



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

AUDIT REPORT

Issue Date: March 23, 2004

Number: 4-17

To: Tom Dumaresq, Chief Financial Officer

/s/ Original Signed
From: Robert G. Seabrooks, Assistant Inspector General for Auditing
Subject: Audit of SBA's FY 2003 Financial Statements - Management Letter

Pursuant to the Chief Financial Officers Act of 1990, attached is Cotton & Company LLP's management letter. The purpose of the management letter is to communicate "non-reportable conditions" to SBA management that came to Cotton & Company's attention during their engagement to audit the U.S. Small Business Administration's (SBA) Fiscal Year (FY) 2003 financial statements. The following areas, which were reported last year, are repeated in this draft report because the conditions, as well as the need for implementing enhanced controls, continue to exist.

- Foreclosed Property Records and Valuation
- Lack of Allotment Detail in the General Ledger
- Other Areas for Improvement, Administrative Costs and Accountable Property
- Non-Fiduciary Intra-governmental Reconciliations
- Funds Control Over Administrative Costs

The management letter also noted new items or weaknesses in the areas of: 1) Disaster Area Office travel authorizations; 2) Disaster Area Office centrally billed account; 3) Loan Servicing Center shipping costs; 4) valuation of interest receivable balances for financial reporting; 5) surety bond guarantee liability estimate documentation; 6) Modification Adjustment Transfer entries for loan guarantee programs; 7) completeness of performance data reporting; 8) recording of Master Reserve Fund cash held outside of Treasury; 9) inappropriate augmentation of appropriations involving methods of payment of contractors; 10) documentation of disaster loan subsidy re-estimate model; and 11) documentation of secondary market guarantee model.

SBA management generally agreed with the auditors' findings and recommendations while requesting that the SBA General Counsel review finding number 14, augmentation of appropriating matters, before action is taken on related recommendation numbers 14A and 14B.

SBA Management also requested that we distribute the final management letter to the various other SBA offices to facilitate the SBA's coordination on initiatives to improve financial management as stated in the auditor's recommendations.

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

Should you or your staff have any questions, please contact Jeff Brindle, Director, Information Technology and Financial Management Group at (202) 205-7490.

Attachments

**AUDIT OF SBA'S FY 2003
FINANCIAL STATEMENTS
MANAGEMENT LETTER
AUDIT REPORT NUMBER 4-17
MARCH 23, 2004**

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.

COTTON & COMPANY LLP

Redacted for FOIA

auditors ♦ advisors

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January 28, 2004

**MANAGEMENT LETTER
U.S. SMALL BUSINESS ADMINISTRATION
FINANCIAL STATEMENT AUDIT
FISCAL YEAR 2003**

Inspector General
U.S. Small Business Administration

We were engaged to audit the U.S. Small Business Administration's (SBA) financial statements as of September 30, 2003, and for the year then ended and have issued, under separate cover, our reports thereon dated January 28, 2004. Our reports included those on SBA's internal control and compliance with laws and regulations, with our compliance report including comments on the Federal Financial Management Improvement Act.

The purpose of this management letter is to communicate "non-reportable conditions" to SBA management. This letter is intended solely for the information and use of SBA management.

We understand your office distributed a draft of this report to SBA management for its evaluation and comment. We also understand that management expressed general agreement while conveying that SBA's General Counsel presently is reviewing the augmentation of appropriation matters discussed in finding number 14, Inappropriate Augmentation of Appropriations; recommendation numbers 14A and 14B. Management's comments are reasonable and we have finalized our report on that basis.

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

Very truly yours,

COTTON & COMPANY LLP

[FOIA Ex. 6]

Charles Hayward, CPA

C&C
established 1981

MANAGEMENT LETTER
U.S. SMALL BUSINESS ADMINISTRATION
FINANCIAL STATEMENT AUDIT
FISCAL YEAR 2003

Certain non-reportable conditions came to our attention during our engagement to audit the U.S. Small Business Administration's (SBA) Fiscal Year (FY) 2003 financial statements. These conditions are discussed in this report. All findings are related to SBA's internal control or compliance shortcomings with regard to pertinent laws and regulations

The following areas, which were reported last year, are repeated this year because the conditions, as well as the need for implementing enhanced control, continue to exist.

- Foreclosed Property Records and Valuation
- Lack of Allotment Detail in the General Ledger
- Other Areas for Improvement, Administrative Costs
- Non-Fiduciary Intragovernmental Reconciliations
- Funds Control Over Administrative Costs

1. Foreclosed Property Records and Valuation

Property that SBA acquires through enforcing payment under secured loans is referred to as "collateral purchased" (Colpur), or foreclosed property inventory. We noted the following three deficiencies with SBA's Colpur accountability. The first two deficiencies caused an overstatement of SBA's consolidated balance sheet line item *Credit Program Receivables and Related Foreclosed Property, Net* as of September 30, 2003. The last deficiency understated financial statement footnote 6 - *Credit Program Receivables and Related Foreclosed Property* component *Defaulted Guaranteed Loans Receivable, Gross* and overstated component *Foreclosed Property*.

- SBA improperly calculated the Net Realizable Value (NRV) of a Colpur item at the time of purchase resulting in a \$625,456 overstatement of the item's value.
- SBA failed to assess the valuation of a Colpur property on an annual basis, thus overstating the item's value by \$298,000.
- SBA misclassified an \$80,760 promissory note as a Colpur item.

Regarding the first two points above, Standard Operating Procedures (SOP) 50 51 2A Loan Liquidation and Acquired Property, Appendix 3, provides the following NRV computation guidelines:

Starting with the appraised value of the Colpur, an adjustment should be made to reduce this to liquidation value... In the absence of local information as to the appropriate size of this adjustment, use the following... If there... [are] any...prior liens, taxes, CPC [care and preservation of collateral] expenses, direct selling costs, and administrative expenses.... [they must be] subtracted from the liquidation value to reach NRV for the Colpur.

For the last point above, Generally Accepted Accounting Principles (GAAP) require that recorded transactions represent underlying economic events.

Recommendation

1A. We recommend that the Chief Financial Officer (CFO) determine if properly valued Colpur information is important for financial management purposes to the degree that incremental costs of stronger internal control are justified. If such costs are warranted, then the CFO should coordinate with the Offices of Capital Access (OCA) and Field Operations (OFO) to dedicate the time and personnel to properly value SBA's Colpur account in accordance with existing policy and procedures, and federal accounting standards.

2. Lack of Allotment Detail in the General Ledger

SBA does not record loan allotment transactions in the Financial Reporting Information System (FRIS) consolidated general ledger (CGL). SBA's Office of Planning and Budget (OPB) records loan allotment transactions for loan guarantee and direct loans in the Loan Allotment Accounting (LAA) system based upon Office of Management and Budget (OMB) apportionments and SBA management allocations. LAA interfaces with the Loan Accounting System (LAS) to ensure that loan approvals (obligations) do not exceed allotments. LAA allotment data are not, however, uploaded into FRIS CGL via the monthly loan update process due to long standing subsidiary system (LAA) reconciliation problems. Consequently, SBA does not record the following accounting entry, for loan funds, as required by Treasury's Standard General Ledger (SGL):

4510	Apportioned Funds	XXX	
4610	Allotted Funds		XXX

Although the absence of this entry has no effect on the financial statements (because SGL accounts 4510 and 4610 map to the same statement of budgetary resources line item, *Unobligated Balances Available, Apportioned, Currently Available*), SBA cannot analyze its use of funds via the FRIS CGL and instead must revert to LAA to establish the apportioned authority amount allotted for loan programs.

The Joint Federal Management Improvement Program's *Core Financial System Requirements* states that:

All transactions to record financial events must post, either individually or in summary, to the general ledger, regardless of origin of the transaction.

Recommendation

2A. We recommend that the CFO continue to work with the Office of the Chief Information Officer (OCIO) to resolve subsidiary system problems impeding the upload of allotment data into the FRIS CGL. Once issues are resolved, the Office of Chief Financial Officer (OCFO) should upload allotment data into the FRIS CGL monthly, or more frequently near the end of the fiscal year if required, to maintain proper budget execution.

3. Other Areas for Improvement, Administrative Costs

Substantive testing conducted in the areas of vendor and credit card expenses at June 30, 2003 identified the following known and projected overstatements of SBA's FY 2003 administrative expenses funded from its Salary and Expense (S&E) appropriation:

Assertions	Number of Exceptions	Known Expense Overstatement	Projected Expense Overstatement
Validity	8	\$35,606	\$94,590
Cut-Off (Non-Grants)	33	\$2,001,961	\$5,319,759
Totals	41	\$2,037,567	\$5,414,349

This table refers to “assertions,” a term used in the General Accounting Office (GAO), President's Council on Integrity and Efficiency *Financial Audit Manual*. This term refers to essential qualities that management represents are embodied in financial statements. These essential qualities are critical for management’s financial statements to be free from material error. The validity assertion relates to whether account balances and activity have been executed with the proper legal and accounting treatment. The cut-off assertion relates to whether account balances and activity relate exclusively to the period or date covered in the financial statements.

In addition to misstatements to administrative expenses, our testing indicated that SBA can improve its supervisory review and approval of administrative transactions, and strengthen internal control over accountable-property. We noted the following exceptions related supervisory review and approval and accountable-property tracking:

Supervisory review and approval of Administrative Transactions:

- 3 out of 135 tested vender payment invoices lacked approving signatures.
- 3 out of 15 tested credit card statements lacked signatures evidencing supervisory review.

Accountable Property Tracking

- 9 out of 46 tested items listed in the accountable property system could not be located in SBA’s office locations.
- 6 out of 46 tested items had locations that differed between the accountable property system and SBA’s office locations.
- 11 out of 46 tested items meeting SBA’s criteria for accountable property tracking were not tracked in SBA’s accountable property system.

Recommendations

We recommend that the CFO:

- 3A. Coordinate with the OFO and stress the importance of supervisory review and approval of administrative transactions to ensure the validity and accuracy of recorded obligations and expenses. Areas of emphasis should include: travel authorization approvals, review of monthly credit card statements, and approval of time and attendance documentation.
- 3B. Work with the Office of Administration (OA) and OFO to strengthen internal control over accountable property. Specifically, we recommend that SBA conduct annual inventory counts and evaluate the adequacy of its current accountable property system in meeting field office needs.

3C. Strengthen financial reporting internal control to ensure that accounting transactions are posted in the fiscal year in which the economic event occurs..

4. Non-Fiduciary Intragovernmental Reconciliations

SBA's Required Supplementary Information (RSI), *Intragovernmental Assets and Liabilities* did not properly report SBA's intragovernmental activity and balances because its procedures were not adequate to ensure the accuracy, reliability, and timeliness of this information. In addition, SBA did not effectively coordinate with non-fiduciary trading partners to fully reconcile intragovernmental balances.

The Treasury Financial Management Service's *Federal Intragovernmental Transactions Accounting Policies Guide, Reconciliation Requirements*, states that:

Agencies should reconcile and confirm intragovernmental activity and balances with their trading partners before....reporting it on the agency's audited financial statements.

OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, provides that:

Reporting entities shall reconcile intragovernmental asset, liability and revenue amounts reported in the RSI with their trading partners.

SBA's inability to fully reconcile and properly report non-fiduciary intragovernmental balances, detailed in the table below, impairs Treasury's ability to reliably and accurately eliminate such activity in the Consolidated Financial Statements of the United States Government.

Account Category	Balance
Accounts Receivable	\$8,000
Accounts Payable	\$(20,000)
Other Liabilities	\$(36,830,000)
Earned Revenue	\$937,000

Recommendation

4A. We recommend that the CFO implement procedures to ensure timely and accurate reporting and reconciliation of intragovernmental amounts. These procedures should include establishing timelines for resolving differences with non-fiduciary trading partners, as well as quality assurance reviews to ensure the accuracy of both amounts confirmed and amounts reported.

5. Funds Control Over Administrative Costs

Several Oracle processing deficiencies resulted in numerous debits posted in Oracle against individual undelivered orders. These problems occurred because:

- Oracle will process payments in excess of obligations as long as the payments do not exceed the initial obligations by ten percent.
- Direct-pay invoices are processed without establishing a related obligation in Oracle.
- SBA's ad-hoc process to post an upward adjustment of prior year obligations results in undelivered orders with debit balances at the transactional level (i.e. purchase order number), however, the general ledger account balance is not misstated.

These factors are indicative of insufficient funds control and resulted in debits posted against undelivered orders at the obligating document level of \$8,782,633, which SBA was unable to fully explain.

OMB Circular A-127 *Financial Management Systems* provides that:

The criteria for recording financial events in all financial management systems shall be consistent with accounting transaction definitions and processing rules defined in the SGL.

In addition, OMB Circular A-11, Part 4, *Instructions on Budget Execution*, states that a funds control system should:

Restrict both obligations and expenditures from each appropriation or fund account to the lower of the amount apportioned by OMB or the amount available for obligation and/or expenditure in the appropriation or fund account.

Recommendations

We recommend that the CFO:

- 5A. Require all transactions processed in Oracle to pass procurement funds control edit checks.
- 5B. Perform an analysis of debits posted against undelivered orders to determine how to properly remove them from the general ledger detail to the extent that they are invalid.
- 5C. Ensure that every obligation and expenditure transaction is processed in accordance with SGL criteria.

6. Disaster Area Office Travel Authorizations

During the first quarter of FY 2003, SBA's annual appropriation was not yet approved by Congress. During this timeframe SBA's operations were funded incrementally by several continuing resolutions, thus limiting the amount of funds that were available to incur obligations for disaster-related travel.

While under continuing resolution, the Office of Disaster Assistance (ODA) instructed its area offices to prepare obligating documents for continuous travel at the estimated amounts of actual costs for the quarter, but to only record partial amounts as obligations in the Oracle general ledger until additional funding became available. As a result, travel obligations in Oracle were understated because obligating documents (travel authorizations) were made for amounts greater than were recorded in Oracle. In addition to misstating recorded obligations, this accounting treatment had an adverse effect on the transactional audit trail and increased SBA's risk of violating provisions of the Antideficiency Act.

The *GAO Red Book (Principles of Federal Appropriations Law)*, Volume II, Chapter 7 states:

[if a transaction meets the criteria for recording an obligation]...the agency not only may but must at that point record the transaction as an obligation. While 31 U.S.C. 1501 does not explicitly state that obligations must be recorded as they arise or are incurred, it follows logically from an agency's responsibility to comply with the Antideficiency Act.

The GAO's *Standards for Internal Control in the Federal Government*, states:

Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help to ensure that all transactions are completely and accurately recorded

Recommendation

6A. We recommend that the CFO coordinate with ODA to develop procedures to ensure that travel authorizations (obligations) are fully recorded in Oracle, thus utilizing automated funds controls at all times, including periods of continuing resolution.

7. Disaster Area Office Centrally Billed Account

Disaster Area Offices (DAOs) utilize the Centrally Billed Account (CBA) mainly to purchase airline tickets for disaster-assistance related travel. We noted two deficiencies in internal control related to use of the CBA:

- **Improper Segregation of Duties.** One DAO employee had the ability to request and approve funding related to CBA transactions and reconcile the CBA statement monthly. Lack of segregation of duties and management oversight over the administration of the CBA account increases the risk of undetected misstatements and creates an environment where fraudulent transactions could be perpetrated and concealed.
- **Untimely Recordation of Obligations.** DAOs did not obligate travel funds paid through the CBA account until they received the monthly credit account statement, thus incurring costs before obligations were recorded. This accounting treatment increased the risk of violating provisions of the Antideficiency Act because valid obligations were not recorded in a timely manner.

SBA's lack of SOPs defining the control environment for the CBA contributed to the noted internal control deficiencies.

The GAO's *Standards for Internal Control in the Federal Government*, states:

Key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event.

Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help to ensure that all transactions are completely and accurately recorded.

The GAO *Red Book*, Volume II, Chapter 7 states that:

...[if a transaction meets the criteria for recording an obligation]...the agency not only may but must at that point record the transaction as an obligation. While 31 U.S.C. 1501 does not explicitly state that obligations must be recorded as they arise or are incurred, it follows logically from an agency's responsibility to comply with the Antideficiency Act.

Recommendation

7A. We recommend that the CFO coordinate with ODA to develop a SOP for administering the CBA. The SOP should, at a minimum, establish appropriate segregation of duties and ensure that proper controls are in place to establish and liquidate obligations in a timely manner.

8. Loan Servicing Center Shipping Costs

The Fresno Loan Servicing Center (FLSC) utilizes United Parcel Service (UPS) to transfer loan files between offices. FLSC does not receive sufficient funding to obligate annual usage amounts at the beginning of the year. To obtain incremental funding during the fiscal year, FLSC, at the direction of the Office of Financial Assistance (OFA) submits a Form 2, *Requisitions for Supplies, Services and Federal Assistance*, to OFA for approval. After approval by OFA, the Form 2 is forwarded to the Office of Procurement and Grants Management (OPGM) for obligation in the Oracle general ledger. This funding process resulted in un-timely obligation of funds, and FLSC was not able to pay valid invoices, sometimes for several months, until funding was approved by OFA and obligated by OPGM.

Delays in recording valid obligations and processing invoices had the following effects during FY 2003:

- SBA incurred costs before funds were obligated.
- SBA had a heightened risk of violating provisions of the Antideficiency Act because valid obligations were not recorded in a timely manner.
- SBA unnecessarily incurred Prompt Payment Act interest charges because invoices were not paid in a timely manner, due to lack of obligated funds.

The GAO *Red Book*, Volume II, Chapter 7 states that

[if a transaction meets the criteria for recording an obligation]...the agency not only may but must at that point record the transaction as an obligation. While 31 U.S.C. 1501 does not explicitly state that obligations must be recorded as they arise or are incurred, it follows logically from an agency's responsibility to comply with the Antideficiency Act.

GAO standards for Internal Control in the Federal Government, states the following:

Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help to ensure that all transactions are completely and accurately recorded.

Recommendation

- 8A. We recommend that the CFO coordinate with OFA and FLSC to develop procedures to obligate funds for loan file shipping costs, sufficient to cover all anticipated expenses, in a timely manner.

9. Valuation of Interest Receivable Balances for Financial Reporting

Upon purchase of defaulted Small Business Investment Company (SBIC) participating securities (PS) (transaction code 205), SBA transfers related outstanding prioritized payments recorded in general ledger (GL) account 1135, *SBIC Advances Outstanding*, to GL account 1312, *Accrued Interest Purchase Gross*. Quarterly, SBA records an entry to credit GL account 1391, *Allowance for Unclassified Accrued Interest Purchased*, for the amount of accrued interest receivable recorded in GL account 1312 that is delinquent more than 90 days. This methodology results in the reporting of an estimated collectible value in GL account 1312 of approximately 50 percent and 30 percent of outstanding prioritized payments related to defaulted SBICs in FYs 2002 and 2003, respectively.

Assertions and supporting analysis provided by the Office of Liquidation (OL) within the Investment Division (ID), however, indicate an eventual 100 percent charge off of these purchased prioritized payments. OL informed us that future recoveries on purchased prioritized payments are unlikely because recoveries will only be realized after outstanding purchased leverage owed to SBA and amounts owed to independent investors by SBICs are fully reimbursed. Thus, the 1391 allowance account should fully offset the defaulted prioritized payments recorded in account 1312 for reporting purposes.

SBA's valuation of outstanding prioritized payments related to defaulted SBICs overstated financial statement line items - *Credit Program Receivables and Related Foreclosed Property and Liability for Loan Guarantees* by \$27 million in FY 2002 and \$10 million in FY 2003.

Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, requires that credit reform related assets be presented at the present value of their estimated net cash inflows.

Recommendations

We recommend that the CFO:

- 9A. Coordinate with ID to ensure that the valuation of purchased prioritized payments is consistent with programmatic experience and expectations.
- 9B. Determine if correcting entries are warranted, in light of materiality, during FY 2004 to properly value purchased prioritized payments presented for FY 2003 comparative purposes.

10. Surety Bond Guarantee (SBG) Liability Documentation

SBA estimates the long-term liability for potential losses related to outstanding surety bond guarantees annually for financial reporting purposes. The liability is estimated utilizing a model that projects future losses net of recoveries based upon historical averages.

SBA does not have sufficient documentation to fully explain the estimate's calculation methodology and underlying assumptions. We had to rely on inquiry and SBA's responses to gain a full understanding of the estimate.

Lack of sufficient documentation to fully explain the estimation methodology and assumptions increases the risk of errors or material misstatements in estimates and prohibits effective quality review and audit processes.

OMB Circular No.A-123, *Management Accountability and Control*, states:

Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

Recommendations

We recommend that the CFO coordinate with the Office of Surety Bond Guarantees to:

- 10A. Document thoroughly, and have readily available for examination, the assumptions and methodology used to calculate the SBG estimated liability and related expense.
- 10B. At least once per year review the assumptions and methodology to ensure they remain relevant and appropriate to the circumstances.

11. Modification Adjustment Transfer for Loan Guarantee Programs

SBA recomputed its recorded gain or loss on loan asset sales during FY 2003 and recorded a Modification Adjustment Transfer (MAT) for section 7(a) and 504 guarantee loan programs. SBA recorded the entire MAT in FY 2003 even though loan sales took place in FYs 1999 through 2003. This accounting treatment overstated FY 2003 *Gross Costs with the Public* by \$29 million and understated prior periods by the same amount.

This misstatement occurred because SBA does not have the necessary control procedures within its financial reporting process to ensure that economic events are recorded in the proper accounting period.

Generally Accepted Accounting Principles require that economic events be recorded in the period in which they occur (i.e. year of loan asset sale).

Recommendation

- 11A. We recommend that the CFO determine if correcting entries are warranted, in light of materiality, during FY 2004 to properly value FY 2003 *Gross Costs with the Public* related to the MAT for guarantee loan programs.

12. Performance Measure Reporting

As required by federal accounting standards, SBA presents performance measure data in the Management Discussion & Analysis (MD&A) section of the Performance and Accountability Report (PAR). The creation of the MD&A is a cooperative effort between SBA's program offices and OCFO. Program offices provide performance data to OCFO, who then includes this performance data in the MD&A. OMB Bulletin 01-02, *Audit Requirement of Federal Financial Statements*, requires auditors to:

Obtain an understanding of the components of internal control relating to the existence and completeness assertions relevant to the performance measures included in the MD&A.

While obtaining an understanding of performance measure internal control, we noted that the internal control related to the existence and completeness assertions of performance data have not been fully designed and placed into operation. We noted the following control deficiencies:

- Program offices were not fully cooperative in providing performance data timely to OCFO for inclusion in the MD&A.
- OCFO did not have procedures to verify the accuracy of data provided by program offices (i.e. agreeing reported information to source documentation).
- OCFO did not have procedures to ensure the timely completion of the MD&A by agreed-upon audit milestone dates.

OCFO should have controls in place designed to assure that performance measurement information is adequately supported in accordance with Statements of Federal Financial Accounting Concepts No. 1, Objectives of Federal Financial Reporting, paragraph 146 (Systems and Control).

Recommendations

We recommend that the CFO:

- 12A. Issue a procedural notice to relevant program offices outlining at a minimum:
 - Due dates for performance data.
 - Documentation required to support reported performance data.
 - Procedures for describing data limitations.
 - Procedures for developing estimates if actual data are not available at fiscal year-end.
- 12B. Develop a methodology, utilizing representative samples if necessary, to verify the completeness and accuracy of performance measure data reported by program offices.
- 12C. Develop a reporting timeline for completing the FY 2004 MD&A , including performance measure data, that will permit sufficient time to gather and summarize data, perform quality assurance reviews on performance data provided by program offices, and allow sufficient time for auditors to apply appropriate audit procedures by the November 15th accelerated deadline.

13. Master Reserve Fund (MRF), Cash Held Outside of Treasury

SBA's fiscal and transfer agent (FTA) maintains the MRF (cash held outside of Treasury) to facilitate operation of the section 7(a) secondary market guarantee (SMG) program. SBA discloses information related to MRF cash activity in its financial statement footnotes (as required by SFFAS No. 7 *Accounting for Revenue and Other Financing Sources*), but does not record MRF cash activity in its general ledger or report MRF transactions to Treasury.

TFM 2-3400 provides guidance for reporting activity on cash held outside the Government on SF-224s, *Statements of Transactions*. Treasury Financial Manual (TFM) 2-3435.10 (Cash Held Outside the Government) requires that (effective January 1, 2003):

Agencies that deposit, hold, and/or invest funds outside of the U.S. Treasury must record those transactions to specific US SGL accounts and report these amounts in their audited financial statements. In addition, agencies must submit those amounts in the ATBs [Adjusted Trial-Balance] to Treasury.

In addition, the Federal Accounting Standards Advisory Board (FASAB) has issued a standard exposure draft entitled *Accounting for Fiduciary Activities*. This standard covers all fiduciary funds whether inside or outside the budget. It defines fiduciary activities as those involving collection or receipt, management and disposition by a federal entity of cash or other assets in which non-federal parties have an ownership interest. The standard would require, if approved in its present form, that federal entities recognize equal and offsetting assets and liabilities in their financial statements for fiduciary assets held in their name. If the FASAB exposure draft becomes effective, failure to record the MRF assets and liabilities on SBA's financial statements will be a departure from Generally Accepted Accounting Principles.

Recommendations

We recommend that the CFO:

- 13A. Work with Treasury and OMB to obtain Treasury account symbols for the MRF and begin reporting its MRF activity to Treasury monthly on the SF-224.
- 13B. Report MRF cash balances as *Cash Held Outside of Treasury* and an offsetting liability on SBA's consolidated balance sheet and Federal Agencies' Centralized Trial-Balance System (FACTS I) Adjusted Trial-Balance (ATB) in future fiscal years.

14. Inappropriate Augmentation of Appropriations

Two matters involving SBA's improper augmentation of appropriations came to our attention as a result of audits conducted by the SBA's Office of Inspector General (OIG) and GAO during FY 2003. The conditions noted were that SBA allows its FTA to retain float interest as compensation for services provided, and SBA requires lenders who participate in the Preferred Lender Program (PLP) to pay a contractor for legislatively-mandated reviews. These matters are discussed below:

- **FTA Float Interest.** In the administration of the SMG program, a FTA collects certain fees on behalf of SBA from borrowers and lenders around the 6th of the month. These fees are due immediately to SBA; however, SBA has allowed the FTA to hold collected amounts 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. This float interest is retained by the FTA as compensation for providing collection services.
- **PLP Reviews.** SBA is legally required to perform reviews of PLP lenders to determine compliance with program regulations and has hired a contractor to perform these services under a no-cost contract. The contractor reviews are fully funded by fees assessed to, and paid by, applicable PLP lenders.

The practices described above represent inappropriate augmentation of the SBA's appropriation because the costs of administering the SMG program and performing reviews of PLP lenders should be paid from SBA's appropriation. This augmentation increases the risk that SBA may have historically violated the Antideficiency Act because SBA incurred costs that were not charged to its appropriation.

GAO's Comptroller General ruled, in 72 Comp. Gen. 164, 165 (1993), that:

An agency may not circumvent Congressional program level funding limitations by augmenting its appropriations from sources outside the government.

Recommendations

We recommend that the CFO:

- 14A. Coordinate with OCA and OA to discontinue the business practices described above that result in augmentation of SBA's appropriation and to pay program costs from the applicable appropriated funds.
 - 14B. Coordinate with the OIG and perform an analysis to determine if SBA's historical augmentation of appropriations resulted in noncompliance with the Antideficiency Act and, if so, immediately take the required actions for Antideficiency Act violations.
15. **Disaster Assistance Loan Subsidy Reestimate Model**

Our review of SBA's disaster assistance loan reestimate model disclosed that the model appears satisfactory with respect to documentation, verification, and validation, given the limitations of the available data and the inherent uncertainty of the underlying events. We noted the following nonreportable conditions, however, relating to model documentation, SAS code, and underlying assumptions:

The model documentation could be enhanced by:

- Including a model abstract specifying the model version, information on model relationships, and a history of precursors, data sources, and technical references.
- Providing a more detailed explanation of terminology for non-technical users.
- Referencing literature supporting the assertion that models that segment data into fairly homogeneous groups, then use the groups' average as the forecast of behavior of any loan in the group, is a commonly used modeling approach that is well known and well regarded.
- Stating explicitly how the sparseness of the available data dictated the modeling approach and created some unavoidable limitations on the quality of the model.
- Clarifying that the classification of loans into homogeneous groups, by loan term, home/business, performance state at present, and age of loan, is the real driver of the model.
- Including more information and documentation supporting the assertion that the model accounts for 40 to 60 percent of the variation in the dependent (predicted) variables.

Computer-based model documentation is a critical control to ensure that models are usable and understandable to both technical and non-technical users and that they are adequately maintained over time. In addition, model documentation serves as a required audit trail to facilitate internal and external verification and validation functions. FASAB's Credit Reform Task Force (Accounting and Auditing Policy Committee), Technical Release No. 3, Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act (Tech Release No. 3), states that agencies should:

Document the agency's cash flow model(s) used, the rationale for selecting the specific methodologies, and the degree of calibration within the model(s). Also, document the sources of information, the logic flow, and the mechanics of the model(s) including the formulas and other mathematical functions. In addition, document the controls over the

model(s) used by the agency in preparing cash flow worksheets. Further, document that the cash flow model(s) reflect the terms of the loan contracts and, in a loan guarantee program, the loan guarantee contracts.

The SAS code could be enhanced by using parameterization, wherein files are named explicitly only once in the run code. We encountered problems when running the model because one of the required files was named in multiple places; one of which was overlooked when the run file was modified to point to the correct file names on our computer. The use of parameterization would prevent this type of problem and would provide increased efficiency when reviewing and running the disaster loan subsidy model.

The reasonableness of assumptions utilized in the disaster model could be improved by:

- Accumulating more information indicating the likely recovery of the borrowers' sources of income. The performance of disaster loans appears to depend more on the recovery of income than on the characteristics of the borrower; income, in turn, depends on local economic conditions, the amount of damage the disaster inflicted on the borrowers' sources of income, and the recovery of those sources and resumption of their former activity.
- Capturing additional data indicating the economic interrelations and the performance of related entities. Economic input-output tables showing purchases by businesses in a North American Industry Classification System (NAICS) code from businesses in other NAICS codes are increasingly available at geographically smaller levels and at finer levels of NAICS code detail. Using these tables (where available at the needed level of detail) to identify interrelationships appears to be one potentially valuable approach, subject to the usual cautions about the potentially poor fit on closer examination.
- Adding model detail to address more explicitly the impact of a given disaster on the borrower's ability to repay. Variables currently used, such as size of loan, term of loan, and length of grace period, are all strongly and highly associated with the magnitude of the disaster. Because the effects of loan size, loan term, and grace period are statistically "confounded", it is impossible to distinguish each variable's contributions to the result.
- Carefully monitoring the potential effect of selling groups of loans that are not representative of the remaining loans within the group from which they came. If, for example, better performing loans within a group were sold, the performance of the remaining loans will consistently and increasingly fall below the model's predictions for the group. Monitoring consistent deviations from the predicted performance is critical to identifying if this vulnerability has occurred.
- Recognizing that the current model cannot differentiate among large unusual disasters other than by loan amount, term and grace period. Another disaster with similar loan amounts terms and grace period will be predicted the same as the most similar previous disaster although actual performance for the second disaster may be substantially different. Monitoring consistent deviations from the predicted performance is critical to identifying if this vulnerability has occurred.

Tech Release No. 3 provides that:

Agencies should prepare all estimates and reestimates based upon the best available data at the time the estimates are made.

While SBA prepared subsidy reestimates utilizing the best available data during FY 2003, additional analysis and the potential identification of additional data sources in the future may allow for the refinement of assumptions and increased accuracy of subsidy cost estimates.

Recommendations

We recommend that the CFO:

- 15A. Complete the disaster model documentation in accordance with Tech Release No. 3 and consider the enhancements that we suggest when finalizing the documentation.
- 15B. Consider the use of parameterization to increase the ease of running the disaster subsidy model.
- 15C. Continue to perform analysis that will result in the identification of new data sources and the refinement of assumptions utilized in the disaster model.

16. Secondary Market Guarantee (SMG) Model

Our review of SBA's SMG model disclosed that documentation supporting the model was incomplete. The model documentation could be enhanced by including:

- A model abstract specifying the model version, information on model relationships, and a history of precursors, data sources, and technical references.
- An overview of the model, including its purpose and general structure.
- A detailed discussion of the estimation, including the approach, data sources, and a description of results.
- A detailed description and discussion of the solution method.

As stated above, Tech Release No. 3, states that agencies should:

Document the agency's cash flow model(s) used, the rationale for selecting the specific methodologies, and the degree of calibration within the model(s). Also, document the sources of information, the logic flow, and the mechanics of the model(s) including the formulas and other mathematical functions. In addition, document the controls over the model(s) used by the agency in preparing cash flow worksheets. Further, document that the cash flow model(s) reflect the terms of the loan contracts and, in a loan guarantee program, the loan guarantee contracts.

The SMG model contained an error in converting quarterly probabilities in the 7(a) model to monthly probabilities for the SMG model. If the probability of an event (default or prepayment) for a quarter is p , then the monthly probability should be $1 - (1-p)^{1/3}$. The SMG model used $p/3$ resulting in an incorrect value.

Recommendations

We recommend that the CFO:

- 16A. Complete the SMG model documentation in accordance with Tech Release No. 3 and ensure that the shortcomings we identified are addressed by the documentation.

16B. Correct the mathematical error in converting quarterly to monthly probabilities in its SMG model.

17. Use of Plug Entries on the Consolidated Statement of Financing

As required by OMB Bulletin 01-09, SBA prepares the consolidated Statement of Financing to:

Articulate the relationship between net obligations derived from an entity's budgetary accounts and the net cost of operations derived from the entity's proprietary accounts by identifying and explaining key differences between the two numbers.

SBA could not fully reconcile net obligations to net cost of operations and thus utilized plug entries to ensure that the sum of consolidated Statement of Financing line items *Adjustments to Net Obligated Resources That Do Not Affect Net Cost of Operations* and *Total Components of Net Cost of Operations Not Requiring or Generating Resources in the Current Period* agreed to line item *Net Cost of Operations*. The net amount of the plug entry was \$1,112,000.

17A. We recommend that the CFO fully reconcile net obligations to net costs of operations as part of the consolidated Statement of Financing compilation process and discontinue using plug entries.

18. Required Supplementary Stewardship Information

Annually, as required by SFFAS No. 8, *Supplementary Stewardship Reporting* (as amended), SBA presents Required Supplementary Stewardship Information (RSSI) in a section of the *Performance and Accountability Report* (PAR) titled *Stewardship Investments in Human Capital* and *Stewardship Investments in Research and Development*. SBA did not, however, have sufficient internal control to ensure that reported RSSI information was clearly linked to outcomes described either in the *Performance* section of its FY 2003 PAR or the FY 2003 budget plan.

SFFAS No. 8 states that:

Managers of the investment program should be able to provide information on the outcomes for the programs for which the investments are reported...The human capital outputs and outcomes should be the same as those measured for the Government Performance and Results Act (GPRA) and the budget.

18A. We recommend that the CFO ensure that the PAR includes outputs and outcomes for all programs presented in the RSSI, and that the outputs and outcomes be the same as those measured for GPRA and the budget.



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

Date: MAR 11 2004

To: Robert G. Seabrooks
Assistant Inspector General for Auditing

From: Thomas A. Dumaresq
Chief Financial Officer

Subject: Audit of SBA's FY 2003 Financial Statements – Management Letter

[FOIA Ex. 4]

The draft management letter for the FY 2003 financial statement audit included in Bill Ellett's email to me on February 25, 2004 provides 30 recommendations for improvement of the SBA's financial management. This memo is to provide the SBA's comments for your consideration in the final management letter.

A number of recommendations in your draft management letter are for the Office of the CFO to coordinate with other SBA offices on initiatives to improve financial management. I recommend that the final management letter be also distributed to these offices to facilitate the SBA's coordination on these initiatives. These recommendations include the following: 1A on loan collateral (Capital Access, Field Operations), 3A on the supervisory review of administrative transactions (Field Operations), 3B on accountable property (Office of Administration, Field Operations), 3C on year-end cut-off procedures (Capital Access, Field Operations, Office of Administration), 6A on the recordation of disaster travel obligations, even during a Continuing Resolution (Office of Disaster Assistance), 7A on the proper use of the Centrally Billed Account for Disaster travel including segregation of duties and timely recordation of obligations (Office of Disaster Assistance), 8A on the obligation of loan servicing center shipping costs (Office of Financial Assistance), 9A on the valuation of purchased prioritized payments (Investment Division) and 14A on the augmentation of appropriations for Fiscal and Transfer Agent interest and PLP contractor reviews (Office of Financial Assistance, Office of Administration and the General Counsel).

Your recommendations 14A and 14B question the augmentation of appropriations for Fiscal and Transfer Agent interest and PLP contractor reviews. The SBA's General Counsel is currently reviewing this issue and our action on these recommendations will depend on this review by the General Counsel.

Thank you for the opportunity to provide comments to the draft management letter. I will be glad to answer any questions that you may have on this response.

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