



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

AUDIT REPORT

Issue Date: November 15, 2006

Number: 7-03

To: Steven C. Preston
Administrator

Jennifer Main
Chief Financial Officer
Exemption 6

From: Debra Ritt
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2006 Financial Statements

Pursuant to the Chief Financial Officers Act of 1990, attached are the Independent Auditor's Report and accompanying reports on internal control and compliance with laws and regulations issued by KPMG LLP for the fiscal year ending September 30, 2006. The audit was performed under a contract with the Office of Inspector General (OIG) and in accordance with *Generally Accepted Government Auditing Standards*; Office of Management and Budget's (OMB) Bulletin 06-03, *Audit Requirements for Federal Financial Statements*, the General Accountability Office (GAO)/President's Council on Integrity and Efficiency (PCIE) *Financial Audit Manual* and GAO's *Federal Information System Controls Audit Manual*.

The KPMG report concluded that SBA's consolidated financial statements presented fairly, in all material respects, the financial position of SBA as of and for the year ended September 30, 2006. It also presented fairly, in all material respects, SBA's net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligation for the year.

With respect to internal controls, KPMG reported a material weakness in SBA's controls over financial reporting and noted two reportable conditions related to Information Technology security controls and budgetary controls surrounding travel vouchers. Details regarding the matters that led to the auditor's conclusion on internal controls are discussed in more detail in Exhibits 1 and 2 of the *Independent Auditors' Report*.

KPMG's tests for compliance with certain laws, regulations, contracts and grant agreements determined that the Agency does not fully comply with the Financial Information Security Management Act or OMB Circular A-130, *Management of Federal Information Resources*, because SBA needs to further improve its entity-wide security program. KPMG's tests also disclosed instances where SBA's financial management systems did not substantially comply with federal financial system requirements of the Federal Financial Management Improvement Act. Details regarding the auditors' conclusions are discussed in more detail in Exhibits 1 and 2 of the *Independent Auditors' Report*. Finally, the auditor disclosed no instances in which SBA's financial management systems did not substantially comply with federal accounting standards, or the United States Standard General Ledger at the transaction level.

We provided a draft of KPMG's report to SBA's Chief Financial Officer (CFO), who concurred with its findings and agreed to implement the recommendations. The CFO expressed disappointment that the progress the Agency has made in financial reporting was not sufficient to reduce the material weakness to a reportable condition. However, she noted that the Agency is committed to excellence in financial management and looking forward to making more progress in fiscal year (FY) 2007.

We have also attached SBA's financial statement reports for FY 2005, which were reissued by Cotton & Company LLP (the predecessor auditor). These reports, which accompany SBA's comparative financial statements for fiscal years 2006 and 2005, were reissued to correct a material error in SBA's footnote disclosures made in its 2003 through 2005 financial statements. On September 19, 2006, SBA notified the predecessor auditor that SBA's *Outstanding Principal at Face Value* and *Outstanding Principal Guaranteed by SBA* were each overstated in the footnotes by \$10 billion. Cotton and Company determined that this information would have affected its report had it been aware of the information at the time of the audit. In its reissued reports Cotton and Company maintains its unqualified opinion on SBA's FY 2005 consolidated balance sheet; and the related consolidated statements of net cost, changes in net position and financing, and the combined statement of budgetary resources for the year then ended.

We reviewed KPMG's and Cotton and Company's reports and related documentation and made necessary inquiries of their respective representatives. Our review was not intended to enable us to express, and we do not express, an opinion on the SBA's financial statements, conclusions about the effectiveness of internal control or conclusions on SBA's compliance with laws and regulations. However, our review disclosed no instances where KPMG or Cotton and Company did not comply, in all material respects, with generally accepted government auditing standards.

We appreciate the cooperation and assistance of SBA, KPMG and Cotton and Company representatives. Should you or your staff have any questions, please contact me at (202) 205-Exemption 2 or Jeffrey R. Brindle, Director, Information Technology and Financial Management Group at (202) 205-Exemption 2

Attachments



KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Office of Inspector General,
U.S. Small Business Administration:

We have audited the accompanying consolidated balance sheet of the U.S. Small Business Administration (SBA) as of September 30, 2006, and the related consolidated statement of net cost, changes in net position, and financing, and the combined statement of budgetary resources (hereinafter referred to as "consolidated financial statements") for the year then ended. The objective of our audit was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our fiscal year 2006 audit, we also considered SBA's internal control over financial reporting, Required Supplementary Stewardship Information, and performance measures, and tested SBA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these consolidated financial statements. The accompanying consolidated financial statements as of September 30, 2005, were audited by other auditors whose report, dual dated November 15, 2005 and November 14, 2006 on those statements was unqualified and included an explanatory paragraph that described a restatement of fiscal year 2005 amounts as discussed in notes 6C and 18 to the consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that SBA's consolidated financial statements as of and for the year ended September 30, 2006, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

Our consideration of internal control over financial reporting, Required Supplementary Stewardship Information, and performance measures resulted in the following conditions being identified as reportable conditions:

- Improvement needed surrounding controls over the financial reporting process;
- Improvement needed in management's information technology security controls; and
- Improvement needed over budgetary controls surrounding obligations.

We consider the first reportable condition, above, to be a material weakness.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed instances of noncompliance or other matters relating to the laws listed below that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*:

- Federal Financial Management Improvement Act of 1996 (FFMIA); and
- Financial Information Security Management Act (FISMA).



The following sections discuss our opinion on SBA's consolidated financial statements; our consideration of SBA's internal controls over financial reporting, Required Supplementary Stewardship Information, and performance measures; our tests of SBA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheet of SBA as of September 30, 2006, and the related consolidated statement of net cost, changes in net position, and financing, and the combined statement of budgetary resources for the year then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 2006, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligation for the year then ended, in conformity with U.S. generally accepted accounting principles.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information, and accordingly, we express no opinion on it.

The information in the fiscal year 2006 Performance Section and Appendices is presented for purposes of additional analysis and is not required as part of the consolidated financial statements. This information has not been subjected to auditing procedures, and accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

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 the internal control over financial reporting that, in our judgment, could adversely affect SBA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated 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 caused by error or fraud, in amounts that would be material in relation to the consolidated financial statements 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 due to error or fraud may nevertheless occur and not be detected.

In our fiscal year 2006 audit, we noted certain matters, described in Exhibits 1 and 2, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that the reportable condition presented in Exhibit 1 is a material weakness. Exhibit 2 presents the other reportable conditions. Summaries of the status of prior year material weaknesses, reportable conditions, and management's response to our findings are included as Exhibits 4, 5, and 6, respectively.



We noted certain additional matters that we have reported to SBA's management in a separate letter dated November 15, 2006.

INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION AND PERFORMANCE MEASURES

Under OMB Bulletin No. 06-03, the definition of material weaknesses is extended to other controls as follows. 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 caused by error or fraud, in amounts that would be material in relation to the Required Supplementary Stewardship Information or material to a performance measure or aggregation of related performance measures, 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 due to error or fraud may nevertheless occur and not be detected.

Our consideration of the internal control over the Required Supplementary Stewardship Information and the design and operation of internal control over the existence and completeness assertions related to key performance measures would not necessarily disclose all matters involving the internal control and its operation related to Required Supplementary Stewardship Information or the design and operation of the internal control over the existence and completeness assertions related to key performance measures that might be reportable conditions.

In our fiscal year 2006 audit, we noted no matters involving the internal control and its operation related to Required Supplementary Stewardship Information that we considered to be material weaknesses as defined above.

In our fiscal year 2006 audit, we noted no matters involving the design and operation of the internal control over the existence and completeness assertions related to key performance measures that we considered to be material weaknesses as defined above.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed one instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03, and is described below.

FISMA. SBA is not in full compliance with FISMA. We noted that during fiscal year 2006, the Office of the Chief Information Officer (OCIO) has worked with its information security program in order to meet FISMA and OMB Circular A-130 guidelines. However, SBA needs further improvement in its entitywide security program to fully meet these guidelines. These matters are described in more detail in Exhibit 2.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03.

As also discussed in the responsibilities section of our report, under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether SBA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and



(3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

The results of our tests of FFMIA disclosed no instances in which SBA's financial management systems did not substantially comply with the Federal accounting standards, or the United States Standard General Ledger (USSGL) at the transaction level. However, the results of our tests of FFMIA disclosed instances, described in more detail in Exhibits 1 and 2, where SBA's financial management systems did not substantially comply with Federal financial management systems requirements.

A summary of the instances of FFMIA noncompliance with Federal financial systems requirements follows:

- FFMIA requires that Federal agencies implement information security controls and contingency planning capabilities in accordance with OMB Circular A-130. During our fiscal year 2006 audit work, we noted weaknesses related to access and security controls on several servers that could be exploited by unauthorized users to gain key information. SBA implemented corrective measures to alleviate these weaknesses just prior to September 30, 2006.
- FFMIA also requires that Federal agencies implement financial systems controls in accordance with OMB Circular A-127. We noted several areas where SBA can improve the controls and processes over financial systems to comply with Circular A-127. For example, SBA restated its credit reform footnote for fiscal year 2005 to correct an error in the disclosures associated with the *Total Outstanding Principal at Face Value* and *Outstanding Principal Guaranteed* by SBA. The causes for this error are related to system limitations coupled with weaknesses in management's review procedures to address the system limitations.

* * * * *

RESPONSIBILITIES

Management's Responsibilities. The United States Code Title 31 Sections 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, SBA prepares and submits financial statements in accordance with OMB Circular A-136.

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles;

Preparing the Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information;
- Establishing and maintaining effective internal controls; and
- Complying with laws, regulations, contracts, and grant agreements applicable to SBA, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies.



Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2006 consolidated financial statements of SBA based on our audit. The accompanying fiscal year 2005 consolidated financial statements were audited by other auditors whose report, dated November 15, 2005 and November 14, 2006 on those statements was unqualified and included an explanatory paragraph that described a restatement of fiscal year 2005 amounts as discussed in notes 6C and 18 to the consolidated financial statements. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 06-03. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of SBA's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
 - Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our audit provides a reasonable basis for our opinion.

In planning and performing our fiscal year 2006 audit, we considered SBA's internal control over financial reporting by obtaining an understanding of SBA's internal controls, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide an opinion on SBA's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, we considered SBA's internal control over the Required Supplementary Stewardship Information by obtaining an understanding of SBA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. We limited our testing to those controls necessary to test and report on the internal control over Required Supplementary Stewardship Information in accordance with OMB Bulletin No. 06-03. However, our procedures were not designed to provide an opinion on internal control over the Required Supplementary Stewardship Information, and accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis and Performance sections, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to test and report on the internal control over key performance measures in accordance with OMB Bulletin



No. 06-03. However, our procedures were not designed to provide an opinion on internal control over reported performance measures, and accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether SBA's fiscal year 2006 consolidated financial statements are free of material misstatement, we performed tests of SBA's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to SBA. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit, and accordingly, we do not express such an opinion.

Under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether SBA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

RESTRICTED USE

This report is intended solely for the information and use of SBA's management, SBA's Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 14, 2006

U.S. Small Business Administration
Material Weakness

Introduction

The internal control weaknesses discussed in this report, and the U.S. Small Business Administration's (SBA) progress toward correcting these weaknesses, are discussed in the context of SBA's organizational structure and its ability to obtain funding to take corrective action. Exhibit 1 describes the material weakness and Exhibit 2 describes the reportable conditions as of and for the year ended September 30, 2006, and our recommendations thereon. The status of prior year compliance and internal control findings are reported in Exhibits 3, 4 and 5, respectively, and SBA management's response is presented in Exhibit 6.

Material Weakness

The material weakness we identified as of and for the year ended September 30, 2006, is summarized below.

(1) Improvement Needed Surrounding Controls over the Financial Reporting Process

During fiscal year 2006, SBA has continued to implement various reconciliation and data quality improvement procedures between and within its various systems and departments in an effort to address prior years' audit findings to ensure that the agency's consolidated financial statements are reasonable and fairly presented. The purpose of these procedural enhancements is to improve the overall quality of the data SBA uses internally to monitor operations and loan portfolio performance as well as to periodically report to its various stakeholders, such as Treasury and OMB. However, as evidenced in the discussion that follows, the structure around these procedures should be strengthened to effect improvement in the quality and accuracy of the quarterly and year-end financial reporting process.

SBA did not timely identify a \$10 billion overstatement in the disclosures concerning guaranteed loans. Specifically, the disclosures for *Outstanding Principal at Face Value* and *Outstanding Principal Guaranteed by SBA* were each overstated in the amount of \$10 billion in the 2003 through 2005 consolidated financial statement footnotes. SBA detected and corrected these errors in the reviews of the fiscal year 2006 third quarter unaudited consolidated financial statements. The overstatements were identified as a result of a data quality review by SBA of its guaranteed loan portfolio balance. The errors were caused because SBA's subsidiary ledger was not in agreement with its general ledger and SBA personnel did not timely analyze the reason for the variances in these general ledger memorandum accounts. As such, the system reconciliation procedures used in 2003 through the third quarter of fiscal year 2006 were ineffective with respect to these accounts. The overstatements did not impact other amounts included in the consolidated financial statements.

Our tests of SBA's financial reporting process also indicate that controls need further refinement. For example, we noted deficiencies in SBA's quality assurance reviews over the preparation of the consolidated financial statements and notes. During our interim and year-end procedures, we tested SBA's controls over generating and reviewing the consolidated financial statements. SBA uses an automated process to download the financial data from the Financial Reporting Information System (FRIS) into an Excel workbook. Embedded in the Excel workbook are a series of automated quality assurance tests to ensure that certain financial information relationships exist. After the workbook generates the consolidated financial statements, the Financial Assurance Division (FAD), Financial Reporting Division (FRD), and the Accounting Liaison Quality Assurance (ALQA) Division all perform procedures to review the content of the consolidated financial statements. The review in its current form is meant to ensure that the basic financial statement relationships exist, such as agreement between the consolidated financial statements and the footnotes. While these procedures need to be performed, SBA needs to include a more comprehensive and in-depth analysis of the consolidated financial statements and

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Material Weakness

footnotes to ensure the reasonableness of the balances. These procedures are important given the decentralized nature of SBA's information systems and overall data gathering processes.

Further, our tests of the agency's credit reform footnote disclosure related to the 7(a) guarantee purchases identified errors. While testing this footnote, we inquired about the balance of the liability related to the Business Loans Guarantees, which didn't reconcile with the credit reform Return on Assets (ROA) model calculations. SBA determined that an error of \$139 million occurred when calculating the year-end amount. SBA subsequently corrected the error in the fiscal year 2006 consolidated financial statements.

The Office of Management and Budget's (OMB) Circular A-123, *Management's Responsibility for Internal Controls*, states: "management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Management shall consistently apply the internal control standards to meet each of the internal control objectives and to assess internal control effectiveness."

Recommendations

We recommend that:

1. The Chief Financial Officer continues to enhance SBA's quality assurance processes related to amounts recorded in SBA's various financial systems. Control policies should ensure that all reconciling items are pursued and fully investigated. In addition, SBA should ensure that all account balances are subject to reconciliation.
2. The Chief Financial Officer requests an in-depth analysis of information presented in the consolidated financial statements be performed each quarter including the footnotes for the third and fourth quarter consolidated financial statements. More specifically, FAD, FRD and ALQA should reconcile the consolidated financial statements and footnote information to actual source data and analyze the financial statement data for reasonableness. These procedures should be added to the existing quality assurance checklists and other financial statement review tools used by SBA.
3. The Chief Financial Officer requests that relevant personnel reconcile loan guarantee data recorded in the general ledger periodically with information reported by SBA's fiscal transfer agent to ensure that the amounts recorded are accurate.

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Reportable Conditions

The reportable conditions identified as of and for the year ended September 30, 2006, are summarized below:

(2) Improvement Needed in Management Information Technology Security Controls

During our review of SBA's information technology (IT) systems and applications, we noted control weaknesses, which can be segmented into the following areas: access to programs and data, software program changes, segregation of duties, and end-user computing.

Access to Programs and Data

Integral to an organization's security program management efforts, technical security access controls for systems and applications should provide reasonable assurance that IT resources such as data files, application programs, and IT-related facilities/equipment are protected against unauthorized modification, disclosure, loss, or impairment.

A summary of the access control weaknesses we identified follow:

Exemption 2

- Exemption 2

Security Plans of Actions and Milestones (POA&Ms) need to be complete. Many POA&Ms we reviewed did not fully reflect SBA's plans to resolve information security weaknesses. Full completion of POA&Ms is critical to track the implementation of improved security controls and to track the security weaknesses that will be mitigated through compensating controls.

- Security awareness and emergency response training efforts need improvement. For example, we noted that for only 9 of 30 fiscal year 2006 new hires, there was no documentation supporting that the new hires had successfully completed computer security awareness training. In addition, there is no formal method of tracking the completion of the security training. Such efforts are important to help ensure that system and application users are aware of their responsibilities regarding system security.

Software Program Changes

The primary focus of an organization's software change/configuration management program is to control software changes made to systems and applications. Without strong controls in this area, there is an

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Reportable Conditions

elevated risk that security features could be inadvertently or deliberately omitted or turned off, or that processing irregularities or malicious code could be introduced into the IT environment.

A summary of the software program change control weaknesses we identified follows:

- Program change and emergency change requests and approvals can be better documented. While some evidence of software changes was provided, it was not complete. In addition, SBA does not have complete policies or procedures for making and approving software changes.
- Complete software change test planning documentation for the Joint Accounting and Administration Management System (JAAMS) and the Financial Reporting Information System (FRIS) was not available for eight of ten sample software changes.

Segregation of Duties

Segregation of duty controls help restrict user access and strengthen the security around unauthorized manipulation of data. Restricting employees from performing incompatible functions or functions beyond their responsibility lowers the risk that critical or sensitive data could be inappropriately manipulated or deleted. Additionally security violations should be documented and reviewed for proper follow-up by management. The following are examples noted regarding deficiencies in SBA IT segregation of duty controls:

The Field Cashiering System (FCS) users are assigned multiple roles (i.e., Cashier, Loan Officer, Reports, Supervisor, mail opener), which elevates the risk of unauthorized access or manipulation of data. According to the FCS user manual, users should be assigned one role.

- A user who performs a legal review on the loan files in the Guaranty Purchase Tracking System (GPTS) can also approve the loan files. The user can perform both functions under the same GPTS user identifier.
- There is no formal segregation of duties procedures documented for FRIS, JAAMS, the Disaster Credit Management System (DCMS), and the Loan Accounting System (LAS).
- SBA does not have adequate storage capacity within the audit logs that record security violations. Furthermore, SBA does not retain security logs for a sufficient period of time. Finally, SBA does not monitor or review security logs for suspicious activity on a timely basis.

End-User Computing

During the fiscal year 2006 SBA financial audit, we found deficiencies in documentation related to end-user computing policies and procedures. For example, SBA has not fully documented agency policies, and program offices have not documented procedures for controlling end-user computing.

End-user computing tools/programs (e.g., spreadsheets and other user-developed programs) provide a unique set of control needs within an organization. By its nature, end-user computing brings the development and processing of information systems closer to the user. This environment may not be subjected to the same structural procedures as is the IT general controls environment.

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Reportable Conditions

Maintaining good IT controls is not only part of a sound management governance structure; it is also required by Federal laws and regulations. For example, the Federal Information Security Management Act (FISMA) requires that Federal agencies follow security guidance issued by the National Institute of Standards and Technology (NIST). NIST provides the following relevant guidance:

- Special Publication 800-53 (*Recommended Security Controls for Federal Information Systems*) guides that the organizations should train personnel in their contingency roles and responsibilities with respect to the information system, provide periodic security training, and maintain sufficient access controls to protect sensitive agency data.
- Special Publication 800-14 (*Generally Accepted Principles and Practices for Security Information Technology Systems*) guides that organizations should ensure effective administration of users' computer access to maintain system security, including user account management and the timely modification or removal of access.
- Special Publication 800-18 (*Guide for Developing Security Plans for Information Technology Systems*) guides there should be a separation of duties between security personnel who administer the access control functions and those who administer the audit trail, and that agencies should fully document software changes as tests are performed.

Further, SBA's internal policies and procedures guide for the maintenance of sound IT controls. For example:

- SBA's SOP 90-47.2 requires the system owners of the automated information systems to report the progress in correcting system weaknesses for the SBA POA&M and validate that the identified weaknesses have been corrected.

SBA's VAT charter requires that external scans and internal scans must be performed monthly

Recommendations

We recommend that:

4. Exemption 2

- Exemption 2

The Chief Information Officer ensure that formal request forms are fully processed before network access is granted.

The Chief Information Officer should coordinate with program offices to ensure that system Plans of Actions and Milestones are fully completed.

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Reportable Conditions

8. The Chief Information Officer should coordinate with other SBA program offices to implement a process to track employee computer security training and to ensure all employees receive such training on a periodic basis.
9. The Chief Information Officer should ensure that system owners for DCMS, FRIS, JAAMS and LAS standardize software change requests and that software change testing documentation is developed in a more consistent and complete manner. This may be accomplished by: (1) Conducting training on the importance of completing such documentation, and (2) issuing guidance on standardization of change requests and change testing documentation.
10. The Chief Financial Officer in conjunction with appropriate program officials should ensure that each user within the Field Cashiering System has only one role in the system. In cases where this may not be feasible given work assignments, then additional compensating controls, such as additional management oversight, should be implemented.
11. The Associate Deputy Administrator for Capital Access in conjunction with appropriate program officials should ensure that each user within the Guaranty Purchase Tracking System has only one role in the system. In cases where this may not be feasible given work assignments, then additional compensating controls, such as additional management oversight, should be implemented.
12. The Chief Operating Officer in conjunction with appropriate program officials should ensure that policies are implemented regarding segregation of duties for FRIS, JAAMS, DCMS, and LAS.
13. The Chief Operating Officer in conjunction with the Office of Chief Information Officer should coordinate with program offices to implement policies for end-user computing, specifically enforcing user-level access controls over existing programs and data objects.
14. The Chief Information Officer obtain the needed storage capacity to store security logs for an adequate period of time. Further, the Chief Information Officer ensure that potential security violations are reviewed for possible inappropriate use of IT equipment and data.

(3) Improvement Needed over Budgetary Controls Surrounding Obligations

During our testwork over SBA's budgetary accounting and control procedures specifically as it relates to the approval and recording of undelivered orders, we noted instances where controls were circumvented or procurement procedures were inconsistently applied. Circumvention of authorization controls or the inconsistent application of established procedures can significantly increase the risk that obligations and expenses related to travel may not be accurately recorded. Our testwork included a sample of 153 items totaling \$87.7 million.

The first three items below relate to disaster program travel activity administered by the Office of Disaster Assistance Administrative Controls. The operations of this office were significantly impacted in the latter part of fiscal year 2005 and the beginning of fiscal year 2006 as SBA responded to the nation's hurricane disasters occurring during that timeframe. The remaining items relate to administrative program activities other than travel.

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Reportable Conditions

The following is a summary of the exceptions noted in our testwork:

- Two instances in which authorizing travel documents in the amount of \$10,000 were not subjected to established review and approval procedures prior to being modified to match actual travel costs incurred of \$30,000. Related to these two selections, KPMG found five instances of either the original obligating document or an amendment being modified from its original obligated amount without additional procurement action being taken.
- Four instances of travel authorization documents in the amount of \$60,000 being approved however the obligation was not recorded at the time of approval due to limited staff resources in the area responsible for recording obligations in the system. In each case, the obligation was not recorded until after the individuals had incurred all travel costs. In one instance, we determined that the remaining undelivered order balance should have been deobligated as of June 30, 2006.
- One instance in the amount of \$20,000 in which a travel obligation amendment was not recorded in the general ledger. The amendment also authorized an extension of the time allowed for travel, and although the time extension was entered into to the general ledger, the amount was not.
- Five instances totaling \$88,413 in which undelivered obligations should have been de-obligated. Our statistical extrapolation resulted in a projected error of \$5.7 million
- Sixteen instances of obligations in the amount of \$8.6 million recorded prior to the documents being approved. The difference between posting dates and the dates noted on the authorizing documents ranged from 1 to 18 days.

The Office of Management and Budget (OMB) Circular A-123, *Management Accountability and Control*, section I defines management controls as “the organization, policies, and procedures used by agencies to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making.” OMB A-123, section II goes on to indicate: “Monitoring the effectiveness of internal control should occur in the normal course of business. In addition, periodic reviews, reconciliations or comparisons of data should be included as part of the regular assigned duties of personnel. Periodic assessments should be integrated as part of management’s continuous monitoring of internal control, which should be ingrained in the agency’s operations.”

Additionally, based on our review of SBA’s Standard Operating Procedures (SOP), Section 20 11 5, we noted that the authorization section does not integrate the recording of procurement procedure activities in the general ledger with the authorization of travel documentation. As such, there is no established relationship between the authorization for and recording of travel-related budgetary obligations.

Recommendations

We recommend that:

15. The Chief Financial Officer implement comprehensive control procedures to ensure travel obligations are properly approved and are accurately and timely entered into the general ledger, and that modifications to travel obligations are subjected to formal approval.

U.S. Small Business Administration
Reportable Conditions

16. The Assistant Administrator for Disaster Assistance ensure that responsible individuals are adequately trained and sufficient monitoring procedures are designed and implemented to ensure personnel comply with the enhanced control procedures.

U.S. Small Business Administration
Status of Prior Year Noncompliance and Other Matters Reported

Fiscal Year 2005 Noncompliance	Fiscal Year 2006 Status of Noncompliance
<p>Federal Financial Management Improvement Act of 1996 (FFMIA) – The US Small Business Administration (SBA) was not in compliance with FFMIA as follows:</p> <ul style="list-style-type: none"> • SBA is not in substantial compliance with Federal financial management systems requirements. <p>SBA is not in substantial compliance with Federal accounting standards.</p> <ul style="list-style-type: none"> • SBA is not in substantial compliance with the U.S. Standard General Ledger (USSGL) at the transaction level. 	<p>The results of our tests over compliance with FFMIA during fiscal year 2006 disclosed that SBA is in substantial compliance with FFMIA as it relates to Federal accounting standards and the USSGL at the transaction level.</p> <p>However, our tests indicated instances in which SBA's information systems did not substantially comply with Federal financial management systems requirements. For example, we noted vulnerabilities on several servers that could be exploited by unauthorized users to gain key system information, and possibly unauthorized access. Additionally, SBA restated their fiscal year 2005 credit reform footnote disclosure due to an error, which was caused in part by system limitations and the lack of an effective mitigating control. See Exhibit 1. <i>Material Weakness, Improvement Needed Surrounding Controls over the Financial Reporting Process</i>, and Exhibit 2. <i>Reportable Conditions, Improvement Needed in Management Information Technology Security Controls</i>.</p>

U.S. SMALL BUSINESS ADMINISTRATION

Status of Prior Year Material Weakness

Fiscal Year 2005 Finding	Fiscal Year 2006 Status of Finding
<p data-bbox="159 495 784 651">Financial Management Reporting Controls: The results of the fiscal year 2005 audit indicated that SBA needed to improve its controls surrounding the financial management reporting process, specifically related to the areas noted below:</p> <p data-bbox="204 678 448 712">Funds Management</p> <ul data-bbox="159 734 792 891" style="list-style-type: none"> <li data-bbox="159 734 792 801">• Financial Accounting Transactions and Review of Account Balances <li data-bbox="159 824 792 891">• Financial Statement Preparation and Quality Assurance 	<p data-bbox="816 495 1455 651">During fiscal year 2006, SBA made significant overall operational improvements over the controls centered on funds management and financial accounting and account balance reviews. However, we noted continuing findings in the financial reporting process.</p> <p data-bbox="816 678 1455 835">Therefore, in fiscal year 2006, we continue to report a material weakness in internal control related to SBA's financial reporting process. See Exhibit 1, Material Weakness, <i>Improvement Needed Surrounding Controls over the Financial Reporting Process</i>.</p>

U.S. SMALL BUSINESS ADMINISTRATION

Status of Prior Year Reportable Conditions

Fiscal Year 2005 Findings	Fiscal Year 2006 Status of Findings
<p>1. Office of Disaster Assistance Administrative Expenditure Controls</p>	<p>During our review over budgetary controls surrounding travel vouchers, specifically as it relates to the approval and recording of undelivered orders, we noted instances where controls were circumvented or procurement procedures were inconsistently applied. The travel vouchers tested relate to travel associated with SBA's disaster program.</p> <p>See Exhibit 2, Reportable Conditions. <i>Improvement Needed over Budgetary Controls Surrounding Obligations.</i></p>
<p>2. Agency-Wide Information Systems Controls</p>	<p>During our review of SBA's information technology (IT) general and application controls, we continued to note opportunities for SBA to improve its internal controls. The control weaknesses that continue to exist are in the following areas: access to programs and data, software program changes, segregation of duties, and end-user computing.</p> <p>Therefore, in fiscal year 2006, the presentation of the issue was modified to reflect current year operations, and we continue to report a reportable condition. See Exhibit 2, Reportable Conditions. <i>Improvement Needed in Management Information Technology Security Controls.</i></p>

CFO Reply

DATE: November 13, 2006

TO: Debra Ritt, Assistant IG for Auditing
Exemption 6

FROM: Jennifer Math, Chief Financial Officer

SUBJECT: FY 2006 Financial Statement Audit Report

The Small Business Administration (SBA) is in receipt of the draft Independent Public Accountant (IPA) report from KPMG that includes the auditor's opinion on the financial statements and review of the Agency's internal control over financial reporting and compliance with laws and regulations. As you know, the IPA audit of the Agency's financial statements and related processes is a core component of SBA's financial management program.

Overall we are very pleased that the SBA has received an unqualified audit opinion from the independent auditor. We believe the unqualified opinion accurately reflects the quality of the Agency's financial statements and our improved accounting, budgeting and reporting processes. As you know, SBA has worked hard over the past several years to address the many findings from our independent auditor. Our core financial reporting data and processes have been substantially improved and we are proud that the results of our efforts have been confirmed by the independent auditor.

The IPA's report includes a material weakness finding in the area of financial reporting. While we are disappointed that all of the progress we feel we have made in this area did not result in reducing the deficiency to a reportable condition, we understand that additional improvements are needed. We are committed to maintaining the strong momentum established this year to improve the Agency's financial management processes and results in FY 2007.

We appreciate all of your efforts and those of your colleagues in the Office of the Inspector General as well as those of KPMG. As we anticipated, having a new auditor this year provided us with new insights and recommendations that will further enhance SBA's financial management practices. Overall we feel our financial management capacity has continued to improve this year and we are proud of what we have accomplished. We continue to be committed to excellence in financial management and look forward to making more progress in the coming year.



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INDEPENDENT AUDITOR'S REPORT

Inspector General
U.S. Small Business Administration

We audited the accompanying consolidated balance sheet of the U.S. Small Business Administration (SBA) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing; and combined statement of budgetary resources for the fiscal year then ended. These financial statements are the responsibility of SBA management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, as amended. Those standards require that we plan and perform our 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 amounts and disclosures in 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.

As discussed in Note 18 to the financial statements, SBA restated its footnote disclosure for guaranteed loans outstanding (face value and amount guaranteed by SBA), as of September 30, 2005, to correct an error in a portion of Footnote 6. SBA overstated the total amount of guaranteed loans outstanding (face value and amount guaranteed by SBA) by \$10 billion due to a data error in SBA's Loan Accounting System. The restated amounts are shown in Footnote 6.C. Had Cotton & Company identified this error in the previous audit, and SBA chose not correct it, we would have issued a modified opinion.

In our opinion, the consolidated balance sheet as of September 30, 2005, the related consolidated statements of net cost, changes in net position, and financing; and the combined statement of budgetary resources for the fiscal year then ended, present fairly, in all material respects, the financial position of SBA as of September 30, 2005, and its net costs, changes in net position, reconciliation of net costs to budgetary obligations and its combined budgetary resources for FY 2005, in accordance with accounting principles generally accepted in the United States of America.

At the end of FY 2005, severe hurricanes occurred that were declared disasters under SBA's Disaster Assistance program. These disasters will affect the composition of new SBA loan portfolios and may affect the outcome and valuation of existing loan portfolios. SBA faces uncertainty as to full future effects on its operations and financial condition caused by these disasters. Subsidy cost estimates and valuation of SBA's credit program receivables and related foreclosed property, net, and liability for loan guarantees in the accompanying financial statements are based on SBA's historical loan program information, which may or may not be representative of variations in loan performance that may occur as a result of these disasters.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Information presented in SBA's FY 2005 Performance and Accountability Report, including management's discussion and analysis, required supplementary stewardship information, required supplementary information, and other accompanying information, are not required parts of basic financial statements, but are additional information required by the Federal Accounting Standards Advisory Board and OMB Circular A-136 *Financial Reporting Requirements*. We applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of supplementary information. This information has not been subjected to auditing procedures, and, accordingly, we express no opinion on it. Our limited procedures raised doubts, however, that we were unable to resolve regarding whether material modification should be made to the information for SBA to conform to OMB Circular A-136.

In accordance with *Government Auditing Standards*, we have also issued reports dated November 15, 2005, on our consideration of SBA's internal control (updated on November 14, 2006) and on its compliance with laws and regulations. Those reports, which disclose reportable conditions in internal control, one of which is a material weakness, and non-compliance with the Federal Financial Management Improvement Act of 1996, are integral parts of a report prepared in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our work.

COTTON & COMPANY LLP

Exemption 6

Charles Hayward, CPA

November 15, 2005, except for the restated portion of Note 6.C and Note 18
for which the date is November 14, 2006
Alexandria, Virginia



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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL

Inspector General
U.S. Small Business Administration

We audited the consolidated balance sheet of the U.S. Small Business Administration (SBA) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing and combined statement of budgetary resources for the fiscal year then ended and have issued our report thereon, dated November 15, 2005, except for the restated portion of Note 6.C and Note 18, for which the date is November 14, 2006. In that report, we issued an unqualified opinion on the Fiscal Year (FY) 2005 consolidated balance sheet; consolidated statements of net cost, changes in net position and financing; and the combined statement of budgetary resources.

We conducted our audit in accordance with auditing standards generally accepted in the United States; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our work, we considered SBA's internal controls over financial reporting by obtaining an understanding of SBA's internal controls, determining if internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our audit procedures for the purpose of expressing our opinion on the financial statements. We limited internal control testing to those controls necessary to achieve objectives described in OMB Bulletin 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 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our work was not to provide assurance on internal controls. 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 internal controls over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants (AICPA) and OMB Bulletin 01-02, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal controls that, in our judgment, could adversely affect SBA's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements 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 matters involving internal control and its operation in the three areas, discussed below, that we consider to be reportable conditions:

1. Financial Management and Reporting Controls
2. Office of Disaster Assistance Administrative Expenditure Controls
3. Agency-Wide Information System Controls

We consider combined matters described in the first area to be a material weakness under standards established by AICPA, as discussed below.

1. FINANCIAL MANAGEMENT AND REPORTING CONTROLS

SBA made substantial and noteworthy improvements to its internal control and quality assurance procedures over financial management and reporting and was able to provide its FY 2005 interim and yearend financial statements, footnotes, supporting trial balances, and key audit deliverables in accordance with agreed-upon milestone dates. In addition, we noted much improvement in the quality, accuracy, and reliability of its financial reports and supporting documentation. SBA's financial management and reporting controls, however, continue to need improvement in the following areas:

- Funds Management
- Financial Accounting Transactions and Review of Account Balances
- Financial Statement Preparation and Quality Assurance

We discuss SBA's control weaknesses and areas needing improvement on the following pages under their respective captions.

Funds Management

We noted two areas of funds management that need improvement.

Loan Undelivered Orders

SBA continues to experience difficulty in monitoring disaster loan program undelivered orders. During FY 2005, SBA included a clause in its standard Loan Authorization and Agreement (LAA) stating that the loan must be disbursed within 6 months from the date on the LAA, or the loan will be cancelled. In addition, another clause requires the borrower to return the signed LAA and other loan closing documents within 2 months from the date on the LAA, or the loan will be cancelled. SBA stated that these administrative requirements are used to expedite the loan application and disbursement process.

During our interim testing at June 30, 2005, we noted instances in which the loan disbursement period had expired and other instances in which the loan should have been cancelled because the borrower had not returned the loan closing documents. Due to the significant increase in the volume of loan approval activity resulting from the hurricanes occurring at the end of FY 2004, SBA was not able to process loan cancellation or extension actions in a timely manner or monitor loan approval status to determine if cancellations or extensions were warranted. The Office of Chief Financial Officer (OCFO) was not aware of the LAA clauses, and its process to monitor undelivered orders was not effective in identifying unneeded undelivered orders in a timely manner.

OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, Section 20, Terms and Concepts, defines a valid obligation as a binding agreement that will result in immediate or future outlays.

In response to our interim testing results, OCFO initiated an effort to ensure that the Office of Disaster Assistance processed as many cancellation and extension actions as possible by September 30, 2005. In addition, SBA developed a \$95.5 million estimate to decrease undelivered orders no longer needed because the disbursement period had expired. It also recorded a \$64.1 million audit adjustment, based on our yearend testing, that disclosed instances in which the loan should have been cancelled because the borrower had not returned the signed loan closing documents within the 2-month period, and SBA had not extended the closing period.

Grant Undelivered Orders

During sample testing of administrative undelivered orders, we identified a \$492,000 undelivered order for a grant obligated in FY 2001. The grant period of performance had expired in August 2003. To date, the grantee has not sought reimbursement for any incurred expenditures, and SBA's Office of Procurement and Grants Management (OPGM) has not been able to confirm whether the grantee has incurred expenditures. Accordingly, SBA could not provide support to substantiate the need for this undelivered order.

SBA does not have a practice in place to ensure that grants are closed out in a timely manner. OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-profit Organizations*, Subpart D, After the Award Requirements, Paragraph .71 (b), states that a recipient shall liquidate all obligations incurred under an award not later than 90 calendar days after the funding period ends or the completion date specified in the award unless an extension is authorized.

Recommendations

We recommend that the Chief Financial Officer (CFO):

- 1.A Continue to enhance SBA's undelivered order monitoring process to include coordination with the Office of Disaster Assistance to ensure that its monitoring takes into consideration processing backlogs and administrative practices having an effect on management's financial statement assertions.
- 1.B Coordinate with the Director, OPGM, to implement timely closeout procedures and strengthen monitoring procedures to ensure that all grant undelivered orders are supported by evidence as to their need and validity.

Financial Accounting Transactions and Review of Account Balances

SBA's internal control and quality assurance review processes continue to need improvement to ensure that accounting transactions are recorded accurately and in a timely manner and in accordance with accounting standards and guidance, and that resulting general ledger account balances are proper. We noted the following matters.

Material Error in Note Disclosure (Added November 2006)

SBA overstated its footnote disclosure for guaranteed loans outstanding (face amount and amount guaranteed by SBA) by \$10 billion, for FY 2003, 2004, and 2005. SBA did not detect this error until FY 2006.

SBA had a long-standing problem due to a system limitation within its loan accounting system reporting tool which caused summary reports for certain memorandum accounts to be understated by \$10 billion.

During FY 2001, SBA posted an off-line accounting entry into its Financial Reporting Information System (FRIS), at which time FRIS maintained the correct balance. The Loan Accounting System (LAS) summary report continued to be understated. During FY 2004, SBA conducted an analysis to demonstrate the need for an adjustment to the LAS summary report and posted an entry into the LAS Summary Report to remedy the long-standing problem. This entry was also recorded in FRIS through an automatic interface with the loan accounting system. SBA failed to reverse the FY 2001 off-line entry, which then resulted in a \$10 billion overstatement in FRIS. SBA prepared the note disclosures using memorandum account balances in FRIS, thus overstating the guaranteed loans outstanding face amount and amount of SBA share.

SBA does not have a reconciliation process in place to reconcile its FRIS general ledger account ending balances to the underlying feeder systems. SBA does perform a reconciliation each time LAS data is uploaded into FRIS to ensure the completeness and accuracy of the LAS upload. Had an ending balance reconciliation been performed, the \$10 billion error would have been identified on a timely basis.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1) requires control activities to ensure that all transactions are completely and accurately recorded.

Improper Accounting Treatment

We noted the following instances in which SBA's accounting transactions were not recorded, processed, summarized, and reported in accordance with the United States Standard General Ledger (USSGL); OMB Circular A-136, *Financial Reporting Requirements*; and federal accounting standards. Substantial compliance with the USSGL at the transaction level, as mandated by the Federal Financial Management Improvement Act, requires that SBA record financial events consistent with applicable posting models/attributes reflected in the USSGL. Generally accepted accounting principles require that transactions be recorded based upon events that actually occurred.

1. Proforma Credit Reform Accounting Transactions: SBA used improper posting logic when calculating an automated journal entry recorded as part of its month-end credit reform accounting transactions. The general ledger account used to record downward subsidy reestimates was erroneously closed, resulting in a zero versus \$58 million account balance. In addition, SBA's expense account used to record interest accumulation on the liability for loan guarantees was misstated by \$58 million. These errors were evident in SBA's June 30, 2005, trial balance because a valid relationship among various general-ledger accounts did not exist. SBA did not identify these errors during its review of the June 30, 2005, trial balance and financial statements. The posting logic was corrected for the yearend financial statement submission.

2. Treasury Borrowing Transactions: SBA incorrectly characterized \$30.5 million as a decrease in Borrowing Authority Converted to Cash rather than Actual Repayment of Debt. On January 12, 2005, SBA executed Standard Form (SF) 1151, Nonexpenditure Transfer Authorization, and converted \$500.3 million of its total \$800.3 million borrowing authority to cash. On January 31, OMB approved an SF 132, Apportionment and Reapportionment Schedule, to reduce SBA's borrowing authority to \$469.8 million, which resulting in SBA borrowing more than its revised authority. On February 9, SBA executed an SF 1151 to decrease amounts previously converted to cash by \$30.5 million. SBA stated that it needed less borrowing authority than was originally approved on its SF 132 because of the decrease between the FY 2004 financial statement downward reestimate and the revised reestimate calculated for the President's budget.

The USSGL has the following specific general ledger accounts and provides standard posting logic for recording borrowing transactions:

- 4141 – Current Year Borrowing Authority Realized
- 4143 – Decreases to Indefinite Borrowing Authority
- 4145 – Borrowing Authority Converted to Cash
- 4146 – Actual Repayment of Debt, Current-Year Authority
- 4148 – Resources Realized From Borrowing Authority

Because SBA had already converted \$500.3 million of the approved borrowing authority to cash, it should have treated the \$30.5 million difference as a repayment. As a result, SBA's Statement of Budgetary Resources, line items *Borrowing Authority* and *Permanently Not Available*, were each misstated by \$30.5 million. SBA did not correct this error.

3. Improper Automated Reversing Entries: SBA erroneously reversed certain accounting entries that had been previously recorded as part of a point-break cleanup project. SBA uses point breaks to distinguish its various loan program account balances within its credit reform financing funds, which account for multiple loan programs within the same fund. As part of an automated routine, the cleanup entries were reversed in error, resulting in a \$26.3 million understatement of allowance for subsidy and a \$26.3 million overstatement of liability for loan guarantee account balances within SBA's Business Loan Guarantee Program financing fund. In addition, these and other general ledger account balances were allocated back to the wrong point break. This error was identified during our audit by inquiring about the significant balance in the liability for loan guarantee general ledger account related to small programs. This error was also evident by reviewing the liability for loan guarantee and allowance for subsidy balances at the point-break level, within the trial balance. They were not identified by SBA as part of its yearend quality review process. SBA corrected this error after we brought it to its attention.

4. Loan Loss Allowances in Liquidating Funds: SBA modified its posting logic for recording its loan loss allowance in one of its pre-credit reform liquidating funds, which resulted in improper general ledger account balances. SBA recorded an accounting entry in its Pollution Control Liquidating Fund to record the use of its appropriation to cover its loss allowance expense. SBA did not have sufficient unexpended appropriations to cover this expense, resulting in improper balances in several general ledger accounts. These improper account balances were evident in SBA's September 30, 2005, trial balance, but were not identified by SBA as part of its yearend quality review process. SBA made a \$10.6 million audit adjustment to correct the improper account balances, and stated that it will revise its posting logic.

5. Budget Proforma Entries: SBA used an application called Budget Proforma to post automated journal entries to record budgetary accounting transactions in its FRIS consolidated general ledger based upon proprietary and memorandum transactions occurring in LAS. This application is necessary because LAS does not include budgetary accounting transactions. We noted instances of improper proforma posting logic for multiple transaction codes that resulted in the following misstatements on the combined statement of budgetary resources:

Line Item	Misstatement
Spending Authority from Offsetting Collections	\$4.8 million understatement
Obligations Incurred	\$12.1 million understatement
Recoveries of Prior-Year Obligations	\$4.3 million understatement
Unobligated Balances	\$3.0 million overstatement

SBA did not reconcile all of its proprietary and related budgetary account balances to ensure that the results of its budgetary proforma posting logic were correct, and its quality assurance process did not

detect these account balance errors. In addition, SBA does not have a change control process in place to ensure that changes made to its budget proforma entries are appropriate and accurate. SBA corrected most of these misstatements for its yearend financial statements.

Improper Loan Approval Amount

SBA does not have effective controls to ensure that loan approval amounts are recorded correctly in LAS. We noted one instance in which a loan approval was entered as \$15 million instead of \$1.5 million. The maximum loan approval amount for each disaster loan is \$1.5 million.

During FY 2005, SBA processed loan approvals in both its legacy Automated Loan Control System (ALCS) and its new Disaster Credit Management System (DCMS). SBA representatives stated that the loan in question was entered directly into LAS because it was processed in ALCS rather than DCMS. Once DCMS went live, ALCS no longer has an automatic interface with LAS, thus requiring data entry into both ALCS and LAS.

SBA further represented that ALCS and DCMS have system edits to prohibit entering loan approvals exceeding \$1.5 million. A similar edit does not exist in LAS. SBA does not have an effective reconciliation process in place to ensure that ALCS and DCMS agree to LAS or a process to review LAS loan approvals for reasonableness.

GAO *Standards for Internal Control in the Federal Government* requires control activities to ensure that all transactions are completely and accurately recorded.

Untimely Charge-Off of Loans Receivable

SBA does not have sufficient controls in place to ensure that approved charge-off actions are recorded in the general ledger in a timely manner. During our testing of loans receivable balances at June 30, 2005, we noted that SBA approved a loan for charge-off in April but did not record the \$610,523 charge-off action until September 2005, after we brought this to SBA's attention. We calculated a \$34.5 million statistically-projected error in the population of loans receivable. Based on this projection, the valuation of the following two components of Footnote No. 6.D, Post-1992 Direct Loans and No. 6.J, Defaulted Guaranteed Loans (Guaranteed after FY 1991), were overstated:

- Loans Receivable, Gross
- Allowance for Subsidy Cost

SBA adjusted its September 30, 2005, financial statement footnote disclosures.

Generally accepted accounting principles require all economic events that have occurred to be recorded and reflected in the financial statements. In addition, GAO's *Standards for Internal Control in the Federal Government* require transactions to be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions.

Recommendations

We recommend that the CFO:

- 1.C Continue to develop, formalize, and document analytical procedures and quality assurance tools to conduct detailed reviews of general ledger account activity and balances to ensure that accounting events are appropriately recorded and reported in accordance with the USSGL, OMB Circular A-136, and federal accounting standards. In addition, we recommend that SBA

accounting personnel continue to obtain training and develop skill sets to enable efficient, complete, and accurate analysis of detailed and summarized financial data. (updated November 2006)

- 1.D Implement a change control process requiring documentation, review and approval of all changes made to the automated proforma accounting entries recorded into FRIS.
- 1.E Coordinate with the Office of Disaster Assistance to implement a monthly reconciliation process to ensure data in both ALCS and DCMS agree to LAS and that data in LAS is accurate and complete.
- 1.F Coordinate with the Office of Financial Assistance to enhance existing controls over the loan charge-off process to ensure that loan charge-off actions are recorded in the general ledger in a timely manner.

Financial Statement Preparation and Quality Assurance

SBA made substantial improvements in its internal control and quality assurance processes designed to ensure that information provided in its interim and final financial statements, related footnote disclosures, and other sections of the Performance and Accountability Report is accurate, relevant, and useful and provided in a timely manner. We noted a few matters, however, in which SBA's footnotes did not contain essential disclosures required by generally accepted accounting principles.

Yearend Accrual to Decrease Undelivered Orders

SBA did not provide a footnote disclosure regarding its \$95.5 million yearend accrual and \$64.1 million audit adjustment necessary to decrease the Disaster Assistance Program undelivered order balance for loans that should have been cancelled as of yearend. This disclosure should have included the basis for making the accrual and audit adjustment and methodologies for determining estimated adjustments.

FY 2005 Subsidy Reestimates

SBA did not provide disclosures about its total subsidy-reestimate expense in Footnote No. 6, Section Q, Credit Program Subsidy Reestimates. SBA's FY 2005 subsidy-reestimate expense included two components:

- The deltas between the FY 2004 unfunded financial statement reestimates and amounts submitted for the FY 2006 President's budget and funded during FY 2005.
- The FY 2005 unfunded financial statement reestimates.

SBA only included the FY 2005 unfunded financial statement reestimates in footnote disclosures submitted with its September 30, 2005, financial statements. During audit planning, we had extensive discussions with SBA management regarding the treatment of the first item and agreed that it should be treated as FY 2005 subsidy-reestimate expense. Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, and No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees*, require entities to disclose interest rate and technical/default reestimates each year.

Reconciliation of Liability for Loan Guarantees

SBA's footnote disclosures submitted with its September 30, 2005, financial statements included a reconciliation schedule showing the beginning balance of the Liability for Loan Guarantees account, current-year activity by component, and ending balance. The reconciliation was not, however, accurate. It included \$680.1 million of current-year activity in the component Amortization of Subsidy; only \$50 million should have been included in this component. The difference should have been broken out into other components, such as fees received and claim payments made to lenders, in accordance with SFFAS No. 18. In addition, SBA included a component for Loans Written Off, which does not represent activity in the Liability for Loan Guarantees account.

Methodology and Assumptions for Calculating Reestimates

SBA's footnote disclosures submitted with its September 30, 2005, financial statements included a section in Footnote No. 6, Credit Program Receivables and Liability for Loan Guaranties [sic], that describes the valuation methodology for post-1991 direct loans and loan guarantees. This disclosure, however, omitted information regarding the time period for which actual cash flows were used and the periods for which estimated cash flows and cash balances were necessary to complete reestimates in a timely manner as of September 30, 2005.

Federal Financial Accounting and Auditing Technical Release 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, Paragraph 53, allows agencies to estimate current-year cash flows on a reasonable basis when computing reestimates as of the end of the fiscal year. It states, however, that an agency's policy should be disclosed in the footnotes to the financial statements.

Management Discussion and Analysis and Performance Measures

SBA's controls around the completeness, accuracy and timeliness of its Management Discussion and Analysis (MD&A) and Performance Measures portions of the Performance and Accountability Reports need improvement. SBA management submitted its second iteration of its MD&A and Performance Measures to us for review on November 8, 2005. The information was partially incomplete, however, and contained a variety of errors, inconsistencies, and ambiguities. SBA did not establish aggressive internal deadlines for the compilation of this information, and, therefore, had insufficient time to perform appropriate quality control procedures before submission to us for review.

Recommendation

We recommend that the CFO:

- 1.G Continue to review requirements and best practices for footnote disclosures and establish a process to ensure that required minimum disclosures and disclosures essential to the fair presentation of SBA's financial statements are provided. In addition, we recommend that SBA continue to require an independent review of its footnotes by an individual not involved in their preparation.
- 1.H Establish and meet an expedited timetable for preparing its MD&A and Performance Measures information, and develop a more rigorous quality assurance review process to ensure that information is accurate and complete by the time it is submitted to the auditors for review.

OFFICE OF DISASTER ASSISTANCE ADMINISTRATIVE EXPENDITURE CONTROLS

SBA did not maintain adequate controls at its Atlanta Disaster Area Office (DAO) over the time and attendance (T&A) reporting processes and Federal Express shipping processes during FY 2005. The T&A process is a critical input within the payroll cycle. In addition, SBA's policies and procedures for these processes were not documented. These processes have inherently high risk for abuse, which could result in improper payments or misuse of funds or assets. The processes are significantly vulnerable to abuse largely because:

- They are decentralized.

SBA has added approximately 2,300 temporary personnel to administer disaster loans and is continuing to expand its resources.
- SBA's infrastructure of a full-time cadre of disaster assistance personnel is currently at capacity as a result of the significant number and severity of disasters occurring during FYs 2004 and 2005.

Time and Attendance Reporting

During our tests of controls, we noted that the DAO accepted either a sign-in sheet or a daily summary spreadsheet in lieu of employee timecards. These were submitted to the DAO by disaster field offices daily for compilation and input into the System for Time and Attendance Reporting (STAR) at the end of the pay period. This system generates a STAR report, which, based on standard operating procedures, should be reviewed for accuracy and signed by employees.

The STAR reports for 30 of the 45 sampled transactions contained a stamp of "Unavailable for Signature" in place of the required employee signature. This was often found in combination with missing employee signature on the timecard (in the form of either a sign-in sheet or summary spreadsheet). When the employee signature was missing from both the STAR report and timecard, the Atlanta DAO had no assurance that the employee had certified his/her T&A for that pay period. In addition, sign-in sheets or summary spreadsheets were missing for 4 of the 45 sample transactions.

Sign-in sheets or summary spreadsheets for 9 of 45 sampled transactions were not properly approved by the employee supervisor. During the period of peak activity in FY 2005, the Atlanta DAO permitted the disaster field offices to submit employee T&A using typed daily summary spreadsheets instead of submitting the individual employee sign-in sheets, which employees frequently sent by facsimile while on travel. Standard practice was for the supervisor to sign only the top page of the 20- to 30-page package of daily summary spreadsheets.

GAO's T&A guide, *Maintaining Effective Control over Employee Time and Attendance Reporting* (GAO-03-352G), page 5, states:

Supervisors and timekeepers should be aware of the work time and absence of employees for whom they are responsible. To help ensure proper recording of T&A information, completed T&A records should be reviewed and approved on an appropriate basis by the supervisor (or other equivalent official).

In addition, GAO's *Standards for Internal Control in the Federal Government*, page 15, states:

Internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination.

Federal Express Shipping Expenses

During our tests of controls, we noted that the Atlanta DAO was not able to validate electronic invoices for Federal Express shipping charges incurred by DAO and disaster field offices, and therefore, could not complete an effective review and approval process of amounts invoiced. Federal Express submits an electronic data file that is uploaded for payment into the Oracle accounting system. A DAO employee performed a comparison of the file uploaded into Oracle to an online Federal Express bill. This is not, however, an effective control to ensure the propriety and accuracy of amounts invoiced. DAO did not retain copies of Federal Express airbills used during the period or require field offices to maintain shipment logs that could be used for validating invoices.

In addition, DAO did not have controls in place to account for and safeguard unused airbills or airbills distributed to disaster field offices.

GAO's *Standards for Internal Control in the Federal Government*, page 15, states that control activities help to ensure that all transactions are completely and accurately recorded. Page 14 also states that an agency must establish physical control to secure and safeguard vulnerable assets.

Recommendation

2. We recommend that the CFO coordinate with the Office of Disaster Assistance to establish policies and procedures for processing T&A reports and Federal Express shipping charges that are effective under the current disaster assistance office environment and develop appropriate internal controls to minimize the risk of improper payment, abuse, or misuse of assets.

3. AGENCY-WIDE INFORMATION SYSTEMS CONTROLS

SBA continued to improve internal control over its information system environment during FY 2005 in certain areas. Specifically, SBA:

- Upgraded the Joint Accounting and Administrative Management System (JAAMS) database and application to include stronger logical access controls and auditing capabilities.
- Enhanced controls over its network by adding additional Intrusion Detection System sensors to the internal network.

These accomplishments were, however, overshadowed by the following weaknesses:

- Management did not take appropriate action to correct known prior weaknesses in a timely manner.
- Controls over administering network accounts remained weak.
- Controls over logging and monitoring activities at the network and application levels remained weak.

- Controls were not adequate to ensure that SBA's IT security awareness program included initial training for all new employees, contractors, and users and periodic refresher training thereafter.
- Independent risk assessments were not performed and documented when systems, facilities, or other major conditions changed. JAAMS did not undergo the recertification and accreditation process, which would include completion of a risk assessment, before being placed back into production after the upgrade to Oracle 11i.
- Controls were not adequate to ensure that Eagan mainframe terminals were automatically logged off after a period of inactivity.
- Management did not take appropriate action to ensure duties within the DCMS were adequately segregated.
- Controls were not adequate to ensure that FRIS backup files were created on a prescribed basis and rotated offsite often enough to avoid disruption if current files were lost or damaged.

SBA's Office of Inspector General will issue a separate report titled *Audit of SBA's Information System Controls, FY 2005*, which will provide additional detail of our scope of work, findings, and recommendations in the following categories:

General Control Categories

- Entity-wide security program control
- Access control
- Application software development and program change control
- System software control
- Segregation-of-duty control
- Service continuity control

Application Control Categories (Oracle administrative accounting system)

- Authorization control
- Completeness control
- Integrity of processing and data file control
- Accuracy control

STATUS OF PRIOR-YEAR FINDINGS

We provide the status of reportable conditions for the prior-year audit in the appendix.

OTHER MATTERS

We considered SBA's internal control over required supplementary stewardship information by obtaining an understanding of SBA's internal control, determining if internal control had been placed in operation, assessing control risk, and performing tests of control as required by OMB Bulletin 01-02. Our objectives were not to provide assurance on internal control; accordingly, we do not provide an opinion on such control.

With respect to internal control related to SBA performance measures, we obtained an understanding of the design of significant internal control relating to existence and completeness assertions, as required by OMB Bulletin 01-02. Based on our limited tests, we concluded that SBA's control over performance measures did not ensure accuracy and reliability, as required by OMB Circular A-136 and prevailing accounting standards. Our procedures were not designed to provide assurance on internal control over reported performance measures; accordingly, we do not provide an opinion on such control.

We noted certain other matters involving internal control that we will report to SBA management in a separate letter.

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

COTTON & COMPANY LLP
Exemption 6

Charles Hayward, CPA

November 15, 2005, except for the finding captioned *Material Error in Note Disclosure (Added November 2006)*, for which the date is November 14, 2006
Alexandria, Virginia

APPENDIX

STATUS OF FY 2004 AUDIT FINDINGS

Description	Recommendation	Status
Financial Management and Reporting Controls	We recommend that the CFO continue to develop new quality assurance review procedures and enhance existing procedures to ensure that all financial transactions are properly reflected in the financial statements, and that footnote disclosures are accurate and logical and contain comprehensive information essential to the fair presentation of SBA's financial condition. We recommend performing additional analytical procedures monthly or quarterly, developing and completing additional checklists, performing studies of best practices, having an independent review conducted by individuals not associated with SBA's daily financial management and reporting responsibilities, such as an outside peer reviewer. (1A)	Improvements Noted; Modified Repeat Condition
	We recommend that the CFO continue to develop new quality control procedures and tools and enhance existing procedures and tools to prevent and detect errors or misstatements in amounts recorded in SBA's financial accounting systems or in the accounting treatment and presentation of economic events and to ensure that underlying transactions in the financial statements are accurate, complete, and presented in conformity with federal accounting standards and principles. We recommend that procedures be included for assigning sufficient human resources to perform financial management and quality assurance functions, providing appropriate training and ensuring knowledge transfer among accountants and analysts responsible for recording, reviewing, and approving accounting transactions, and developing appropriate skill sets to enable efficient, complete, and accurate analysis of detailed and summarized financial data. (1B)	Improvements Noted; Modified Repeat Condition
	Continue to refine the review process implemented during FY 2004 to identify invalid or unneeded Disaster Program undelivered orders and develop a similar review process for the Business Direct Loan Program. (1C)	Modified Repeat Condition
	Coordinate with the Director of OPGM to ensure that a written grant amendment is issued to extend the performance period for the grant identified above. (1D)	Implemented
	Coordinate with OPGM to implement a control to ensure that all future administrative undelivered orders are supported by valid obligating documents. (1E)	Modified Repeat Condition

Description	Recommendation	Status
	We recommend that the CFO implement procedures to require senior management review and approval of all obligation activity in expired funds and maintain sufficient documentation to substantiate its validity and compliance with OMB Circular A-11 and the Anti-Deficiency Act. (1F)	Implemented
	We recommend that the CFO strengthen internal controls to ensure that all requisite trading partner data are fully captured in SBA's accounting system, and that all trading partners are contacted quarterly to reconcile differences. In addition, we recommend that CFO seek assistance from OMB to enhance cooperation from non-responsive trading partners. (1G)	Implemented
Credit Reform Controls	We recommend that the CFO investigate the feasibility of enhancing the agency's accounting data structure to include a program code within the financial reporting information system and update this new program code data element for existing financial records. If this is not feasible, we recommend that the CFO maintain an authoritative crosswalk between point breaks and programs and develop procedures to ensure accurate and consistent summarization of data at the program level. (2A)	Implemented
	We recommend that CFO continue to improve its quality assurance and review process to ensure that historical accounting data used in cash flow models are complete and accurate based on underlying accounting records. (2B)	Implemented
	We recommend that the CFO develop and implement procedures for ensuring consistency and a clear audit trail between the discount rate resulting from the interest rate re-estimate and discount rates used for both subsequent technical re-estimates and calculations of interest income and expense transactions with Treasury. (2C)	Implemented
	We recommend that CFO continue to refine its quality review procedures to ensure that it correctly applies procedures necessitated by the use of the balances approach, if restatements are required in the future. (2D)	Implemented
	We recommend that the CFO continue to develop and refine existing analytical tools and analyses to substantiate the reasonableness of forecasted cash flows and subsidy re-estimates produced by its models, including analytical analyses of actual plus projected cash flows over the cohort life, statistical methods for establishing the degree of uncertainty inherent in the subsidy models, and procedures	Implemented

Description	Recommendation	Status
	to determine model quality. (2E)	
	We recommend that the CFO develop and test an approach for quantifying the impact on re-estimates and account balances caused by differences between actual and projected cash flows if SBA continues to use interim data for computing its re-estimates. (2F)	Implemented
Agency-Wide Information Systems Control	Please refer to SBA's OIG report titled <i>Audit of SBA's Information System Controls, FY 2004</i> .	Unresolved. Updated in SBA's OIG report titled <i>Audit of SBA's Information System Controls, FY 2005</i> .



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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Inspector General
U.S. Small Business Administration

We audited the consolidated balance sheet of the U.S. Small Business Administration (SBA) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing and combined statement of budgetary resources for the fiscal year then ended and have issued our report thereon, dated November 15, 2005, except for the restated portion of Note 6.C and Note 18, for which the date is November 14, 2006. In that report, we issued an unqualified opinion on the Fiscal Year (FY) 2005 consolidated balance sheet; consolidated statements of net cost, changes in net position and financing; and combined statement of budgetary resources.

We conducted our audit in accordance with auditing standards generally accepted in the United States; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*.

SBA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether SBA's financial statements are free of material misstatement, we performed tests of agency compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin 01-02, including requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to SBA.

The results of our tests of compliance with the laws and regulations described in the preceding paragraph, exclusive of FFMIA, disclosed no instances of noncompliance that are required to be reported 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, federal accounting standards, and the United States Government Standard General Ledger (USSGL) at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. Results of our tests disclosed instances, described below, indicating that SBA's financial management systems did not substantially comply with federal financial management system requirements, federal accounting standards, and USSGL at the transaction level.

Details regarding each of the matters discussed below are in our Independent Auditor's Report on Internal Control (applicable section cited below).

SBA is not in substantial compliance with federal financial management system requirements, because:

- Access control, segregation-of-duty, and other general-control weaknesses existed, which are described in the Office of Inspector General report titled *Audit of SBA's Information System Controls, FY 2005*. (3. Agency-Wide Information System Controls)
- Security weaknesses and non-conformances with OMB Circular A-130, *Management of Federal Information Resources*, continued to exist in certain major applications and general support systems. (3. Agency-Wide Information System Controls)

SBA was not in substantial compliance with federal accounting standards, because it:

- Overstated undelivered orders when it failed to deobligate unneeded obligations. (1. Financial Management and Reporting Controls, Funds Management)
- Overstated the Liability for Loan Guaranties [sic] and understated Credit Program Receivables and Related Foreclosed Property, Net, line items resulting from reversing a journal entry in error. (1. Financial Management and Reporting Controls, Financial Accounting Transactions and Review of Account Balances, Improper Automated Reversing Entries)
- Improperly accounted for its loan loss allowances in liquidating funds (1. Financial Management and Reporting Controls, Financial Accounting Transactions and Review of Account Balances, Loan Loss Allowances in Liquidating Funds)
- Overstated loans receivables and allowance for subsidy accounts at June 30, 2005, because it did not record a charge-off action timely. (1. Financial Management and Reporting Controls, Financial Accounting Transactions and Review of Account Balances, Untimely Charge-off of Loans Receivable)
- Omitted essential disclosures regarding yearend accruals to decrease disaster program undelivered orders, FY 2005 subsidy expense, activity by component in the Liability for Loan Guarantees account, and use of projected FY 2005 cashflows and balances in calculating reestimates. (1. Financial Management and Reporting Controls, Financial Statement Preparation and Quality Assurance)

SBA was not in substantial compliance with the USSGL at the transaction level, because it:

- Recorded invalid spending authority from offsetting collections, obligations incurred, and recoveries of prior-year obligations due to improper budget proforma posting logic. (1. Financial Management and Reporting Controls, Financial Accounting Transactions and Review of Account Balances, Budget Proforma Entries)
- Did not use proper posting logic when calculating an automated month-end credit reform journal entry. (1. Financial Management and Reporting Controls, Financial Accounting Transactions and Review of Account Balances, Proforma Credit Reform Accounting Transactions)
- Did not properly account for borrowing transactions (1. Financial Management and Reporting Controls, Financial Accounting Transactions and Review of Account Balances, Treasury Borrowing Transactions)

SBA's Office of the Chief Financial Officer is responsible for financial management systems within SBA. We recommend that SBA assign priority to corrective actions for these FFMIA-related matters consistent with requirements of OMB Circular A-50, *Audit Followup*.

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

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

COTTON & COMPANY LLP
Exemption 6

Charles Hayward, CPA

November 15, 2005, except for reference to our reissued audit report
Alexandria, Virginia

Financial Statements and Notes

The U.S. Small Business Administration prepares its financial statements as a critical aspect of ensuring the accountability and stewardship for the public resources entrusted to the SBA. Preparation of these statements is also an important part of SBA's financial management goal of providing accurate and reliable information that may be used to assess performance and allocate resources.

SBA's management is responsible for the accuracy and propriety of the information contained in the principal financial statements and the quality of internal controls. The statements are, in addition to other financial reports, used to monitor and control budgetary resources. The SBA prepares financial statements from its books and records in accordance with the accounting principles generally accepted in the United States for federal entities and the formats prescribed by the Office of Management and Budget.

The **Consolidated Balance Sheet** summarizes the assets, liabilities and net position by major category as of the reporting date. Intragovernmental assets and liabilities resulting from transactions between federal agencies are presented separately from assets and liabilities from transactions with the public.

The **Consolidated Statement of Net Cost** shows, by strategic goal, the net cost of operations for the reporting period. Net cost of operations consists of full program costs incurred by the SBA less the exchange revenues earned by those programs.

The **Consolidated Statement of Changes in Net Position** presents SBA's beginning and ending net position by two components - Cumulative Results of Operations and Unexpended Appropriations. It summarizes the change in net position by major transaction category. The ending balances of both components of net position are also reported on the Balance Sheet.

The **Combined Statement of Budgetary Resources** report provides information about funding and availability of budgetary resources and the status of those resources at the end of the reporting period. Data on the Combined Statement of Budgetary Resources is consistent with information reflected on the Report on Budget Execution and Budgetary Resources (SF 133), with the one exception of offsetting receipts. Offsetting receipts offset budget authority and outlays at the agency level in the Budget of the United States Government, but are not reflected in the SF 133. The SBA included offsetting receipts in this statement for the purpose of reconciling outlay information presented to the Budget of the United States Government.

The **Consolidated Statement of Financing** shows the relationship between SBA's net obligations and net cost of operations by identifying and explaining the key differences between the two amounts. The SBA reports net obligations from budgetary accounting and net cost of operations from proprietary accounting. The statement shows total budgetary resources recognized during the reporting period and adjustments to these resources based upon whether they were used to finance net obligations, net cost or both.

The **Required Supplementary Information** presents a Combining Statement of Budgetary Resources report by principal functional area.

The **Required Supplementary Stewardship Information** provides information on SBA's investment in human capital.

U. S. Small Business Administration
Consolidated Balance Sheet
as of September 30, 2006 and 2005

(Dollars in Thousands)

	2006	2005
ASSETS		
Intragovernmental Assets		
Fund Balance with Treasury (Note 2)	\$ 6,653,612	\$ 7,558,096
Total Intragovernmental Assets	6,653,612	7,558,096
Assets - Public and Other		
Cash (Note 3)	726	2,010
Accounts Receivable (Note 5)	54,854	54,933
Credit Program Receivables and Related Foreclosed Property, Net (Note 6)	6,382,126	4,276,972
Equipment and Internal Use Software, Net (Note 7)	7,355	14,001
Total Assets - Public and Other	6,445,061	4,347,916
Total Assets	\$ 13,098,673	\$ 11,906,012
LIABILITIES		
Intragovernmental Liabilities		
Interest Payable	\$ 7,167	\$ 7,696
Debt (Note 9)	9,330,382	7,735,907
Net Assets of Liquidating Funds Due to Treasury (Note 10)	173,687	253,035
Downward Reestimate Payable to Treasury (Note 1, Note 13)	704,506	950,645
Other (Note 8, Note 11)	19,326	14,234
Total Intragovernmental Liabilities	10,235,068	8,961,517
Other Liabilities - Public		
Accounts Payable (Note 1)	24,819	34,193
Accrued Grant Liability (Note 1)	53,050	51,260
Liability for Loan Guaranties (Note 4, Note 6)	1,630,821	2,145,462
Federal Employee Compensation Act Actuarial Liability (Note 8)	27,045	28,967
Surety Bond Guarantee Program Future Claims (Note 8)	22,119	23,107
Other (Note 8, Note 11)	40,250	43,857
Total Other Liabilities - Public	1,798,104	2,326,846
Total Liabilities	12,033,172	11,288,363
NET POSITION		
Unexpended Appropriations (Note 1)	1,839,288	1,110,131
Cumulative Results of Operations (Note 1)	(773,787)	(492,482)
Total Net Position	1,065,501	617,649
Total Liabilities and Net Position	\$ 13,098,673	\$ 11,906,012

The accompanying notes are an integral part of these statements

U. S. Small Business Administration
Consolidated Statement of Net Cost
For the years ended September 30, 2006 and 2005

(Dollars in Thousands)

	2006	2005
Strategic Goal 1: Improve Economic Environment for Small Business		
Gross Cost	\$ 42,874	\$ 36,748
Net Cost of Strategic Goal 1	42,874	36,748
Strategic Goal 2: Increase Small Business Success by Bridging Competitive Opportunity Gaps		
Gross Cost	166,964	631,729
Less: Earned Revenue	196,594	394,586
Net Cost of Strategic Goal 2	(29,630)	237,143
Strategic Goal 3: Restore Homes and Businesses Affected by Disaster		
Gross Cost	1,840,266	877,485
Less: Earned Revenue	450,716	415,302
Net Cost of Strategic Goal 3	1,389,550	462,183
Cost Not Assigned to Strategic Goals		
Gross Cost	68,925	71,735
Net Cost Not Assigned to Strategic Goals	68,925	71,735
 Net Cost of Operations	 \$ 1,471,719	 \$ 807,809

Note 12, Note 14

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration
Consolidated Statement of Changes in Net Position
For the years ended September 30, 2006 and 2005

(Dollars in Thousands)

	<u>2006</u>	<u>2005</u>
Beginning Cumulative Results of Operations	\$ (492,482)	\$ (2,143,169)
Budgetary Financing Sources		
Appropriations Used	1,963,262	3,133,669
Donations of Cash and Cash Equivalents	70	29
Other Financing Sources		
Transfers Out Without Reimbursement		(662,732)
Imputed Financing from Costs Absorbed by Others	16,530	15,880
Other - Current Year Liquidating Equity Activity	(30,301)	(28,350)
Other - Non-entity Activity	(759,147)	
Total Financing Sources	1,190,414	2,458,496
Less: Net Cost of Operations	1,471,719	807,809
Ending Cumulative Results of Operations	\$ (773,787)	\$ (492,482)
Beginning Unexpended Appropriations	\$ 1,110,131	\$ 540,894
Budgetary Financing Sources		
Appropriations Received	2,062,768	3,894,521
Appropriations Transferred In	712,000	
Rescissions	(13,991)	(8,275)
Adjustment - Cancelled Authority	(35,103)	(100,815)
Other Adjustments	(33,255)	(82,525)
Appropriations Used	(1,963,262)	(3,133,669)
Total Budgetary Financing Sources	729,157	569,237
Ending Unexpended Appropriations	\$ 1,839,288	\$ 1,110,131
Ending Net Position	\$ 1,065,501	\$ 617,649

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration
Combined Statement of Budgetary Resources
For the years ended September 30, 2006 and 2005

(Dollars in Thousands)

	September 30, 2006			September 30, 2005		
	Budgetary	Non-Budgetary Financing	Total	Budgetary	Non-Budgetary Financing	Total
BUDGETARY RESOURCES						
Unobligated Balance						
Brought Forward October 1	\$ 974,337	\$ 5,746,977	\$ 6,721,314	\$ 387,390	\$ 5,988,883	\$ 6,376,273
Recoveries of Prior Year Obligations	55,671	208,751	264,422	63,657	187,452	251,109
Budget Authority						
Appropriations Received	2,062,768		2,062,768	3,894,521		3,894,521
Borrowing Authority		12,089,779	12,089,779		4,201,785	4,201,785
Spending Authority from Offsetting Collections						
Earned	652,668	3,449,297	4,101,965	414,808	4,527,711	4,942,519
Change in Unfilled Customer Orders	(262,296)	716,641	454,345	350,946	(29,711)	321,235
Total Budget Authority	2,453,140	16,255,717	18,708,857	4,660,275	8,699,785	13,360,060
Nonexpenditure Transfers, Net						
Budget Authority	712,000		712,000			
Permanently Not Available	(205,413)	(3,649,798)	(3,855,211)	(283,318)	(5,052,492)	(5,335,810)
Total Budgetary Resources	\$ 3,989,735	\$ 18,561,647	\$ 22,551,382	\$ 4,828,004	\$ 9,823,628	\$ 14,651,632
STATUS OF BUDGETARY RESOURCES						
Obligations Incurred, Net						
Direct	2,198,165	11,750,289	13,948,454	2,815,590	4,076,651	6,892,241
Reimbursable	931,900		931,900	1,038,077		1,038,077
Total Obligations Incurred, Net	3,130,065	11,750,289	14,880,354	3,853,667	4,076,651	7,930,318
Unobligated Balances, Available	735,907	5,372,660	6,108,567	745,121	3,485,949	4,231,070
Unobligated Balances, Not Available	123,763	1,438,698	1,562,461	229,216	2,261,028	2,490,244
Total Status of Budgetary Resources	\$ 3,989,735	\$ 18,561,647	\$ 22,551,382	\$ 4,828,004	\$ 9,823,628	\$ 14,651,632

Note 15

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration
 Combined Statement of Budgetary Resources
 For the years ended September 30, 2006 and 2005

(Dollars in Thousands)

	September 30, 2006			September 30, 2005		
CHANGE IN OBLIGATED BALANCES	Budgetary	Non-Budgetary Financing	Total	Budgetary	Non-Budgetary Financing	Total
Obligated Balance Brought Forward, Net October 1						
Unpaid Obligations Brought Forward	\$ 394,382	\$ 519,423	\$ 913,805	\$ 413,449	\$ 389,825	\$ 803,274
Uncollected Customer Payments from Federal Sources Brought Forward	394,382	(77,023)	(77,023)	(233)	(106,732)	(106,965)
Total Obligated Balance Brought Forward, Net	394,382	442,400	836,782	413,216	283,093	696,309
Obligations Incurred	3,130,065	11,750,289	14,880,354	3,853,667	4,076,651	7,930,318
Gross Outlays	(2,300,697)	(6,620,893)	(8,921,590)	(3,809,074)	(3,759,603)	(7,568,677)
Recoveries of Prior Year Unpaid Obligations	(55,671)	(208,751)	(264,422)	(63,657)	(187,452)	(251,109)
Change in Uncollected Customer Payments from Federal Sources	(716,641)	(716,641)	(716,641)	231	29,710	29,941
Obligated Balance, Net, End of Period						
Unpaid Obligations	1,168,079	5,440,068	6,608,147	394,382	519,423	913,805
Uncollected Customer Payments from Federal Sources	1,168,079	(793,664)	(793,664)	394,382	(77,023)	(77,023)
Total Obligated Balance, Net, End of Period	1,168,079	4,646,404	5,814,483	394,382	442,400	836,782
Net Outlays						
Gross Outlays	2,300,697	6,620,893	8,921,590	3,809,074	3,759,603	7,568,677
Offsetting Collections	(390,372)	(3,449,297)	(3,839,669)	(765,987)	(4,527,711)	(5,293,698)
Net Outlays Before Offsetting Receipts	1,910,325	3,171,596	5,081,921	3,043,087	(768,108)	2,274,979
Offsetting Receipts	(88)	(1,005,287)	(1,005,375)	3,043,087	(539,753)	(539,753)
Net Outlays	\$ 1,910,237	\$ 2,166,309	\$ 4,076,546	\$ 3,043,087	\$ (1,307,861)	\$ 1,735,226

Note 15

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration
Consolidated Statement of Financing
For the years ended September 30, 2006 and 2005

(Dollars in Thousands)

	2006	2005
Resources Used to Finance Activities		
Budgetary Resources Obligated		
Obligations Incurred	\$ 14,880,354	\$ 7,930,318
Less: Spending Authority from Offsetting Collections and Recoveries	4,820,732	5,514,863
Obligations Net of Offsetting Collections and Recoveries	10,059,622	2,415,455
Less: Offsetting Receipts	1,005,375	539,753
Net Obligations	9,054,247	1,875,702
Other Resources		
Transfers Out Without Reimbursement		(662,732)
Imputed Financing	16,530	15,880
Other Financing Sources	(789,448)	(28,350)
Net Other Resources Used to Finance Activities	(772,918)	(675,202)
Total Resources Used to Finance Activities	8,281,329	1,200,500
Resources that Do Not Finance Net Cost of Operations		
Increase in Budgetary Resources Obligated for Goods, Services, and Benefits		
Ordered But Not Yet Provided	(4,987,088)	(121,313)
Resources that Fund Expenses Recognized in Prior Periods	(460,835)	(2,117,729)
Budgetary Offsetting Collections and Receipts that Do Not Affect Net Cost of Operations		
Credit Program Collections	3,448,944	4,527,711
Offsetting Receipts	1,005,375	539,753
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	(6,572,825)	(3,715,881)
Other - Current Year Liquidating Equity Activity	30,301	28,350
Other Resources that Do Not Affect Net Cost of Operations	187	(3,120)
Total Resources that Do Not Finance Net Cost of Operations	(7,535,941)	(862,229)
Total Resources Used to Finance the Net Cost of Operations	745,388	338,271
Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period		
Components Requiring or Generating Resources in Future Periods		
Change in Annual Leave Liability	1,785	(374)
Upward Reestimates of Credit Subsidy Expense	727,892	456,215
Change in Revenue Receivable from Public	4,112	1,888
Provision for Losses on Estimated Guaranties	(988)	3,075
Change in Unfunded Employee Benefits	2,306	531
Total Components Requiring or Generating Resources in Future Periods	735,107	461,335
Components Not Requiring or Generating Resources		
Depreciation or Amortization	6,646	6,380
Change in Bad Debt Expense - Pre-1992 Loans	(15,671)	1,863
Other (Income) Expenses Not Requiring Budgetary Resources	249	(40)
Total Components Not Requiring or Generating Resources	(8,776)	8,203
Total Components of the Net Cost of Operations that Will Not Require or Generate Resources in the Current Period	726,331	469,538
Net Cost of Operations	\$ 1,471,719	\$ 807,809

Note 16

The accompanying notes are an integral part of these statements.

Note I. Significant Accounting Policies

Reporting Entity

The Small Business Act of 1953 created the Small Business Administration as an independent federal agency. SBA's mission is to maintain and strengthen the nation's economy by aiding, counseling, assisting and protecting the interests of small businesses and to help businesses and families recover from disasters. The SBA operates through the execution of a congressionally approved budget that funds its programs. The budget consists of one year, multiyear and no year appropriations that fund salaries, expenses and program activities.

Basis of Accounting and Presentation

The SBA prepares financial statements to report its financial position and results of its operations as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. The financial statements are prepared from the Agency's books and records in accordance with generally accepted accounting principles for federal agencies and the formats prescribed by the Office of Management and Budget. The statements are in addition to the other financial reports that are used to monitor and control budgetary resources. As a federal agency, the SBA cannot incur obligations without authority from the Congress and an apportionment by the Office of Management and Budget.

These financial statements reflect transactions recorded on both a proprietary accrual accounting basis and a budgetary obligation basis, in accordance with concepts and guidance provided by the OMB, the Federal Accounting Standards Advisory Board, and the U. S. Department of the Treasury. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when liabilities are incurred, without regard to receipt or payment of cash. Budgetary accounting recognizes the legal obligation or restriction of funds in advance of the proprietary accruals and facilitates compliance with legal constraints and controls over the use of federal funds.

Use of Estimates

SBA's management makes assumptions and estimates to prepare the financial statements, based upon the facts that exist when the statements are prepared. Actual results may differ from those estimates and the differences may be significant. The most significant differences between actual results and SBA's estimates may occur in the valuation of credit program receivables under Federal Credit Reform Act of 1990 guidelines. The SBA recognizes the sensitivity of credit reform modeling to slight changes in some model assumptions and uses continual review of model factors, statistical modeling and annual reestimates to reflect the most accurate cost of the credit programs to the U. S. government.

Budgets and Budgetary Accounting for Loan Programs

SBA's loan disbursements are financed by appropriations for long-term loan subsidy cost and borrowings from the U. S. Department of the Treasury for the remaining non-subsidized portion of the loans. The Congress may provide one year, multi-year or no year appropriations to cover the estimated long-term costs of the loan programs. The non-subsidized portion of each loan disbursement, financed initially under permanent indefinite authority to borrow funds from the Treasury, is repaid from collections of loan fees, repayments and default recoveries. The Congress limits the dollar amount of obligations that can be made for direct loans and loan guaranties in its annual appropriation bill.

A permanent indefinite appropriation is available to finance any reestimated increase of subsidy costs that occurs after the year in which a loan is disbursed. Reestimated reductions of subsidy costs are returned to the Treasury and are unavailable to the SBA. As required by the Federal Credit Reform Act of 1990 (FCRA), the SBA uses budgetary "program accounts" to account for appropriations in its credit programs and nonbudgetary "financing accounts" to account for credit program cash flow. Estimates and upward reestimates of credit program subsidy expenses are recorded in SBA's program accounts. Financing accounts are used to account for the Treasury borrowings and the collection of loan fees, repayments, default recoveries, disbursement of loans and downward reestimates of credit subsidy expenses.

Accounts Payable

Accounts Payable are amounts due to public entities that will be liquidated during the next operating cycle. Included in the liability are payables to lender banks for the bank share of loan collections and to vendors for goods and services.

Accrued Grant Liability

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. The SBA accrues a liability for expenditures incurred by grantees prior to receiving grant funds for the expenditures. The amount to be accrued is determined through an analysis of grant expenditures. The Small Business Development Program and several other grant programs are subjected to this treatment.

Contingencies

The SBA is a party in various administrative proceedings, legal actions, environmental suits and claims. In the opinion of SBA's management and legal counsel, the ultimate resolution of these proceedings, actions, suits and claims will not materially affect the financial position or results of SBA's operations. There was no loss estimated as being reasonably possible at September 30, 2006 and \$1.0 million was estimated as of September 30, 2005. The estimate was not accrued because the likelihood of loss was not probable.

Cumulative Results of Operations

Cumulative Results of Operations, presented on the Balance Sheet and on the Statement of Changes in Net Position, is the accumulated difference between expenditures and financing sources since the inception of the Agency. Unfunded expenses do not yet have a financing source and thus increase the loss the SBA reports as Cumulative Results of Operations. Conversely, assets purchased and capitalized on the Balance Sheet have a funding source, but do not affect the Statement of Net Cost, therefore decreasing the loss reported as the Cumulative Results of Operations. The largest category of unfunded expenses at the SBA is year-end reestimates which are funded in the following year. The majority of the Cumulative Results of Operations reported results from these unfunded reestimates.

Unexpended Appropriations

Unexpended Appropriations is the portion of SBA's appropriations received which are either undelivered or unobligated. Delivered orders result in expended appropriations and reduce the total

reported as Unexpended Appropriations. Undelivered orders are the amount of orders of goods or services which have not been actually or constructively received.

Employee Benefits

Leave

A liability for employee annual leave is accrued as it is earned and reduced as leave is taken. Each year the balance of accrued annual leave is adjusted to reflect current pay rates as well as forfeited "use or lose" leave. Amounts are reported as unfunded to the extent current or prior year appropriations are not available to fund annual leave earned but not taken. Sick leave and other types of non-vested leave are expensed as taken.

Employee Health and Life Insurance Benefits

SBA employees may choose to participate in the contributory Federal Employees Health Benefit and the Federal Employees Group Life Insurance Programs. The SBA matches a portion of the employee contributions to each program. Matching contributions are recognized as current operating expenses.

Employee Pension Benefits

SBA employees participate in either the Civil Service Retirement System or the Federal Employees' Retirement System (FERS) and Social Security. These systems provide benefits upon retirement and in the event of death, disability or other termination of employment and may also provide pre-retirement benefits. They may also include benefits to survivors and their dependents, and they may contain early retirement or other special features. SBA's contributions to both retirement plans, as well as to the government-wide Federal Insurance Contribution Act, administered by the Social Security Administration, are recognized on the Consolidated Statement of Net Cost as current operating expenses.

Federal employee benefits also include the Thrift Savings Plan. For FERS employees the SBA matches employee contributions to the plan, subject to limitations. The matching contributions are recognized as current operating expenses.

Imputed Financing Costs

The SBA recognizes the full cost of providing all employee and future retirement benefits, including life and health insurance, at the time employee services are rendered. Eligible retired SBA employees can continue to participate in health and life insurance plans. The cost is funded through Agency contributions, employee compensation to the extent withheld from employee and retiree pay, from matching of employee withholding for Thrift Savings Plan and FICA, and by the OPM which administers the retirement programs for SBA employees.

The OPM calculates imputed costs as the actuarial present value of future benefits attributed to services rendered by covered employees and eligible retired SBA employees during the accounting period, net of the amounts contributed by employees, retirees, and the Agency. The SBA recognizes the imputed costs as current operating expense in the Statement of Net Cost and as a part of net cost funded by an imputed financing source included in determining SBA's net position.

Federal Employees Compensation Act

The Federal Employees Compensation Act provides income and medical cost protection to covered federal civilian employees injured on the job and to beneficiaries of employees whose deaths are attributable to job-related injury or disease. The FECA program is administered by the Department of Labor. Labor pays valid claims as they occur, which are billed to the SBA annually and funded and paid approximately 15 months later. Labor also calculates an estimated actuarial liability for future benefits based upon historical experience and other economic variables. Projected annual benefit payments are then discounted to present value using the forecasted interest rates for 10-year Treasury notes and bonds published by the OMB in its economic assumptions for the federal budget. The SBA recognizes a current unfunded cost for the actual claims paid and the change in the FECA actuarial liability each year.

Reclassifications

For FY 2006, OMB revised Circular A-136, "Financial Reporting Requirements". The format and presentation of the Statement of Budgetary Resources and Statement of Net Cost were reorganized in this revision. The SBA changed the format of its FY 2005 SBR and SNC data to be comparable to the new FY 2006 presentation. Additionally, certain other lines of the FY 2005 principal financial statements and footnotes were reclassified to match the FY 2006 presentation.

Note 2. Fund Balance with Treasury

The Department of the Treasury processes cash receipts and disbursements on SBA's behalf to pay liabilities and finance loan program costs. SBA's cash receipts are deposited to accounts at the Treasury. SBA's fund balances with the Treasury are available to make expenditures. Separate records are maintained for SBA's program, financing, liquidating and other accounts. Fund balances at the Treasury include expired year amounts, which are unavailable for obligation, as well as amounts currently available for new obligations.

(Dollars in Thousands)

As of September 30,	2006	2005
Appropriated Funds	\$ 1,919,252	\$ 1,188,806
Financing Funds	4,625,848	6,189,379
Liquidating Funds	86,593	154,993
Revolving Fund	21,533	24,580
Trust Fund	369	338
Total Entity Fund Balance with Treasury	6,653,595	7,558,096
Non-Entity Fund Balance	17	
Total Fund Balance with Treasury	\$ 6,653,612	\$ 7,558,096
Status of Fund Balance with Treasury		
Unobligated Balance Available	\$ 6,108,567	\$ 4,231,070
Unobligated Balance Unavailable	1,562,461	2,490,244
Obligated Balance Not Yet Disbursed	5,814,483	836,782
Borrowing Authority Not Converted to Funds	(6,831,916)	
Non-Budgetary	17	
Total Fund Balance with Treasury	\$ 6,653,612	\$ 7,558,096

Unobligated balances become available when apportioned by the OMB for obligation in the current fiscal year. Obligated balances not yet disbursed include unpaid obligations offset by uncollected customer payments from other Federal Government accounts. The unobligated and obligated balances are reflected on the Statement of Budgetary Resources. See Note 15 for further discussion of unobligated balances.

Note 3. Cash

The SBA field offices and its fiscal agents hold collections from borrowers in Treasury General Accounts at financial institutions until transferred to the Treasury. These unrestricted collections are recorded as Undeposited Collections – Cash in Transit and total \$0.7 million and \$2.0 million at September 30, 2006 and 2005.

Note 4. Master Reserve Fund

When Congress enacted the Small Business Secondary Market Improvement Act of 1984, it authorized the SBA to guaranty the timely payment of principal and interest on trust certificates representing an ownership interest in a pool of the guaranteed portions of the SBA 7(a) loans. The SBA provides the guaranty through the Secondary Market Guaranty program. The program encompassed \$14.6 billion and \$14.9 billion of outstanding trust certificate principal at September 30, 2006 and 2005, respectively. The guaranty of timely payment on trust certificates is distinct from the guaranty against default on the underlying 7(a) loans. The SBA established the Master Reserve Fund to facilitate the operation of the SMG program. The MRF is an account through which all payments from the underlying 7(a) loans and remittances to trust certificate investors flow.

The cost of the SMG program depends on several factors, including the difference in the maturity terms of the trust certificates and underlying 7(a) loans, the cash flow performance of the underlying loans and the spread between trust certificate coupon rates and yields available on Treasury investment instruments. Estimates for the cash flow performance of the 7(a) loans underlying the SMG pools are derived directly from the 7(a) subsidy model.

In the SMG program, each trust certificate is typically backed by loans with a range of maturity terms. Because the trust certificate takes on the maturity of the longest-term underlying loan, it amortizes more slowly than most of its underlying loans. As a result, loan payments that will ultimately be paid out to the trust certificate holders temporarily accumulate in the MRF. Typically, the investment rate earned on these accumulated funds is less than the coupon rate that must be paid to trust certificate holders; this negative spread is the primary source of the cost of the SMG program. The magnitude of the cost depends on how long the temporary accumulation of funds in the MRF persists and on the size of the spread. The costs are offset by interest earned on loan payments and prepayments that are temporarily held in the MRF before being disbursed to certificate holders.

The cost of the SMG program's timely payment is being accounted for under the requirements of the Federal Credit Reform Act of 1990 beginning with the FY 2005 budget. Also, the cost of the SMG program has been reestimated and included in SBA's financial statements beginning in FY 2003. The SBA changed some aspects of the program beginning in FY 2005 to achieve a zero subsidy cost for the SMG. Changes included expediting the pass-through of partial prepayments and no longer retaining in the MRF the principal portion of the first payment on newly issued trust certificates. Both of these changes served to reduce the accumulation of funds in the MRF, where they would earn a lower investment return than the coupon rate payable to trust certificate holders. See Note 6l for a further discussion of this topic.

The MRF balance is invested entirely in Treasury securities and repurchase agreements backed by Treasury securities. MRF investments are managed by the SBA's fiscal transfer agent, with oversight provided by SBA's MRF Investment Committee. MRF assets are fiduciary in nature and are held outside of the Treasury. In accordance with current federal reporting standards, they do not appear in the principal financial statements of the SBA.

The composition of the MRF and a reconciliation of the changes in MRF assets are included in the following table:

Master Reserve Fund Assets

(Dollars in Thousands)

As of September 30,	2006	2005
Short Term Securities		
Money Market Funds	\$ 40,954	\$ 38,394
Treasury Bills	154,023	154,596
Repurchase Agreements	337,876	379,190
Total Short Term Securities	<u>532,853</u>	<u>572,180</u>
Long Term Securities		
Treasury Bonds	42,763	60,637
Treasury Notes	1,215,920	987,183
Net Interest	14,276	12,664
Total Long Term Securities	<u>1,272,959</u>	<u>1,060,484</u>
Net Assets	<u>\$ 1,805,812</u>	<u>\$ 1,632,664</u>

Reconciliation of MRF Assets

For the Years Ending September 30,	2006	2005
Beginning Net Assets	<u>\$ 1,632,664</u>	<u>\$ 1,425,689</u>
Receipts		
Loan Payments from Borrowers	1,734,543	1,467,508
Prepayments and Default Payments	3,439,172	2,385,684
Earned Income	79,972	62,630
Net Realized Gain (Loss)	(12,646)	(23,125)
Total Receipts	<u>5,241,041</u>	<u>3,892,697</u>
Disbursements		
Payments to Investors	5,065,197	3,683,450
Expenses	2,696	2,272
Total Disbursements	<u>5,067,893</u>	<u>3,685,722</u>
Ending Net Assets	<u>\$ 1,805,812</u>	<u>\$ 1,632,664</u>

Note 5. Accounts Receivable

Accounts receivable consists of amounts owed to the SBA by the public. The SBA has determined that uncollectible or unrecoverable accounts receivable are not significant and therefore does not establish an allowance for these amounts.

(Dollars in Thousands)

As of September 30,	2006	2005
Public		
Guaranty Fees Receivable	\$ 36,711	\$ 39,606
Refunds	4,088	3,146
Other	14,055	12,181
Total Public	<u>\$ 54,854</u>	<u>\$ 54,933</u>

Note 6. Credit Program Receivables and Liability for Loan Guaranties

A. Loan Program Descriptions and Cost Determinations

Loan Program Descriptions

The SBA administers guaranteed and direct loan programs that help small businesses obtain financing, and a direct loan program that assists homeowners, renters and businesses to recover from disasters.

Major Direct Loan and Loan Guaranty Programs

<u>Program group</u>	<u>Program type</u>	<u>Program</u>
Disaster	Direct	Disaster Assistance Loans
Business	Direct	7(m) Microloan
Business	Guarantied	7(a) Loan Guaranty
Business	Guarantied	Section 504 Certified Development Company
Business	Guarantied	Small Business Investment Company Debenture
Business	Guarantied	Small Business Investment Company Participating Securities
Business	Guarantied	Secondary Market Guaranty

SBA's business loan programs include its flagship 7(a) Loan Guaranty Program in which the SBA guarantees up to 90 percent of the principal amount of loans made by banks and other lending institutions to small businesses not able to obtain credit elsewhere. The Section 504 Certified Development Company Program provides guaranties of principal and interest payments on debentures issued by development companies that make small business loans secured primarily by real estate. The Small Business Investment Company Debentures and Participating Securities Programs provide guaranties of principal and interest payments on securities issued by investment capital firms, which in turn make investments in small businesses. The 7(m) Microloan Program provides direct loans to nonprofit intermediaries, which use these funds to make loans up to \$35,000 to eligible small businesses. See Note 4 for further discussion of the Secondary Market Guaranty.

SBA's Disaster Assistance Loan Program makes direct loans to disaster victims under four categories: (1) loans for homes and personal property, (2) physical disaster loans to businesses of any size, (3) economic injury loans to small businesses without credit available elsewhere and (4) economic injury loans to eligible businesses affected by essential employees called up to active duty in the military reserves. The maximum interest rate is 4 percent for applicants without credit available elsewhere and 8 percent for applicants with credit available elsewhere.

Credit Program Receivables and Liabilities for Loan Guaranties

The Federal Credit Reform Act of 1990 governs direct loans made after FY 1991. FCRA loans are valued at the present value of expected future cash flows, discounted at the interest rate of marketable Treasury securities. The subsidy allowance account represents the difference between the outstanding loans receivables balance and the net present value of the estimated cash flows of the loans over their remaining term. The subsidy allowance is subtracted from the outstanding loans receivable balance to obtain the net loans receivable balance.

The FCRA also governs loan guaranties made after FY 1991. An allowance for the cost of outstanding guaranties is determined and recorded as a liability on SBA's balance sheet. The liability is determined by calculating the net present value of expected future cash flows for outstanding guaranties in a manner similar to that used for direct loans. Guarantied loans purchased by the SBA upon borrower default are established as loan receivables and are valued in a similar manner as direct loans under the FCRA.

Direct loans made prior to FCRA are recorded at cost with an allowance for uncollectible amounts calculated using historical loss experience. For loan guaranties made prior to FCRA, a liability for expected future losses on outstanding guaranties is established based on historical experience. Guarantied loans purchased upon borrower default are established as loan receivables with an allowance for losses based on historical loss experience.

The SBA advances payments semiannually to the Federal Financing Bank for loans guarantied under Section 503 of the Small Business Act. The advances are liquidated by receipt of the installment payments on loans made by state and local development companies. To the extent that those installments may not repay advances, balances from development companies that remain collectible are reported as credit program receivables.

Advances are similarly made to honor SBA's timely payment requirement of principal and interest due for debentures in SBA's Section 504 Certified Development Company and Small Business Investment Company Programs. These advances are also reported as credit program receivables.

Subsidy Funding under Federal Credit Reform

The FCRA requires that the credit subsidy costs of direct loans and loan guaranties be expensed in the year loans are disbursed. The credit subsidy cost is the net present value of expected cash inflows and outflows over the life of a guarantied loan, or the difference between the net present value of expected cash flows and the face value of a direct loan. The SBA receives appropriations annually to fund its credit programs based on the subsidy rate applied to the credit program level approved by the Congress. As loans or guaranties are made, the subsidy rate is applied to loan disbursements to determine the subsidy cost and establish a direct loan subsidy allowance, or a liability for loan guaranties. In accordance with the FCRA, subsidy costs are reestimated annually.

Interest Receivable

Interest receivable is comprised of accrued interest on loans receivable and purchased interest related to defaulted guarantied loans. Interest income is accrued at the contractual rate on the outstanding principal amount and is reduced by the amount of interest income accrued on non-performing loans in excess of 90 days delinquent. Purchased interest is carried at cost. A 100 percent loss allowance is established for all purchased interest on non-performing loans made prior to FY 1992.

Foreclosed Property

Foreclosed property is comprised of real and business-related property acquired through foreclosure on loans and defaulted loan guaranties. Properties acquired as a result of defaulted loans committed after FY 1991 are shown at appraised value which is adjusted to the present value of expected future cash flows for financial statement presentation through the allowance for subsidy. Other foreclosed property is shown at the appraised value. SBA's foreclosed property inventory has declined in recent years as SBA's lending partners have assumed nearly all liquidation responsibilities. At September 30, 2006 SBA's foreclosed property was \$14.2 million related to 60 loans. The properties had been held for an average

of 1,171 days. At September 30, 2005 foreclosed property was \$12.2 million related to 61 loans. The properties had been held for an average of 795 days.

Valuation Methodology for Post-1991 Direct Loans and Loan Guaranties

Guaranteed and direct loans committed after FY 1991 are based on the net present value of their expected future cash flows. The SBA estimates future cash flows for guaranteed and direct loans using economic and financial credit subsidy models. The SBA has developed a customized credit subsidy model for each of its major loan guaranty and direct loan programs.

SBA's models vary in the specific methodologies they employ to forecast future program cash flows. In general, however, models for all major credit programs use historical data as the basis for assumptions about future program performance and then translate these assumptions into nominal cash flow estimates by applying rules about program structure. Nominal cash flow forecasts are discounted using the Treasury interest rates provided by the OMB.

Historical data used as the basis for program performance assumptions is drawn primarily from data systems maintained by the SBA and its contractors. The historical data undergoes quality review and analysis prior to its use in developing model assumptions.

Key input to the subsidy models vary by program. Input includes items such as:

- Contractual terms of the loan or guaranty such as loan amount, interest rate, maturity and grace period
- Borrower characteristics
- Loan origination methods
- Economic indicators such as gross domestic product growth and unemployment rate
- Loan performance assumptions, for example: conditional purchase and prepayment rates, and recovery rates
- Loan fee rates

Valuation Methodology for Pre-1992 Direct Loans and Loan Guaranties

The SBA values pre-credit reform direct and defaulted guaranteed loans by estimating an allowance for loan losses. This allowance is offset against gross loan receivables to obtain SBA's expected net collections from these assets. The SBA establishes a 100 percent allowance for pre-credit reform direct and defaulted guaranteed loans that are past due more than 180 days.

A liability is also established for active pre-credit reform loan guaranties. The liability is estimated based on historical experience.

B. Credit Program Receivables and Related Foreclosed Property, Net

(Dollars in Thousands)

As of September 30, 2006	Pre-1992 Loans	Post-1991 Loans	Total
Direct Business Loans			
Business Loans Receivable	\$ 30,185	\$ 129,230	\$ 159,415
Interest Receivable	3,322	1,314	4,636
Foreclosed Property	3,343		3,343
Allowance	(10,328)	(16,657)	(26,985)
Total Direct Business Loans	26,522	113,887	140,409
Direct Disaster Loans			
Disaster Loans Receivable	26,053	6,742,153	6,768,206
Interest Receivable	187	50,564	50,751
Foreclosed Property		907	907
Allowance	(3,148)	(1,400,200)	(1,403,348)
Total Direct Disaster Loans	23,092	5,393,424	5,416,516
Defaulted Guaranteed Business Loans & Other Loan Receivables			
Defaulted Guaranteed Business Loans	103,210	3,197,246	3,300,456
Other Loans Receivable (see note below)		660,974	660,974
Interest Receivable	1,692	9,442	11,134
Foreclosed Property	3,832	6,133	9,965
Allowance	(33,545)	(3,123,783)	(3,157,328)
Total Defaulted Guaranteed Business Loans & Other Loan Receivables	\$ 75,189	\$ 750,012	\$ 825,201
Total Credit Program Receivables & Related Foreclosed Property, Net			\$ 6,382,126

As of September 30, 2005	Pre-1992 Loans	Post-1991 Loans	Total
Direct Business Loans			
Business Loans Receivable	\$ 35,716	\$ 133,095	\$ 168,811
Interest Receivable	4,499	1,475	5,974
Foreclosed Property	3,554		3,554
Allowance	(11,949)	(24,075)	(36,024)
Total Direct Business Loans	31,820	110,495	142,315
Direct Disaster Loans			
Disaster Loans Receivable	31,443	3,598,812	3,630,255
Interest Receivable	294	19,407	19,701
Foreclosed Property	-	863	863
Allowance	(3,921)	(689,963)	(693,884)
Total Direct Disaster Loans	27,816	2,929,119	2,956,935

B. Credit Program Receivable and Related Foreclosed Property, Net (Continued)

As of September 30, 2005	Pre-1992 Loans	Post-1991 Loans	Total
(Dollars in Thousands)			
Defaulted Guaranteed Business Loans & Other Loan Receivables			
Defaulted Guaranteed Business Loans	168,725	3,604,145	3,772,870
Other Loans Receivable (see note below)		599,549	599,549
Interest Receivable	4,639	11,750	16,389
Foreclosed Property	4,105	3,659	7,764
Allowance	(65,173)	(3,153,677)	(3,218,850)
Total Defaulted Guaranteed Business Loans & Other Loan Receivables	\$ 112,296	\$ 1,065,426	\$ 1,177,722
Total Credit Program Receivables & Related Foreclosed Property, Net			\$ 4,276,972

Note: Other Loan Receivables include payments advanced by the SBA against future reimbursements in the SBIC and 504 guaranty programs.

C. Loans Disbursed and Outstanding Loan Obligations

(Dollars in Thousands)

Direct Loans

New Loans Disbursed During the Year Ending September 30,	2006	2005
Business Direct Loan Program	\$ 15,683	\$ 18,514
Disaster Loan Program	3,660,069	998,146
Total Direct Loans Disbursed	\$ 3,675,752	\$ 1,016,660

Outstanding Loan Obligations as of September 30,	2006	2005
Business Direct Loan Program	\$ 25,497	\$ 25,786
Disaster Loan Program	5,392,931	462,114
Total Direct Loan Obligations	\$ 5,418,428	\$ 487,900

Guaranteed Loans

New Loans Disbursed During the Year Ending September 30,	2006	2005
Total Principal Disbursed at Face Value	\$ 18,859,894	\$ 18,935,912
Total Principal Disbursed Guaranteed by the SBA	14,888,693	14,666,599

Outstanding Loan Obligations as of September 30,	2006	2005
Business Guaranteed Loan Programs	\$ 13,502,075	\$ 14,275,869

Loans Outstanding as of September 30,	2006	Restated 2005
Total Principal Outstanding at Face Value	\$ 67,242,067	\$ 63,260,764
Total Principal Outstanding Guaranteed by the SBA	54,606,533	51,060,226

Restatement of FY 2005 Amounts

During FY 2006, the SBA discovered an error in the presentation of Guaranteed Loans Outstanding in its FY 2005 financial statement Note 6K. The amounts shown for Guaranteed Loans Outstanding as of September 30 were overstated by \$10 billion due to a data error in SBA's loan accounting system. The correction of this error has lowered the FY 2005 amounts in Note 6C above by \$10 billion, compared to the amounts in SBA's 2005 financial statements. Since these amounts are for informative purposes only and are not contained in any financial statement line items, there is no further impact of this correction in SBA's FY 2006 financial statements or notes.

Loans Outstanding as of September 30,	FY 2005	
	Reported	Restated
Total Principal Outstanding at Face Value	\$ 73,260,764	\$ 63,260,764
Total Principal Outstanding Guaranteed by the SBA	61,060,226	51,060,226

D. Subsidy Cost Allowance Balances

(Dollars in Thousands)

For the Years Ending September 30,	2006	2005
Post-1991 Business Direct and Purchased Guaranteed Loans		
Beginning Balance of Allowance Account	\$ 3,177,752	\$ 2,889,690
Current Year's Subsidy (see 6G for breakdown by component)	1,484	1,959
Loans Written Off	(997,108)	(415,189)
Subsidy Amortization	(2,057)	(2,226)
Allowance Related to Guaranteed Loans Purchased This Year	946,786	693,675
Miscellaneous Recoveries and Costs	21,668	28,355
Balance of Subsidy Allowance Account before Reestimates	3,148,525	3,196,264
Technical Assumptions/Default Reestimates	(8,085)	(18,512)
Ending Balance of Allowance Account	<u>\$ 3,140,440</u>	<u>\$ 3,177,752</u>
Post-1991 Disaster Direct Loans		
Beginning Balance of Allowance Account	\$ 689,963	\$ 613,279
Current Year's Subsidy (see 6G for breakdown by component)	536,477	127,579
Loans Written Off	(107,236)	(79,585)
Subsidy Amortization	(43,104)	(20,523)
Miscellaneous Recoveries and Costs	12,442	14,512
Balance of Subsidy Allowance Account before Reestimates	1,088,542	655,262
Technical Assumptions/Default Reestimates	311,658	34,701
Ending Balance of Allowance Account	<u>\$ 1,400,200</u>	<u>\$ 689,963</u>

E. Loan Guaranty Liability Balances

(Dollars in Thousands)

For the Years Ending September 30,	2006	2005
Pre-1992 Business Loan Guaranties		
Beginning Balance of Liability for Loan Guaranties	\$ 2,798	\$ 6,324
Adjustment to Expected Losses, Guaranties Outstanding	(1,756)	(3,526)
Ending Balance of Liability for Loan Guaranties	1,042	2,798
Post-1991 Business Loan Guaranties		
Beginning Balance of Liability for Loan Guaranties	\$ 2,142,664	\$ 2,517,728
Current Year's Subsidy (see 6G for breakdown by component)	3,638	35,133
Fees	640,060	584,585
Interest Accumulation Factor	49,577	(50,123)
Claim Payments to Lenders	(981,968)	(1,246,681)
Adjustment Due to Reestimate & Guaranteed Loan Purchases	35,181	553,006
Miscellaneous Recoveries and Costs	47,297	
Balance of Liability for Loan Guaranties before Reestimates	1,936,449	2,393,648
Technical Assumptions/Default Reestimates	(306,670)	(250,984)
Ending Balance of Liability for Loan Guaranties	\$ 1,629,779	\$ 2,142,664
Total Ending Balance of Liability for Loan Guaranties	\$ 1,630,821	\$ 2,145,462

Note: Due to the accounting methodology used in FY 2005, the Reestimates line includes only the principal portion of the downward reestimates. Interest portion for FY 2005 is part of Subsidy Amortization.

F. 2006 Subsidy Rates by Program and Component

Loan Programs	Interest	Default	Fees	Other	Total Rate
Direct Loan Programs					
Microloan	6.95%	0.22%			7.17%
Disaster Loan	8.10%	9.77%		(3.23)%	14.64%
Guaranty Business Loan Programs					
7A		3.52%	(3.52)%		0.00%
504 CDC		3.13%	(3.50)%	0.37%	0.00%
SBIC Debenture		8.97%	(9.05)%	0.08%	0.00%
SBIC New Markets		15.70%			15.70%

The subsidy rates in Table F above pertain only to loans obligated in the current year. These rates cannot be applied to the loans disbursed during the current year to yield the subsidy expense because loans disbursed during the current year include loans obligated in prior years. Subsidy expenses reported in Table G below results from the disbursement of loans obligated in the current year as well as in prior years, and includes reestimates.

G. Subsidy Expense by Component

(Dollars in Thousands)

For the Years Ending September 30,	2006	2005
Business Loan Guaranties		
Defaults	\$ 9,630	\$ 142,345
Fees	(5,660)	(103,457)
Other	(332)	(3,755)
Subsidy Expense Before Reestimates	3,638	35,133
Reestimates	(306,670)	(374,293)
Total Guaranteed Business Loan Subsidy Expense	\$ (303,032)	\$ (339,160)
Business Direct Loans		
Interest	\$ 1,450	\$ 1,918
Defaults	34	41
Subsidy Expense Before Reestimates	1,484	1,959
Reestimates	(8,085)	(19,379)
Total Business Direct Loan Subsidy Expense	\$ (6,601)	\$ (17,420)
Disaster Direct Loans		
Interest	\$ 300,886	\$ 80,718
Defaults	354,157	73,789
Fees	(13)	(71)
Other	(118,553)	(26,857)
Subsidy Expense Before Reestimates	536,477	127,579
Reestimates	311,658	44,267
Total Disaster Direct Loan Subsidy Expense	\$ 848,135	\$ 171,846

H. Administrative Expenses

The SBA received appropriations to administer its credit programs, including the making, servicing and liquidation of its loans and guaranties. Amounts expensed in the Statement of Net Cost are:

(Dollars in Thousands)

For the Years Ending September 30,	2006	2005
Disaster Direct Loan Programs	\$ 449,549	\$ 189,922
Business Loan Programs	123,651	124,974
Total Administrative Expense	\$ 573,200	\$ 314,896

I. Credit Program Subsidy Reestimates

Reestimates are performed annually, on a cohort-by-cohort basis. The purpose of reestimates is to update original program cost estimates to reflect actual cash flow experience as well as changes in forecasts of future cash flows. Forecasts of future cash flows are updated based on new information about historical program performance, revised expectations for future economic conditions, and enhancements to cash flow projection methods. Financial statement reestimates were performed using nine months of actual and three months of projected performance data for FY 2006, with four exceptions:

- Purchases for the SBIC Debenture and SBIC Participating Securities programs are actual purchases for the fiscal year.
- Prioritized payments, reimbursements, and profit participation cash flows in the SBIC Participating Securities program for the fiscal year all occur prior to the end of August and are therefore actual amounts for the fiscal year.
- The reestimate for the 2006 cohort of the Disaster Assistance program is based on actual data through September 18 and estimates for the remaining 12 days.
- The reestimate for the 7(a) Business Loan program is based on 12 months of actual data. A full year of data was used to capture the impact on projected cash flows of SBA's efforts in the fourth quarter of FY 2006 to charge off purchased loans at the conclusion of primary collection activities.

Business Guaranteed Loan Programs

Net subsidy reestimates for business guaranteed loan programs follow:

(Dollars in Thousands)

Guaranteed Loan Program Subsidy Reestimates	2006	2005
7(a) Loan Guaranty	\$ (63,676)	\$ 177,752
7(a) Star	(16,228)	22,173
504 CDC Debentures	(145,643)	(189,640)
SBIC Debentures	(67,846)	(55,229)
SBIC Participating Securities	(72,379)	(300,626)
Secondary Market Guaranty Program	60,408	(5,360)
All Other Guaranty Loan Programs	(1,306)	(23,363)
Total Guaranteed Loan Program Subsidy Reestimates	\$ (306,670)	\$ (374,293)

The 504 Certified Development Companies Program had the largest net reestimates for guaranteed business loan programs in FY 2006 with a net \$145.6 million downward reestimate. The downward reestimate was partly due to a change in the methodology used by the Department of Commerce's Bureau of Economic Analysis to calculate state unemployment rates and the retroactive application of the new rates. The rest of the downward reestimate results from a slight improvement in projected performance in the remaining years within the cohorts.

The reestimates performed for the FY 2006 financial statements for the 7(a) Loan Guaranty Program, SBA's flagship and largest program, generated one of the smallest dollar value changes in subsidy expense in the program's history. The downward reestimate was mostly the result of better than previously projected program performance and the change in the methodology used to calculate state

unemployment rates. The reestimates reflect the stability of the ongoing loan performance as well as the consistency of the credit subsidy model.

The two SBIC programs had net downward reestimates because the SBA, based on additional actual performance data, reduced the amount of projected purchases in the remaining performance years with in the cohorts. The improved performance is consistent with an easing of the downturn in the venture capital industry that began with the Internet bubble collapse about six years ago. The overall impact of improved performance on the program's reestimates was partially offset for the SBIC Participating Securities program by upward reestimates required for disbursements in the more recent cohorts.

The \$50 million upward reestimate in the Secondary Market Guaranty program for reestimates performed from the FY 2006 financial statements plus the \$10 million upward reestimate for 2007 President's Budget reestimates, included above, and were mostly in the 2004 cohort. That \$38 billion cohort includes all secondary market pools formed in FY 2004 and earlier. The upward reestimates in all cohorts are primarily the result of lower than projected returns from investments in Treasury securities within the Master Reserve Fund during FY 2006 and, based on mid-session review economic assumptions, lower projected returns in the future.

Business Direct Loan Programs

Subsidy reestimates for business direct loan programs follow:

(Dollars in Thousands)

Business Direct Loan Program Subsidy Reestimates	2006	2005
7(m) Microloan	\$ 3,530	\$ (35,429)
SBIC Preferred Stock	(11,953)	16,554
All Other Direct Loan Programs	338	(504)
Total Direct Loan Program Subsidy Reestimates	\$ (8,085)	\$ (19,379)

This is the second year that reestimates were performed for all of the SBA's small loan programs using Balance Approach Reestimate Calculators. The most significant reestimate for the Direct Business Loan Programs for the FY 2006 financial statements is a \$12.0 million net downward reestimate for the SBIC Direct Preferred Stock Fee Program. Most of that reestimate resulted from an enhancement in the method used to project the amount of recoveries for that small program.

Disaster Direct Loan Programs

Subsidy reestimates for disaster direct loan programs follow:

(Dollars in Thousands)

Disaster Direct Loan Program Subsidy Reestimates	2006	2005
Disaster	\$ 316,758	\$ 19,682
World Trade Center Disaster	(5,100)	24,585
Total Disaster Direct Loan Program Subsidy Reestimates	\$ 311,658	\$ 44,267

The Disaster program had relatively minor reestimates with the exception of the 2005 and 2006 cohorts which were reestimated for the first time this year. Typically, due to the grace period for disaster loans, cohorts are not reestimated until the end of the second year. The SBA performed reestimates for the 2006 cohort at the end of the first year because of the size of the cohort which reflects SBA's unprecedented lending in the Gulf Coast area following Hurricanes Katrina, Rita and Wilma. The 2005 and 2006 cohorts have \$4.5 billion in disbursements through the end of FY 2006 and account for \$265.1 million of the net upward reestimate. Both cohorts had significant upward reestimates because of the difference in the composition of actual versus the formulation cohorts. The formulation cohorts projected that a significant portion of borrowers would qualify for a higher "credit elsewhere" interest rate. Actually, in FY 2005 and FY 2006, less than three percent of the loans disbursed pays the higher rate. The cost to the Government is significantly higher for "non-credit elsewhere" borrowers because a substantial portion of the interest is subsidized.

Note 7. Equipment and Internal Use Software, Net

Equipment is capitalized at full cost when the initial unit acquisition cost is \$50,000 or more and service life is at least two years; otherwise, it is expensed when purchased. Currently the SBA has no equipment meeting the capitalization threshold.

Software intended for internal use, whether internally developed, contractor developed or purchased, is capitalized at cost if the initial unit acquisition cost is \$250,000 or more and service life is at least two years. Costs that do not meet the capitalization criteria are expensed when incurred.

Capitalized software costs include all direct and indirect costs incurred, including overhead to develop the software. Software for internal use is amortized using the straight-line method over its useful life, not to exceed five years. Amortization begins when the system is put into operation. The costs of enhancements are capitalized when it is more likely than not that the enhancements will result in significant additional capabilities.

Assets meeting the capitalization thresholds established, at September 30, 2006 and 2005 are detailed below.

(Dollars in Thousands)

	2006	2005
Cost of Software in Use	\$ 28,994	\$ 28,994
Amortization of Software in Use	<u>(21,639)</u>	<u>(14,993)</u>
Total Equipment and Internal Use Software, Net	<u>\$ 7,355</u>	<u>\$ 14,001</u>

Note 8. Liabilities Not Covered by Budgetary Resources

Liabilities not covered by budgetary resources are liabilities for which congressional action is needed before budgetary resources can be provided. These unfunded liabilities at September 30, 2006 and 2005 consisted of:

(Dollars in Thousands)

	2006	2005
Intragovernmental Liabilities - Other		
Employment Taxes Payable	\$ 1,946	\$
Federal Employee Compensation Act Payable	<u>5,643</u>	<u>5,283</u>
Total Intragovernmental Liabilities - Other	<u>7,589</u>	<u>5,283</u>
Federal Employee Compensation Act Actuarial Liability	\$ 27,045	\$ 28,967
Other Liabilities		
Prior Liens on Real Estate Payable	960	89
Accrued Unfunded Annual Leave	22,737	20,952
Surety Bond Guarantee Program Future Claims	<u>22,119</u>	<u>23,107</u>
Total Other Liabilities	<u>45,816</u>	<u>44,148</u>
Total Liabilities Not Covered by Budgetary Resources	<u>\$ 80,450</u>	<u>\$ 78,398</u>

The liability for Surety Bond Guarantees is an estimate of future claims in the SBG Program for guaranties outstanding at year-end.

Note 9. Debt

Borrowings payable to the Treasury result from loans provided by the Treasury to fund the portion of direct loans not covered by subsidy appropriations and to fund the payment of downward subsidy reestimates and other credit program disbursements (see Note 15). The SBA makes periodic principal repayments to the Treasury based on the analysis of its cash balances and future disbursement needs.

Borrowings payable to the Federal Financing Bank are the result of its financing of the SBA Section 503 Debentures issued prior to 1988.

All debt is intragovernmental and covered by budgetary resources. Debt transactions for the periods ending September 30, 2006 and 2005 and resulting balances are:

Intragovernmental Debt

(Dollars in Thousands)

Department of Treasury	2006	2005
Beginning Balance	\$ 7,694,998	\$ 8,545,701
New Borrowing	5,257,863	4,201,785
Repayments	(3,649,799)	(5,052,488)
Ending Balance	\$ 9,303,062	\$ 7,694,998

Federal Financing Bank	2006	2005
Beginning Balance	\$ 40,909	\$ 58,273
Repayments	(13,195)	(16,870)
Change in Interest Payable	(394)	(494)
Ending Balance	\$ 27,320	\$ 40,909

Total Debt	\$ 9,330,382	\$ 7,735,907
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Note 10. Net Assets of Liquidating Funds Due to Treasury

Net Assets of Liquidating Funds Due to Treasury is the residual of the book value of assets less liabilities in the Liquidating Funds for loans made prior to FY 1992. Subsequent to the issuance of its audited financial statements each year, the SBA returns to the Treasury the portion of this balance that is considered to be the unobligated balance for budgetary reporting at fiscal year-end (see Note 15).

(Dollars in Thousands)

As of September 30,	2006	2005
Pollution Control Equipment Guaranty Fund	\$ 5,421	\$ 8,548
Disaster Loan Fund	39,217	89,697
Business Loan and Investment Fund	129,049	154,790
Total Due Treasury	\$ 173,687	\$ 253,035

Note 11. Other Liabilities

Other liabilities at September 30th were:

(Dollars in Thousands)

	2006	2005
Other Liabilities - Intragovernmental Entity		
Current		
Employment Taxes Payable	\$ 2,442	\$ 2,116
Advances from Other Agencies	8,438	4,304
Judgment Fund		1,300
Total Current	<u>10,880</u>	<u>7,720</u>
Non-current		
Employment Taxes Payable	1,946	
Federal Employee Compensation Act Payable	5,643	5,283
Payable to Federal Financing Bank	838	1,231
Total Non-current	<u>8,427</u>	<u>6,514</u>
Total Entity	<u>19,307</u>	<u>14,234</u>
Non-entity		
Current		
Payable to Treasury	19	
Total Other Liabilities - Intragovernmental	<u>\$ 19,326</u>	<u>\$ 14,234</u>
Other Liabilities - Public Entity		
Current		
Accrued Funded Payroll Benefits	\$ 15,523	\$ 19,174
Accrued Unfunded Annual Leave	22,737	20,952
Suspense Accounts	1,013	3,642
Total Current	<u>39,273</u>	<u>43,768</u>
Non-current		
Prior Liens on Real Estate Payable	960	89
Total Non-current	<u>960</u>	<u>89</u>
Total Entity	<u>40,233</u>	<u>43,857</u>
Non-entity		
Current		
Non-entity Current Payable	17	
Total Other Liabilities - Public	<u>\$ 40,250</u>	<u>\$ 43,857</u>

Note 12. Leases

The SBA leases all facilities from the General Services Administration. The SBA enters into an Occupancy Agreement with GSA for each facility. GSA, in turn, leases commercial facilities or provides space in federal buildings. Agreements for space in federal buildings can be vacated with 120 to 180 days notice. However, the SBA anticipates continuing the same or similar facilities leases in the future. These leases with GSA are operating leases and are expensed in the Statement of Net Cost when incurred. FY 2006 and 2005 facilities lease costs were \$46.1 million and \$40.4 million. Future lease payments below assume a three percent inflation factor from the FY 2007 projected total as estimated by the GSA, as well as continued costs during the next five years as leases expire and new leases are added. Payments after 2011 reflect only current leases that will still be in effect then, projected to the end of each lease term.

Future Facilities Operating Lease Payments

(Dollars in Thousands)

FY	Dollars
2007	\$ 42,512
2008	43,787
2009	45,101
2010	46,454
2011	47,848
After 2011	58,177
Total	<u>\$283,879</u>

Note 13. Non-entity Reporting

Non-entity Assets are assets held by the SBA but not available to the SBA. The primary non-entity asset held by the SBA is the Fund Balance with the Treasury held in the Treasury general fund accounts specifically established for SBA's downward subsidy reestimates for its discretionary loan programs. Because the loan programs are discretionary, the downward reestimates are not available to the SBA and they are returned to the Treasury in the fiscal year following the accrual of the reestimates. During the year, these general fund accounts contain SBA's prior year reestimates. At year-end, the funds are swept by the Treasury; therefore, the SBA does not report a year-end non-entity fund balance. Also at year-end, the SBA accrues the current years' reestimates, including downward reestimates as applicable. For the downward reestimates, in the loan financing funds, the accrual adjustment reduces loan subsidy expense, and records a transfer out to the non-entity fund, a reduction of subsidy allowance, and an amount payable to the non-entity fund. The non-entity Treasury general funds contain a corresponding amount receivable in anticipation of the receipt of the downward reestimates in the following year.

For consolidated financial statement presentation, the SBA eliminates the payable to the non-entity fund and the receivable from the financing funds, since both are included in SBA's reporting entity.

(Dollars in Thousands)

	2006	2005
Entity		
Financing Fund Payable	\$ (704,506)	\$ (950,645)
Non-entity		
Miscellaneous Receipts Fund Receivable	<u>704,506</u>	<u>950,645</u>
Balance Sheet Reported Payable and Receivable	<u>\$ 0</u>	<u>\$ 0</u>

Note 14. Statement of Net Cost

Federal cost accounting standards require the SBA to report operating costs by strategic goal activity. Full costs include all direct and indirect costs for a strategic goal. Full costs are reduced by exchange (earned) revenues to arrive at net operating cost.

Operating Cost

The full and net operating costs of SBA's major strategic goals are presented in the Consolidated Statement of Net Cost. Full costs are comprised of all direct costs for the strategic goals and those indirect costs which can be reasonably assigned or allocated to the strategic goals, including employee pension and other retirement benefit costs paid by the OPM and charged to the SBA.

The negative Net Cost of Strategic Goal 2 for FY 2006 of \$29.6 million arises from the business loan downward subsidy reestimate of \$314.8 million. The SBA reestimates its loan program costs each year consistent with OMB guidance and FASAB standards. Because the reestimates may be downward as well as upward, the SBA potentially can have negative costs in Strategic Goal 2 which includes business loan costs and Strategic Goal 3 which includes disaster loan costs.

Earned Revenue

Earned revenues arise from exchange transactions, and are deducted from the full cost of SBA's major strategic goals to arrive at net strategic goals costs. The SBA recognizes earned revenues when reimbursements are payable from other federal agencies and the public, as a result of costs incurred or services performed. A major source of earned revenue includes interest earned on SBA's outstanding Business and Disaster loan portfolios and interest earned on uninvested funds in the credit reform financing accounts.

Reporting by Strategic Goal

The SBA reports costs consistent with its strategic goals. The costs of Goal 4 "ensure that all SBA strategic goals operate at maximum efficiency and effectiveness by providing them with high quality executive leadership and support services" are fully allocated to the other three strategic goals. Goal 4 costs are estimated at \$132 million and \$ 82.5 million for FY 2006 and FY 2005. Costs Not Assigned to Strategic Goals on the Statement of Net Cost includes costs of congressionally mandated grant programs and the Office of the Inspector General.

Intragovernmental Gross Cost is cost incurred by the SBA in exchange transactions with other federal agencies. Gross Cost with the Public is cost incurred by the SBA in exchange transactions. Intragovernmental Earned Revenue is revenue earned by the SBA in exchange transactions with other federal agencies. Earned Revenue from the Public is revenue earned by the SBA in exchange transactions.

The classification as Intragovernmental Costs or Gross Cost with the Public relate to source of the goods and services received by the SBA and not to the classification of related revenue. The classification of revenue or cost being defined as "intragovernmental" or "public" is defined on a transaction by transaction basis. The purpose of this classification is to enable the federal government to provide consolidated financial statements, and not to match the public and intragovernmental revenue with costs that are incurred to produce public and intragovernmental revenue.

(Dollars in Thousands)

For the Years ending September 30,	2006	2005
Strategic Goal 1: Improve Economic Environment for Small Business		
Intragovernmental Gross Cost	\$ 8,284	\$ 7,659
Gross Cost with the Public	34,590	29,089
Total Strategic Goal 1 Gross Cost	42,874	36,748
Strategic Goal 2: Increase Small Business Success by Bridging Competitive Opportunity Gaps		
Intragovernmental Gross Cost	\$ 152,976	\$ 219,245
Gross Cost with the Public	13,988	412,484
Total Strategic Goal 2 Gross Cost	166,964	631,729
Intragovernmental Earned Revenue	132,218	182,594
Earned Revenue from the Public	64,376	211,992
Total Earned Revenue Strategic Goal 2	196,594	394,586
Strategic Goal 3: Restore Homes and Businesses Affected by Disaster		
Intragovernmental Gross Cost	\$ 555,340	\$ 467,160
Gross Cost with the Public	1,284,926	410,325
Total Strategic Goal 3 Gross Cost	1,840,266	877,485
Intragovernmental Earned Revenue	254,067	269,761
Earned Revenue from the Public	196,649	145,541
Total Earned Revenue Strategic Goal 3	450,716	415,302
Cost Not Assigned to Strategic Goals		
Intragovernmental Gross Cost	\$ 13,316	\$ 14,952
Gross Cost with the Public	55,609	56,783
Total Gross Cost Not Assigned to Strategic Goal	68,925	71,735

Note 15. Statement of Budgetary Resources

The Statement of Budgetary Resources presents information about total budgetary resources available to the SBA and the status of those resources, as of September 30, 2006 and 2005. SBA's total budgetary resources were \$4.0 billion and \$4.8 billion for the years ended September 30, 2006 and 2005. Additionally, \$18.6 billion and \$9.8 billion of nonbudgetary resources including borrowing authority and collections of loan principal, interest and fees, in financing funds were reported for the years ended September 30, 2006 and 2005.

Adjustments to Beginning Balance of Budgetary Resources

The SBA made no adjustments to the beginning budgetary resources during the years ended September 30, 2006 and 2005.

Permanent Indefinite Appropriations

SBA's Financing Funds receive permanent indefinite appropriations annually to fund increases in the projected subsidy costs of loan programs as determined by the reestimation process required by the Federal Credit Reform Act of 1990. SBA's Liquidating Funds also receive permanent indefinite appropriations to fund obligations. The Financing Funds are used for credit program obligations made subsequent to FY 1991; Liquidating Funds are used for credit program obligations made prior to FY 1992.

Decreases in projected subsidy costs in the Financing Funds are returned to the Treasury through SBA's annual reestimation process. The prior year's ending unobligated balances in SBA's Liquidating Funds are also transferred to Treasury annually.

Borrowing Authority and Terms of Borrowing

The SBA is authorized to borrow from the Treasury's Bureau of Public Debt when funds needed to disburse direct loans and purchase guaranteed loans exceed subsidy costs and collections in the nonbudgetary loan financing funds. In FY 2006 and 2005, the SBA received \$12.1 billion and \$4.2 billion of borrowing authority from the OMB. At the end of FY 2006, the SBA had \$6.8 billion in borrowing authority available that will be used to fund Disaster loans disbursed in the future. At the end of FY 2005, the SBA had no available borrowing authority. The SBA pays interest to the Treasury based on Treasury's cost of funds. The rate at which interest is paid to the Treasury on the amounts borrowed (or received from the Treasury on uninvested cash balances) in a loan financing fund for a particular cohort is a disbursement-weighted average discount rate for cohorts prior to FY 2002 or a single effective rate for cohorts beginning with FY 2002. The SBA calculates and repays borrowings not needed for working capital at midyear for prior year cohorts and at the end of each fiscal year for the current year cohort. The SBA uses the loan principal, interest and fees collected from the public in its loan financing funds to repay its borrowings. The repayment maturity dates for the borrowing from the Treasury are based on the loan maturities used in the subsidy calculation. The maturities range from sixteen years for Direct Business loans, twenty-five years for Guaranteed Business loans and thirty years for Disaster loans.

Apportionment Categories of Obligations Incurred

During FY 2006 and FY 2005, the SBA incurred \$14.9 billion and \$7.9 billion of direct and reimbursable obligations of which \$0.6 billion and \$0.5 billion was apportioned in category A and \$14.3 billion and

\$7.4 billion was apportioned in category B. Category A apportionments are restricted by quarter and program, Category B apportionments are restricted by purpose and program.

Unobligated Balances

Unobligated balances at September 30, 2006 and 2005 are \$7.7 billion and \$6.7 billion which include \$1.6 billion and \$2.5 billion of unavailable unobligated balances. These balances are unavailable primarily because they are unapportioned by OMB. SBA accumulates these unobligated balances in its nonbudgetary financing accounts during the fiscal year (\$6.8 billion in FY 2006 and \$5.7 billion in FY 2005) from program collections that are used primarily to repay the Treasury borrowings in the following fiscal year. In addition, unobligated balances are accumulated in budgetary accounts from appropriations (\$0.9 billion in FY 2006 and \$1.0 billion in FY 2005) that are used to finance SBA's ongoing program operations.

Undisbursed Obligations

Undisbursed obligations for Disaster loan approvals were adjusted downward by \$200.9 million and \$159.5 million at September 30, 2006 and 2005, to recognize the expiration of approvals that were past the disbursement period or past the document return date specified in the borrower's loan authorization for loans approved prior to February 1, 2006. The adjustment included corollary downward adjustment of \$28.6 million and \$20.5 million to the Disaster subsidy obligation. A new disaster loan authorization and approval form was implemented February 1, 2006 that will reduce and eventually eliminate this adjustment in the future. This adjustment had a corresponding effect on the Unobligated Balances discussed above.

Undelivered Orders

Undelivered orders for the periods ended September 30, 2006 and 2005 were \$6.5 billion and \$0.8 billion.

Differences between the Statement of Budgetary Resources and the Budget of the U. S. Government

There were no material differences between the Statement of Budgetary Resources for FY 2005 and the President's Budget submission for FY 2007. The President's Budget with actual numbers for FY 2008 has not yet been published. The SBA expects no material differences between the President's Budget "actual" column and the FY 2006 reported results when the budget becomes available in February, 2007.

Note 16. Statement of Financing

The Statement of Financing demonstrates the relationship of budgetary amounts reported on the Statement of Budgetary Resources (which is prepared on a combined basis) to the proprietary amounts reported on the Statement of Net Cost (which is prepared on a consolidated basis). The focus of this presentation is to reconcile net obligations to the net cost of operations.

The SBA presents the Statement of Net Cost using the accrual basis of accounting. This differs from the obligation-based measurement of total resources supplied, both budgetary and from other sources, on the Statement of Budgetary Resources. The Statement of Financing reconciles the two cost measurements, assuring that financial statement information is consistent with budgetary reports. Starting with net obligations, the Statement of Financing adjusts for resources that do not fund net cost of operations and components of net cost of operations that do not generate or use resources to arrive at net cost per the Statement of Net Cost.

Liabilities Not Covered by Budgetary Resources on the Balance Sheet (Note 8) differs from Components Requiring or Generating Resources in Future Periods on the Statement of Financing primarily due to reestimated subsidy costs of loan programs. The subsidy costs are shown in the Statement of Net Cost and are to be covered by budgetary resources but these resources, while available under permanent and indefinite authority, were not provided by year-end. Additionally, there will always be a difference for existing liabilities because the Statement of Financing reports only current year changes, not balances. The table below details these differences:

(Dollars in Thousands)

As of September 30,	2006	2005
Current Year Liabilities Not Covered By Budgetary Resources	\$ 80,450	\$ 78,398
Prior Year	<u>78,398</u>	<u>75,468</u>
Change in Liabilities Not Covered By Budgetary Resources	2,052	2,930
Upward/Downward Reestimates of Credit Subsidy Expense	727,892	456,215
Change in Revenue Receivable from Public	4,112	1,888
All Other	<u>1,051</u>	<u>302</u>
Components (of Net Cost) Generating Resources in Future Periods (Statement of Financing)	<u>\$ 735,107</u>	<u>\$ 461,335</u>

Note 17. Significant Events

In late August, September and October 2005, Hurricanes Katrina, Rita and Wilma struck the Gulf Coast. When disaster strikes in the United States, SBA's loans are the sole form of federal credit assistance for damage incurred by non-farm, private-sector homeowners and businesses.

A record level in excess of \$11 billion of Disaster loans was approved by the SBA in FY 2006 for Gulf Coast hurricane victims. The approval of new Disaster loans for these hurricanes is virtually complete. Also, about \$2.8 billion of the \$11 billion in approvals had been cancelled at borrower request due to receipt of insurance proceeds or other circumstances under which the loans were no longer required by the end of FY 2006. The SBA disbursed \$3.7 billion of Disaster loans in FY 2006, mostly for the Gulf Coast hurricanes. Disbursements and cancellations for the balance of the \$11 billion will continue into FY 2007 and after.

The federal response to the Gulf Coast hurricanes has also included other federal agencies, such as the Department of Housing and Urban Development and the Federal Emergency Management Agency who assist victims with grant funds, often administered by states. The SBA expects that some of its borrowers will receive grant funds supplied by HUD through the states of Louisiana and Mississippi. To comply with statutory requirements concerning duplication of benefits, the SBA will either cancel loans not yet disbursed, or apply grant funds to pay off loans already disbursed. Although only \$25,000 of grant funds were disbursed by Gulf Coast states in FY 2006, currently, the SBA estimates that \$285 million of disbursed disaster loans could be prepaid by grant funds due to this program, affecting future credit program receivables. The estimate of \$285 million is based on the ration of total grant money available to estimated total eligible damage derived from FEMA and HUD analysis applied to the eligible portion of SBA loan Disbursements. Also the receipt of grant funds will affect the amount of SBA's undelivered orders and unobligated balance as reported on the Statement of Budgetary Resources in amounts not yet determined.

At the end of FY 2005, the SBA was uncertain as to the impact of the Gulf Coast hurricanes on its existing portfolio of business loans or the possibility of changes to SBA's business and disaster programs that might affect credit program costs. The SBA has found, however, during FY 2006 that the hurricanes have not significantly impacted the Agency's credit program costs in its existing portfolio of loans and guaranties. Also, the Agency's business and disaster program costs were not affected by major program changes in response to the hurricanes.

Note 18. Restatement

In July 2006, the SBA discovered an error in Note 6K of its FY 2005 financial statements. This error overstated the total amount of guaranteed loans outstanding and SBA's share at September 30, 2005, 2004 and 2003, as restated on the 2004 financial statements, by \$10 billion. The error has been corrected in the FY 2005 column of Note 6C in this report. The error did not affect any other amounts elsewhere in the FY 2005 financial statements. The SBA is disclosing the error in these FY 2006 financial statements and in "Management's Discussion and Analysis" in this FY 2006 Performance and Accountability report. In addition, the SBA has notified the Government Accountability Office, the Office of Management and Budget and the Department of Treasury of the error. The SBA deems this notification and disclosure to be adequate and in accordance with applicable federal reporting requirements.

U. S. Small Business Administration
Required Supplementary Stewardship Information
Stewardship Investments in Human Capital
for the five years ended September 30, 2006

Human Capital investments are expenses included in net cost for education and training programs that are intended to increase or maintain national economic productive capacity and that produce outputs and outcomes that provide evidence of maintaining or increasing national productive capacity. The definition excludes education and training expenses for Federal personnel.

Small Business Development Centers deliver management and technical assistance, economic development and management training to existing and prospective small businesses through cooperative agreements with universities and colleges and government organizations.

Service Corps of Retired Executives (SCORE) is a nonprofit organization which provides small business counseling and training under a grant from the SBA. SCORE members are successful, retired business men and women who volunteer their time to assist aspiring entrepreneurs and small business owners. There are SCORE chapters in every state.

Women's Business Centers provide assistance to women business owners and acts as their advocate in the public and private sectors in a number of locations around the U.S.

Business Information Centers (BIC) funding was discontinued in FY 2005 and the expenses in FY 2005 and FY 2006 are dwindling as the program winds down. BICS provided a one-stop location where current and future small business owners could receive assistance and advice.

All Other Training and Assistance Programs includes primarily Small Business Training provided by a counselor from a resource partner, district office, or SBA sponsor who delivers a structured program of knowledge, information or experience on a business-related subject. The training lasts for one or more hours and includes an agenda, attendee list, and a trainer evaluation. The session may be for an individual or a class. Training is also available online on a number of subjects of interest to the small business person. Other programs not separately detailed include Native American Outreach and Drug Free Work Place. As additional years of data accumulate, the investments will be presented separately.

Significant Human Capital investments occur within the following programs:

(Dollars in Thousands)

Stewardship Investments	2006	2005	2004	2003	2002
Small Business Development Centers	\$ 105,743	\$ 104,075	\$ 97,250	\$ 99,293	\$ 100,276
Service Corps of Retired Executives	15,285	18,669	17,993	10,305	15,021
Women's Business Centers	10,382	11,172	19,218	15,361	16,141
Business Information Centers	96	147	9,480	8,426	14,033
All Other Training and Assistance Programs	24,417	46,451	8,770	30,398	15,944
Total	\$ 155,923	\$ 180,514	\$ 152,711	\$ 163,783	\$ 161,415

U. S. Small Business Administration
Required Supplementary Stewardship Information
Stewardship Investments in Human Capital

for the five years ended September 30, 2006

(Dollars in Thousands)

	2006	2005	2004	2003	2002
Small Business Development Centers	\$ 105,743	\$ 104,075	\$ 97,250	\$ 99,293	\$ 100,276
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