

Updated information for Report No. 1-08

Subsequent Independent Auditor's Action Affecting Reliance on SBA's Audited Financial Statements for FY 2000 and 2001

The Small Business Administration (SBA) was notified on December 20, 2002, by its independent auditor that SBA's financial statements for fiscal years 2000 and 2001, and the auditor's reports thereon, should no longer be relied on. SBA has indicated it is committed to resolving the discrepancies which involve its disaster loan cost models and the related accounting as quickly as possible and will be issuing revised financial statements and audit reports upon completion of an analysis underway to assess the impact of the discrepancies. A copy of the letter dated January 6, 2003, notifying one of the various Congressional oversight Committees is attached along with the notification from the independent auditor.



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

JAN 6 2003

The Honorable John Kerry
Chairman
Committee on Small Business and Entrepreneurship
United States Senate
Washington, DC 20510

Dear Chairman Kerry:

The purpose of this letter is to make you aware that the U.S. Small Business Administration (SBA) has been advised by its independent auditor, Cotton & Company LLP (Cotton), "...that SBA's financial statements for fiscal years 2000 and 2001, and Cotton & Company's audit reports thereon, should no longer be relied upon." According to Cotton, those financial statements may need "material adjustments for...disaster loans sold, disaster loan subsidy expense, and other directly-related accounts and footnotes corresponding with the SBA's disaster loan program."

Current senior SBA management (including the new Chief Financial Officer team put in place by Administrator Barreto) became aware of this issue and was working to solve it prior to receiving Cotton's determination. SBA is closely examining its disaster loan subsidy cost calculation and is making every effort to resolve the issue by the end of March 2003. In addition to employing all available SBA staff, the Agency is contracting for assistance from outside experts to review and verify SBA's analysis. It is also important to recognize that the issue is limited solely to the disaster loan subsidy estimates and SBA's disaster loan sale results.

In short, at issue is the consistency and precision of SBA's methods for valuing its disaster loans sold through the asset sales program and those that are retained in the Agency's loan portfolio. SBA followed all of the guidance available in developing its cost models and validated that the models were consistent and satisfactory prior to beginning the sales program. However, over time the results have revealed inconsistencies between the model used to determine the loan "value to government" for sale purposes and the model required for measuring the program's budget and accounting cost under the Federal Credit Reform Act. The model used for disaster loan sales has shown a substantial gain while the model used for budgeting purposes has shown a loss. In addition, the models appear to lack the precision necessary for accurately valuing the impact of the asset sales on the disaster loan portfolio.

It is important to note that SBA's FY 2000 and FY 2001 financial statements both disclosed the accounting book losses associated with SBA's disaster loan sales.

SBA IS AN EQUAL OPPORTUNITY EMPLOYER AND PROVIDER

Furthermore, throughout the asset sales program, SBA has followed the budgeting and accounting guidance issued by the Office of Management and Budget and Financial Accounting Standards Advisory Board and sought outside experts to help develop the program and cost models.

SBA is committed to resolve the discrepancies as quickly as possible. The impact of our efforts to revise our disaster loan cost models and the related accounting, however, may affect the required appropriations for SBA's disaster loan program and the cost of SBA's disaster loan asset sales. Revised financial statements and audit reports will be issued upon completion, if necessary and appropriate.

If you have any questions or require any additional information, please do not hesitate to contact me at 202-205 6449.

Sincerely,



Thomas Dumaesq
Chief Financial Officer

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, CISA
MATTHEW H. JOHNSON, CPA, CGFM ♦ SAM HADLEY, CPA, CGFM ♦ COLETTE Y. WILSON, CPA ♦ ALAN ROSENTHAL, CPA

December 20, 2002

Mr. Thomas Dumaresq
Chief Financial Officer
U.S. Small Business Administration
409 Third Street, SW
Washington, DC 20416

Dear Mr. Dumaresq:

As required by auditing standards issued by the American Institute of Certified Public Accountants, this letter will advise you to notify all persons known to be relying or likely to rely upon SBA's FY 2000 and 2001 financial statements and related Cotton & Company audit reports that:

- Those financial statements and reports should no longer be relied on, because of the possibility that material adjustments may be necessary for disaster loans sold, disaster loan subsidy expense, and other directly-related accounts and footnotes corresponding with SBA's disaster loan program.
- Revised financial statements and audit reports will be issued upon completion and subject to the results of your investigation.

Before SBA makes its notification, please assure that you discuss with appropriate regulatory agencies the disclosure to be made or other measures to be taken in the circumstances.

Please refer to auditing standard AU 561, Subsequent Discovery of Facts Existing at the Date of the Auditor's Report, for criteria governing our responsibilities. Cotton & Company will work with you to ensure that requirements are understood and met as they apply to this matter.

Very truly yours,

COTTON & COMPANY LLP



Charles Hayward, CPA

cc: Mr. Peter McClintock
Acting Inspector General


established 1981

**AUDIT OF SBA'S FY 2000
FINANCIAL STATEMENTS
AUDIT REPORT NUMBER 1-08
FEBRUARY 28, 2001**

This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.



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

AUDIT REPORT
Issue Date: February 28, 2001
Number: 1-08

To: Joseph P. Loddo, Chief Financial Officer

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

Subject: Audit of SBA's FY 2000 Financial Statements

Pursuant to the Chief Financial Officers Act of 1990, attached is the Independent Auditors' Report issued by Cotton & Company LLP. They concluded that the financial statements present fairly, in all material respects, the financial position of SBA as of September 30, 2000, and 1999, and its net costs, changes in net position, budgetary resources, and financing for the years then ended in conformity with generally accepted accounting principles.

The section on SBA's internal control structure discusses reportable conditions related to the financial reporting process and the agency-wide security program. The section on compliance with laws and regulations discloses no instances in which SBA's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996. Additionally, no instances of noncompliance with other laws and regulations were identified in this section. The auditors found other management and internal control issues that will be communicated in a separate management letter.

SBA management stated that it would work to maintain this high standard while making SBA even more efficient and effective in serving the needs of the nation's small businesses. They also stated they are working to eliminate the reportable conditions on the financial reporting process and controls over agency information systems. **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 decision on SBA Form 1824, Recommendation Action Sheet, also attached, within 30 days.

Should you or your staff have any questions, please contact Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-7204.

Attachments

COTTON & COMPANY LLP

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Inspector General
United States Small Business Administration

Independent Auditors' Report

Cotton & Company LLP audited the accompanying Balance Sheet of the U.S. Small Business Administration (SBA) as of September 30, 2000, and 1999, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing for the years then ended. These financial statements are the responsibility of SBA management and were prepared in accordance with Office of Management and Budget (OMB) Bulletin No. 97-01, Form and Content of Agency Financial Statements, as amended. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with *Government Auditing Standards*, auditing standards generally accepted in the United States of America, and OMB Bulletin No. 01-02, Audit Requirements for Federal Financial Statements. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures relating to the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

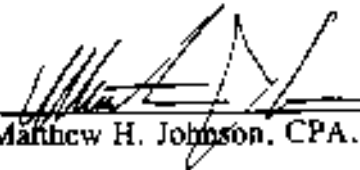
Our audit was conducted to form an opinion on the financial statements. We did not audit information that is not a required part of the financial statements, and therefore, do not express an opinion on it. We did apply certain limited procedures that consisted principally of inquires of management and selected tests of this information, such as comparing it for consistency with the financial statements and footnotes. This unaudited information, listed below, is not a required part of the financial statements, but is supplementary information required by OMB Bulletin 97-01, as amended:

- Management's Discussion and Analysis
- Required Supplementary Information
- Required Supplementary Stewardship Information
- Other Accompanying Information

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 2000, and 1999, and its net costs, changes in net position, budgetary resources, and financing for the years then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we issued separate reports dated February 23, 2001, on SBA's internal control and compliance with laws and regulations. Our reports on internal control and compliance are an integral part of an audit conducted in accordance with *Government Auditing Standards* and, in considering audit results, these reports should be read together with this report.

COTTON & COMPANY LLP

By. 
Matthew H. Johnson, CPA. 1

February 23, 2001
Alexandria, Virginia

COTTON & COMPANY LLP

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Inspector General
United States Small Business Administration

Independent Auditors' Report on Internal Control

Cotton & Company LLP audited the Balance Sheet of the U.S. Small Business Administration (SBA) as of September 30, 2000, and 1999, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing for the years then ended. We have issued our report thereon dated February 23, 2001. We conducted our audit in accordance with *Government Auditing Standards*, auditing standards generally accepted in the United States of America, and Office of Management and Budget (OMB) Bulletin No. 01-02, Audit Requirements for Federal Financial Statements.

In planning and performing our audit, we considered SBA's internal control over financial reporting by obtaining an understanding of the agency's internal control, determining if internal control had been placed in operation, assessing control risk, and performing tests of controls to determine auditing procedures for the purpose of expressing our opinion on the financial statements. We limited internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect an agency's ability to record, process, summarize, and report financial data consistent with management assertions in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amount that would be material in relation to the financial statement being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

We noted no matters involving internal control and its operation that we consider material weaknesses as defined above. We did, however, note two matters, discussed in the

following paragraphs, involving the internal control and its operation that we consider to be reportable conditions.

FINANCIAL REPORTING PROCESS

During FY 2000, SBA significantly improved internal control over its financial reporting process; further improvements are, however, still needed. In our FY 1999 audit report, we stated that SBA's financial reporting process did not ensure that its financial statements were free of material misstatements. As a result of that finding and our related recommendations, SBA developed and implemented an automated financial reporting system that significantly improved the accuracy and efficiency of the financial reporting process. Thus, we do not consider the financial reporting process a material weakness.

We did, however, note a reportable condition. Processes and procedures are not adequately documented, and a fully effective quality assurance process is not in place. Because of this condition, errors occurred, some of which we highlight below:

- SBA did not properly account for prior-year re-estimates in determining the adjustment for the FY 2000 subsidy re-estimate.
- SBA's reported amount of guaranteed loans outstanding was not correct, because its system truncates amounts.
- SBA did not properly prepare for the accounting effects associated with this year's loan asset sale.

We recommend that the Chief Financial Officer (CFO) continue SBA's efforts to improve the financial reporting process by:

- Completing documentation for all aspects of the financial reporting process, including preparing journal vouchers; calculating loss allowances; preparing and updating trial balances; preparing financial statements and footnotes; and updating the chart of accounts, transaction descriptions, Standard Operating Procedures, and guidance for conducting quality assurance reviews.
- Preparing consolidated agency-wide financial statements on a quarterly basis. This will allow SBA to identify and resolve issues and problems prior to yearend.

AGENCY-WIDE SECURITY PROGRAM

During FY 2000, SBA significantly improved internal control over its information system environment. Thus, we no longer consider information systems as a material weakness in the FY 2000 SBA financial statement audit. During FY 2000, SBA continued to build on its FY 1999 improvements and accomplished several important milestones. Even with this progress, however, full implementation has not yet been achieved.

SBA has developed an entity-wide security program that provides a framework for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of computer-related controls. We consider the framework a good start toward providing the necessary security program to protect and secure SBA's information technology environment. The security-monitoring program is not, however, fully implemented, and, thus, we consider this

area a reportable condition. SBA's Office of Inspector General will issue a separate report titled *Audit of SBA's Information System Controls, FY 2000* that will detail our findings and recommendations in this area.

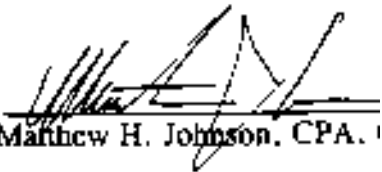
We recommend that SBA continue its efforts toward full implementation of an agency-wide information system security program.

In addition, we considered SBA's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the agency's internal control, determining if these internal controls had been placed in operation, assessing control risk, and performing tests of controls as required by OMB Bulletin No. 01-02 and not to provide assurance on these internal controls. Accordingly, we do not provide an opinion on such controls.

Finally, with respect to internal control related to performance measures reported in Management's Discussion and Analysis, Performance Goals and Results, we obtained an understanding of the design of significant internal control relating to existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

This report is intended solely for the information and use of SBA management, OMB, and Congress. It is not intended to be and should not be used by anyone other than these specified parties.

COTTON & COMPANY LLP

By 
Matthew H. Johnson, CPA. 1

February 23, 2001
Alexandria, Virginia

COTTON & COMPANY LLP

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Inspector General
United States Small Business Administration

Independent Auditors' Report on Compliance with Laws and Regulations

Cotton & Company LLP audited the Balance Sheet of the U.S. Small Business Administration (SBA) as of September 30, 2000, and 1999, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing for the years then ended and have issued our report thereon dated February 23, 2001. We conducted our audit in accordance with *Government Auditing Standards*, auditing standards generally accepted in the United States of America, and Office of Management and Budget (OMB) Bulletin No. 01-02, Audit Requirements for Federal Financial Statements. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

SBA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of SBA's compliance with certain provisions of laws and regulations. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 01-02, including requirements referenced in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to SBA.

The results of our tests of compliance disclosed no instances of noncompliance with other laws and regulations discussed in the preceding paragraph, exclusive of FFMIA, that we are required to report under *Government Auditing Standards* or OMB Bulletin 01-02.

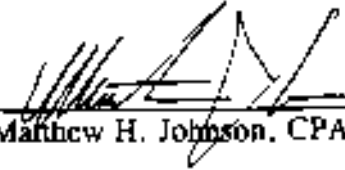
Under FFMIA, we are required to report whether SBA's financial management systems substantially comply with Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed the procedures specified in OMB's January 4, 2001, FFMIA implementation guidance.

Test results disclosed no instances in which SBA's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of SBA management, OMB, and Congress. It is not intended to be and should not be used by anyone other than these specified parties.

COTTON & COMPANY LLP

By. 
Matthew H. Johnson, CPA. 1

February 23, 2001
Alexandria, Virginia



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

DATE: FEB 28 2001

TO: Phyllis Fong
Inspector General

FROM: Joseph P. Loddo
Chief Financial Officer

A handwritten signature in black ink, appearing to read "J.P. Loddo".

SUBJECT: Response to Draft Audit Report

The SBA has received the completed work of your independent auditor, Cotton and Company, LLP, on our FY 2000 financial statements. I understand that there has been a great deal of cooperation and support between your staff, the independent auditor, and the staff of SBA, especially in the CFO office. The results of these efforts are clear. SBA has now received its fifth clean opinion, removed all material internal control weaknesses, and is also in substantial compliance with the FFMIA.

This is a tremendous achievement and a first for the Federal credit agencies. It is also a recognition of the especially hard work I know SBA staff endured over these past few years to achieve this high standard of excellence in Federal financial management. This report sends a strong message to the new Administration, the new Congress, and the American public that SBA maintains fiscal discipline over its programs and activities, that its financial condition is sound, and that there is integrity in the financial reporting that we do. This is in light of our increasing role to support expanding small business assistance programs nationwide, our stewardship over a loan portfolio that has doubled in size to \$50 billion, and this with 28 percent fewer staff than we had a decade ago.

President Bush has publicly expressed his strong support for continued improvement of Federal financial management, and has challenged all Federal agencies to obtain clean financial audits by 2002. Not surprisingly, SBA has exceeded that expectation. The auditor did report two conditions needing improvement. The SBA is working to eliminate these reportable conditions on the financial reporting process and the controls over Agency information systems. The challenge that lies ahead for us now is to maintain this high standard of excellence as we strive to make SBA even more efficient and effective in serving the needs of the nation's 25 million small businesses. We want to become a world-class financial management organization, and I know you will continue to support us in this journey.

CC: Robert Seabrooks, AIG for Auditing

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