

**AUDIT OF INTERNAL CONTROL
OVER COLSON SERVICES
CORPORATION'S CONTRACT AS
CENTRAL SERVICING AGENT FOR
SBA'S CERTIFIED DEVELOPMENT
COMPANY LOAN PROGRAM**

REPORT NUMBER 2-29

SEPTEMBER 16, 2002

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

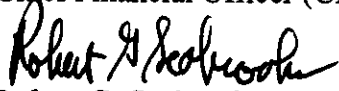
AUDIT REPORT

Issue Date: September 16, 2002

Number: 2-29

To: Ronald E. Bew
Associate Deputy Administrator for Capital Access

Thomas A. Dumaresq
Chief Financial Officer (CFO)

From: 
Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of Internal Control Over Colson Services Corporation's
Contract as Central Servicing Agent for SBA's Certified
Development Company Loan Program

Attached is a copy of the subject audit that was issued by Cotton & Company, LLP. The report discusses the need for SBA to: (1) improve its reconciliation procedures with Colson to ensure that amounts recorded in SBA's Loan Accounting System are correct, and (2) increase oversight over Colson's compliance with various contract terms.

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 80 days on the attached SBA Forms 1824, Recommendation Action Sheet. If you disagree with the recommendations, please provide your reasons in writing.

Any questions you may have regarding this report may be directed to Robert Hultberg, Director, Business Development Programs Group, at (202) 205-7577.

Attachments

INDEPENDENT ACCOUNTANT'S REPORT

**PERFORMANCE AUDIT OF
INTERNAL CONTROL OVER
COLSON SERVICES CORPORATION'S
CONTRACT AS CENTRAL SERVICING AGENT FOR
SBA'S CDC LOAN PROGRAM**

**Performed by:
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U.S. Small Business Administration
Office of Inspector General

INDEPENDENT ACCOUNTANT'S REPORT

Cotton & Company was engaged by the U.S. Small Business Administration's (SBA) Office of Inspector General (OIG) to conduct a performance audit of internal control procedures in place at Colson Services Corporation as of December 31, 2000. The audit included a review of internal control procedures at SBA that would ensure the accuracy of data supplied and duties performed under Colson's contract as a central servicing agent (CSA) for SBA's Certified Development Company (CDC) program. This report provides the performance audit results.

We conducted this engagement under applicable standards for performance audits contained in *Government Auditing Standards*, as revised, promulgated by the U.S. General Accounting Office.

RESULTS IN BRIEF

We found that controls were generally in place and effective. We did, however, note that SBA could:

1. Improve its reconciliation procedures with Colson to ensure that amounts recorded in SBA's Loan Accounting System (LAS) are correct. SBA did not record \$22.7 million in CDC loans funded in May 2000.
2. Increase oversight of Colson's compliance with various contract terms. We noted several instances in which Colson did not adhere to contract terms.

Additionally, we followed up on a previous OIG audit and found that some of the prior findings remain unresolved.

SBA's Office of Financial Assistance and its Office of the Chief Financial Officer provided comments to a draft of this report. We have provided these responses as attachments.

BACKGROUND

The Certified Development Company program, authorized by Section 502 of the Small Business Investment Act of 1958 (Public Law 85-699, as amended), provides growing businesses in economically depressed areas with long-term fixed-rate financing for major fixed assets, such as land and buildings.



CDCs, which are locally formed nonprofit corporations, work with SBA and private-sector lenders to provide financing to small businesses. The number of CDCs nationwide is approximately 280, and each CDC covers a specific geographical area.

Funding for a typical CDC project includes a:

- Loan for about 50 percent of project cost secured with a senior lien from a private-sector lender.
- Loan for up to 40 percent of project cost secured with a junior lien from a CDC (backed by a 100-percent SBA-guaranteed debenture, not to exceed \$1.3 million).
- Contribution of at least a 10-percent equity from the small business receiving assistance.

The CDC loan program is financed by fees paid by borrowers. These fees compensate all parties involved in the process: CDCs, Colson; and SBA. Fees are adjusted annually.

A sale of 20-year CDC debentures occurs each month, and 10-year term debentures are sold every other month. The Bank of New York, the current trustee, calculates loan amortization after the public sale depending upon interest rates and issuer of the debentures. Merrill Lynch and Credit Suisse alternate as underwriters for debenture sales.

Colson is CSA for the CDC loan program under a contract effective January 1, 1995, that has been modified and extended to 2010 if optional periods are exercised. As CSA, Colson collects a fee from each borrower's monthly payment. Colson is entitled to 4/64 of 1 percent as its share of the CSA fee. It remits the remainder of the fee to SBA.

Colson's duties under the contract include:

- Establishing and maintaining fund accounts.
- Receiving and processing payments from borrowers, including prepayments.
- Notifying SBA of shortfalls in borrower payments and receiving and accounting for guaranty payments made by SBA.
- Disbursing twice-yearly payments to debenture-holders.
- Disbursing fees and interest earned in accordance with contract provisions.
- Maintaining the computer system and software used in accounting for loans.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objective

The primary audit objective was to assess internal control over Colson program operations, including policies and procedures implemented to ensure Colson's compliance with laws, regulations, and contract requirements, and over safeguarding of assets, segregation of duties, accurate and timely recording of transactions, and information processing to ensure data validity and reliability.

Scope

The audit scope was limited to SBA and Colson activities and procedures in place over Colson's activities as CSA for the CDC program. We performed testing and reconciliation procedures over transaction data for Calendar Year 2000. The audit scope included reviewing prior OIG audit recommendations to determine implementation actions and assessing internal and external risks.

Methodology

We interviewed individuals within SBA's Office of Financial Assistance (OFA), Office of the Chief Information Officer (OCIO), and Office of Procurement and Grants Management (OPGM). We also interviewed individuals at Colson and its independent public accountants (IPA). We performed the procedures enumerated below:

- Reviewed prior OIG audit recommendations to determine Colson's implementation actions.
- Compared contract provisions, including applicable modifications, with Colson's procedures observed through program and financial walkthroughs and through interviews with SBA personnel.
- Tested the adequacy of system general and application controls over fee calculations and accuracy of data entry using a statistically significant random sample of each data type.
- Reviewed SBA oversight procedures, including those for reconciling and resolving differences between SBA and Colson data.
- Reported results and made recommendations for improvement.

FOLLOW-UP ON PRIOR AUDIT

Our procedures were designed to follow up on accounting and monitoring recommendations relevant to the CDC loan program made in the OIG's *Audit of SBA's Oversight of Colson Services Corp.*, Report No. 3-2-H-007-036, dated June 16, 1993. Specifically, relevant recommendations were:

| Finding or Recommendation No. and Summary | Status | Cotton & Company Follow-Up |
|--|---|---|
| 5. SBA allowed inappropriate use and retention of CDC funds by Colson. The report recommended that SBA obtain future authorization from CDCs for future expenditures, determine if reimbursement of CDCs is required, and ensure proper disbursement of CDC funds. | No additional instances were noted. | None required. |
| 6. SBA's monitoring of Colson's activities was inadequate. Recommendations included: | Not implemented. | Concur. See Finding 2 below. |
| 6A. SBA implement procedures to initiate a quality control review of Colson on a periodic basis to ensure compliance with contractual and legal requirements. | | |
| 6D. SBA ensure compliance with contract provisions concerning program audit requirements. | Colson complies with provision H-15 of the CSA contract, which requires Colson to obtain a financial statement audit and an independent audit of "the operations of the CSA." | Colson does not comply with all contract terms, and SBA does not monitor contract compliance. |

FINDINGS AND RECOMMENDATIONS

Some of the prior findings, summarized above, remain unresolved. We suggest the Office of Financial Assistance and the CFO work together to either implement or resolve remaining OIG recommendations and our recommendations.

In our audit, we identified two findings that indicate internal control weaknesses.

1. Reconciliation Procedures

SBA does not have reconciliation procedures in place to ensure that amounts recorded in LAS are correct. SBA did not record \$22,650,000 of CDC loans funded in May 2000 in LAS and did not discover this error.

FASAB's *Statements of Federal Financial Accounting Concepts #1* addresses internal control:

... sound controls over internal processes are essential both to safeguard assets and to ensure economy, efficiency and effectiveness....
(Paragraph 149)

Financial reporting should be reliable: that is, the information presented should be verifiable and free from bias and should faithfully represent what it purports to represent. To be reliable, financial reporting needs to be comprehensive. Nothing material should be omitted....
(Paragraph 160)

After each monthly debenture sale, SBA receives loan-by-loan information from the sale trustee, Bank of New York. Colson receives the same information and begins receiving and processing borrower payments on each loan. The Denver Finance Center (DFC) receives data downloads and fee remittances each month from Colson. Under data transfer standards implemented in May 1999, DFC does not accept loan-by-loan data downloads into LAS unless they equal the remittance amount received. Further, DFC does not reconcile data or remittance amounts with any expected fee income or with Bank of New York funding data.

Colson remitted \$7,367,931.42 of 50-basis-point CDC loan funding fees to SBA in 2000, and SBA recorded this amount as part of its fee income; Colson and DFC records agree. This amount is exactly 50 basis points (0.005) of net debentures of \$1,473,586,598.45, the CDC funded loans for the year. Had SBA monitored and reconciled its fee income with this type of calculation monthly, it could have discovered that \$22,650,000 of funded loans had not been recorded. As a result, SBA's primary database, LAS, is incorrect. Without additional internal control procedures in place to ensure the accuracy of data received from Colson and the Bank of New York, errors, either intentional or unintentional, could be material.

Recommendations

We recommend that the Chief Financial Officer in coordination with the Office of Capital Access:

- 1A. Establish and require adherence to formal, written reconciliation procedures over all data transferred among the Bank of New York, Colson, and SBA to ensure accuracy of LAS data.
- 1B. Use the CDC program trial balance maintained at Colson to record items on SBA's financial statements that are not already received in the loan-by-loan data transfer, primarily interest income, program fees expenses, and bank account balances.

SBA Comments

SBA concurred with this finding and our recommendation.

2. **Contract Compliance**

Colson is not complying with all contract terms. We noted differences, summarized below, between Contract No. 8157-OFA-95 requirements and Colson practices, further reinforcing the need for a fully comprehensive monitoring program.

| Contract Requirement | Colson Implementation | Effect |
|----------------------|-----------------------|--------|
|----------------------|-----------------------|--------|

Ex. 4 and 5

SBA's Response: SBA stated that it was aware of this issue and that it had begun corrective actions.

Ex. 4 and 5

SBA's Response: SBA agreed that Colson is not complying with this provision of the contract but that to do so would violate banking regulations and that the contract language required modifications to ensure consistency with banking regulations. SBA provided recommended changes to the contract language that if incorporated into the current contract would resolve this non-compliance.

Ex. 4 and 5

SBA's Response: SBA did not agree that Colson was not complying with this provision because it was depositing the funds immediately into a demand deposit account as required, but that banking regulations precluded interest earnings on such an account. SBA provided recommended changes to the contract language that if incorporated would clarify the requirements.

| Contract Requirement | Colson Implementation | Effect |
|----------------------|-----------------------|--------|
|----------------------|-----------------------|--------|

Ex. 4 and 5

SBA's Response: SBA did not agree that Colson was not complying with this provision but stated that it has entered into negotiations with Colson to modify the contract so that interest earned on funds as discussed above would be transferred to SBA's Trust Account. We believe that is the intent of the contract that Colson is not to earn any funds on the above transactions, however, modifications to the contract as discussed by SBA in its response should, once implemented, correct this deficiency.

Recommendations

- 2A. We recommend that the Associate Deputy Administrator for Capital Access modify the CSC contract to ensure that it is consistent with banking regulations and provides clarity as to the intent of the program.
- 2B. We further recommend that the Associate Deputy Administrator for Capital Access monitor contract compliance directly or modify the CSA contract to require Colson to obtain independent evaluation of contract compliance.

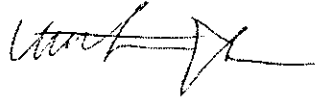
SBA Comments

In its response to our draft report, SBA generally agreed with our finding that Colson was not complying with all contract terms. It stated, however, that the non-compliance was primarily because the contractual terms conflicted with banking regulations. Further management recommended language to modify the contract terms which we believe will provide more clarity and resolve the non compliance items. As such, we have modified our recommendation accordingly.

Management did not concur with our recommendation for SBA to monitor contract compliance directly or modify the CSA contract to require Colson to obtain independent evaluation of contract compliance. SBA stated that it has adequate monitoring of the contract through annual financial statement audits and internal control reviews of Colson. We do not agree with this assertion. Neither the financial statement audit nor the internal control reviews are intended to ensure compliance with contractual terms.

This report is intended solely for the information and use of SBA OIG, which is responsible for its limited distribution.

COTTON & COMPANY LLP

A handwritten signature in black ink, appearing to read 'Matthew H. Johnson', with a stylized flourish at the end.


Matthew H. Johnson, CPA, CGFM

January 5, 2002
Alexandria, Virginia



U.S. SMALL BUSINESS ADMINISTRATION
Office of the Chief Financial Officer

DATE: August 6, 2002

FROM: Thomas A. Dumaresq
Chief Financial Officer 

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

SUBJ: Performance Audit of Internal Control over Colson
Services Corporation's Contract as Central
Servicing Agent for SBA's CDC 503/504 Program

We have reviewed the draft Independent Accountant's Report, dated May 7, 2002, regarding internal control over Colson Services Corporation's (Colson) administration of the CDC 503/504 program. The Office of the Chief Financial Officer (OCFO) fully supports the objective of effective internal control over the SBA's financial activities. The OCFO met recently with the Office of Capital Access (OCA) to discuss an increased role for OCFO staff in the internal control over the 504 program. The OCA has agreed to this increased role and we will work together to address the internal control weaknesses found in this audit report.

Regarding reconciliation procedures, the current review recommends that the Chief Financial Officer:

1A *Establish and require adherence to formal, written reconciliation procedures over all data transferred among the Bank of New York, Colson, and SBA to ensure accuracy of LAS data.*

Comment – We concur with this recommendation. The OCFO currently has no role in the data transfer of Colson/CDC funding data. Data files are received by the Office of the Chief Information Officer (OCIO) and reviewed by the OCA. In response to this recommendation, the OCFO is willing to work with OCA to document and maintain effective internal control over the recordation of funding data. Regarding the .50% funding fee, data could be checked against the monthly funding amount and the OCFO will work with OCA to document and maintain this control. Regarding servicing fees collection, the OCFO does currently validate the total collected to the fee detail. However, additional data is required from Colson to do a more comprehensive reconciliation. Further research with Colson, however, could determine that current data and controls are adequate. This recommendation should be also directed to the OCA.

1B *Use the CDC program trial balance maintained at Colson to record items on SBA's financial statements that are not already received in the loan-by-loan data transfer, primarily interest income, program fees, expenses, and bank account balances, in its financial statements.*

Comment – We concur with this recommendation. The OCFO will work with the OCA to determine which of the above items on the Colson program trial balance should properly be recorded on the SBA's financial statements. The materiality of the amounts and the extent of the accounting process required will also be considered.

Regarding contract compliance, the current review recommends that the Chief Financial Officer:

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Ex. 5

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

Date: August 6, 2002

To: Robert G. Seabrooks
Assistant Inspector General for Auditing

From: James E. Rivera
Associate Administrator for Financial Assistance *JER*

Subj: Audit of Central Servicing Agent

Attached is the response of the Office of Financial Assistance to the draft report on the audit of the Central Servicing Agent contract for the 503/504 program. We are available to discuss our response with you at your convenience.

SBA IS AN EQUAL OPPORTUNITY EMPLOYER AND PROVIDER

Contract Compliance

The following is a discussion of the Audit findings listed in the chart on page 6 and 7 of the draft report. The recommendations are addressed after the discussion of the Audit findings.

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