, how the administrative entity accounts for and reports the fund, and its authority to use those collections.*
- (b) *The sources of revenue or other financing for the period and an explanation of the extent to which they are inflows of resources to the Government or the result of intragovernmental flows.*
- (c) *Condensed information about assets and liabilities showing investments in Treasury securities, other assets, liabilities due and payable to beneficiaries, other liabilities, and fund balance.*
- (d) *Condensed information on net cost and changes to fund balance showing revenues by type (exchange/nonexchange), program expenses, other expenses, other financing sources, and other changes in fund balance.*

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APPENDIX D

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- (e) *Any revenues, other financing sources, or costs attributable to the fund under accounting standards, but not legally allowable as credits or charges to the fund.*

The SBA's FY 2002 financial statements will include the above information, but, it will be included in a footnote to the financial statements, not in the face of the financial statements. Inclusion of the MRF balance and activity in the financial statements themselves would overstate the SBA's assets (by \$1.2 billion) and cash activity (by \$3.0 billion) for the year. The MRF is not "money for the government" and is not deposited in the Treasury or included in Treasury cash reporting. Rather, the MRF is derived from 7(a) secondary market cashflow to meet obligations due to secondary market investors. Any residual amount in the MRF funds not ultimately needed to meet secondary market obligations would belong to the SBA and be reported in the Agency's financial statements.

IG Recommendation

1B. Statistically reconcile the MRF as to the different amounts that make up the MRF to more properly identify the public funds from the MRF principal amounts. This would include: initial borrower payments held by the MRF, accumulated revenues and/or liabilities from loan pool operations, administrative fees and interest earnings.

CFO RESPONSE

We agree with this recommendation. During FY 2002, the SBA obtained an estimate of the amount of the MRF that might ultimately be available to the government. The SBA's fiscal agent developed this estimate through an analysis of a representative sample of 50 closed MRF pools. Although the fiscal agent does not maintain an accounting of MRF funds on an individual pool basis, the actual mechanics of MRF activity were used by the fiscal agent to model the results of the 50 closed pools. This is a start toward the objective of this recommendation.

The SBA will work with its fiscal agent to develop a plan for obtaining a complete accounting of the MRF including the revenue, expenses and the liability for secondary market obligations. This may, however, require an extensive enhancement to the fiscal agent's accounting system to provide "pool accounting" showing MRF results on an individual pool basis. This may be expensive and could require substantial time for its completion. In the interim, the results of the 50 pool analysis will be used to provide data for SBA's financial statements. SBA will also consider whether any of the more accessible data could be used to address this recommendation in the short run.

IG Recommendation

1C. Work with the Office of Management and Budget (OMB) and Treasury officials to properly establish symbols and titles for the SBA Master Reserve Fund.

CFO RESPONSE

As stated in the response to 1A., the MRF is not "money for the government" and is not deposited in the Treasury or currently included in Treasury cash reporting. We believe that the reporting of the MRF has been consistent with past Treasury and OMB guidance.

The SBA will obtain Treasury advice as to the inclusion of the MRF in the Treasury reporting requirement beginning January 1, 2003 on Cash and Investments Held Outside of Treasury (CIHO). Assuming the MRF is to be included in CIHO, the SBA will work with Treasury to comply with this requirement.

The OMB has mandated that the MRF be included in the reporting requirements under the Federal Credit Reform Act (FCR.) The SBA will work with the OMB to determine the nature and extent of the reporting under FCR.

We are not certain how the reporting requirements of FCR and CIHO will work together. Perhaps the cashflow and balance of the MRF will be reported under CIHO, while the MRF residual will be included under FCR. The SBA will work with OMB and Treasury to implement FCR and CIHO together.

CONCLUSION

Thank you for this opportunity to reply to the draft report on the "Audit of SBA's Oversight of the Fiscal Agent for the 7(a) Loan Program." I will be glad to answer any questions that you may have on this response.

APPENDIX E

AUDIT REPORT DISTRIBUTION

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