AUDIT OF SBA'S FY 2006

FINANCIAL STATEMENTS – MANAGEMENT LETTER

AUDIT REPORT NUMBER 7-11

JANUARY 17, 2007

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

AUDIT REPORT
Issue Date: January 17, 2007
Number: 7-11

To: Jennifer B. Main
Chief Financial Officer

Herbert L. Mitchell
Associate Administrator for Disaster Assistance

Michael W. Hager
Associate Deputy Administrator for Capital Access

Richard Brechbiel
Chief Human Capital Officer

[Exemption 6]

From: Debra Ritt
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2006 Financial Statements – Management Letter

Attached is the Management Letter issued by KPMG LLP which identifies non-reportable conditions that came to KPMG's attention during its audit of SBA's FY 2006 financial statements. 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*.

KPMG addressed recommendations to SBA's Chief Financial Officer (CFO), Associate Administrator for Disaster Assistance, Chief Human Capital Officer, and Associate Deputy Administrator for Capital Access (ADACA). We provided a draft of KPMG's report to each of these officials who generally concurred with most, but not all of the findings. These officials agreed to implement the recommendations or have already taken actions to address the underlying conditions. All of managements' responses are synopsized in the report and can be viewed in their entirety at the end of this report.

Should you or your staff have any questions, please contact Jeff Brindle, Director, Information Technology and Financial Management Group at (202) 205- [Exemption 2]

Attachment

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General Counsel	3
Director, Little Rock Commercial Loan Servicing Center	1
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KPMG

KPMG LLP
2001 M Street, NW
Washington, DC 20036

MANAGEMENT LETTER

November 14, 2006

CONFIDENTIAL

Office of the Inspector General,
U.S. Small Business Administration and
Administrator of the SBA

We have audited the consolidated financial statements of the U.S. Small Business Administration (SBA) for the year ended September 30, 2006 and have issued our report thereon dated November 14, 2006. In planning and performing our audit of the financial statements of SBA, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

During our audit, we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are presented in appendix A.

Our audit procedures are designed primarily to enable us to form an opinion on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of SBA gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This report is intended solely for the information and use of the Office of the Inspector General, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

Appendix A

Small Business Administration
Management Letter Comments

Improvements are needed over the monthly Fund Balance with Treasury reconciliation

During our initial walk-throughs of SBA's monthly Fund Balance with Treasury (FBWT) reconciliation process and discussions with SBA personnel, we noted the following:

- The monthly FBWT reconciliation is a decentralized process in which four individuals are assigned the duties of reconciling the agency's various fund types such as loan, administrative, payroll, and Surety Bond Guarantee fund types. The process used to reconcile these fund types is not consistently applied to all reconciliations. In addition, management does not perform an overall review of the total FBWT, at a consolidated level between SBA's general ledger and the U.S. Department of the Treasury (Treasury).

- For the administrative fund types (7300100, 7300200, 73010100, 73010200, 73X3200, 73X3220), a review and approval of the reconciliation is performed but not always in a timely manner. For example, at the time of our walk-through in May 2006, the March 2006 reconciliation was not reviewed/approved.

Treasury Financial Manual, Part 2, Chapter 5100 Supplement, states that "on a monthly basis all agencies must complete and fully document a reconciliation of Fund Balance with Treasury. The reconciliation should be signed-off by an authorized agency official as evidence that the reconciliation was properly completed and reviewed. Federal agencies must research and resolve differences reported on the monthly [Financial Management Service] FMS 6652. They also must resolve all differences between the balances reported on their G/L FBWT accounts and balances reported on the FMS 6653, 6654, and 6655 [now the Government-wide Account Statement reports]. FMS notifies agencies of their deposit and disbursement differences on FMS 6652."

Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, Section II, Part E states that "monitoring the effectiveness of internal control should occur in the normal course of business. In addition, periodic reviews of 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."

Recommendations:

We recommend that SBA's Chief Financial Officer (CFO):

1. Develop policies and procedures to define areas of reconciliation authority, the method of reconciliation to be used, and responsibility to help ensure that all funds are accounted for and reconciled in a timely and consistent manner as defined by the Treasury Financial Manual. The procedures should require that the monthly FBWT reconciliation is "signed off" by both the preparer and a management-level reviewer in a timely manner; and

2. Develop a monthly summary analysis of all reconciled Treasury fund symbols between the general ledger and the Treasury reports to ensure that the final amounts reconciled agree in total to the total funds reported as held by Treasury. This summary total should also reconcile to the FBWT reported

by SBA in its monthly and quarterly financial statements. Additionally, SBA should assign the responsibility for this monthly summary analysis to a specific group within FRD.

Management's Response:

We concur with this finding and recommendation.

Improvement is needed in field cashiering

The following observations were made during field cashiering testwork at various SBA District Offices and Loan Centers:

- All sites do not consistently follow SBA's internal Standard Operating Procedures (SOP) for depositing checks as documented in the *Cash Control and Process Procedures*, SOP 20 05 (4). Of the 337 deposited checks selected for examination at the six field sites, we identified the following:
    - Fourteen checks individually greater than \$5,000 were not deposited in the bank by the next business day following the date of receipt. The checks were deposited approximately 3 to 20 days subsequent to the date of receipt.
    - Fifty checks included in a batch to be deposited with a cumulative balance less than \$5,000 were not deposited by the Thursday following the day of receipt.
    - Twenty-eight checks were not deposited when the lock box reached a balance greater than \$5,000.

- For seven checks at the Herndon Guaranty Purchase Center, the deposit date per the bank deposit slip did not agree to the Deposit and Transfer date recorded at the site in the Field Cashiering System (FCS). All seven of these checks related to one specific deposit. The deposit slip was dated January 5, 2006, but the "Deposited and Transferred" date in FCS was January 13, 2006.

Pursuant to SBA's *Cash Control and Process Procedures* (SOP 20 05 (4)), "each field office must establish an internal 'cutoff' time, after which deposits received are dated for, and processed on, the next business day....Each field office must coordinate processing schedules that allow deposits to reach the depositary before the financial institution's close of business deadlines."

The SOP states that "the cashier sends all payments totaling more than \$5,000 to the [Denver Finance Center] DFC on the day of receipt. [The field office] may hold payments totaling less than \$5,000 in the safe for up to 1 week. [The field office] must send all payments [they] are holding to the DFC by Thursday of each week."

In addition, the SOP states that the cashier selects "completed" items in FCS to create the deposit. After the deposit is ready to take to the bank the cashier must select the "deposited" button and then select the "submit" button located on the deposit screen. Immediately after making the deposit at the bank, the cashier must access FCS and select the "deposited and transferred" box and the "submit" button. The data is then transmitted to update the Loan Accounting System (LAS).

Small Business Administration
Management Letter Comments

SBA personnel attributed their lack of adherence to the SOP to unclear rules documented in the SOP as to when checks must be deposited and a lack of employee oversight as to when checks are ready for deposit. Some offices interpreted the SOP to mean that the deposit deadline timeline begins at the time the check receipt is processed rather than when the check is received.

The improper and untimely processing of deposits increases the possibility that checks received at the SBA field sites are not properly reported in the financial statements. For instance, checks still in possession at the sites will be recorded as "Cash on Hand" in the financial statements, when this cash actually should have been deposited in order to decrease the loan receivable balance (The "Cash on Hand" is determined by a Query in the FCS). In addition, untimely deposits increase the risk of theft or loss.

Recommendations:

We recommend that the CFO:

3. Revise the applicable SOPs to better document the timetable from receipt of the check to deposit. In addition, the SOP should address the processing timeline for a check deposited in the Field Cashiering System;

4. Implement training for SBA personnel involved in the Field Cashiering process to improve the consistency with which the various SBA office personnel process and deposit checks; and

5. Ensure that deposits are being processed and deposited in a timely manner.

Management's Response:

We concur with this finding and recommendation.

Improvement is needed over the review of data used in the credit reestimate models

During testwork over the Accounting Liaison and Quality Assurance (ALQA) team's review of the credit reform models, we noted that ALQA did not formally research and document one difference between LAS and the Electronic Loan Information Processing System (ELIPS) data which exceeded its internally determined materiality threshold for follow-up. The lack of a complete review and documentation resulted because management felt that the differences were materially resolved overall.

SBA's *Policies and Procedures for Budget Formulation Estimates and Reestimates*, maintained by the Office of Financial Analysis, require ALQA to compare the ELIPS data provided by the Office of the Chief Information Officer to LAS to ensure accuracy and completeness of the source data used in the cash flow models. Any difference in excess of one percent is to be researched and resolved.

Small Business Administration
Management Letter Comments

Recommendations:

KPMG recommends that the CFO:

6. Ensure that all material variances found in the reconciliation between MARS and ELIPS are researched, resolved, and documented in accordance with stated policy.

Management's Response:

ALQA did research all of the cash flow differences between the loan accounting and modeling data. The one 7(a) program item noted by the auditor was examined and determined to be insignificant by ALQA staff and the Modeling Team. During FY 2007, one of our initiatives is to more formally document quality assurance results, and we think that this improvement will eliminate similar findings by the auditor in the future.

Improvement is needed in controls over cash and negotiable instruments at the Little Rock Commercial Loan Servicing Center (CLSC)

The "Checks Received Report" and "Checks Received Aging Reports" are listings of all cash, checks, and negotiable instruments that have been received by a servicing center and input into FCS. Checks are to be removed from these FCS reports upon deposit or other appropriate settlement. Additionally, all checks and negotiable instruments in the servicing center's custody are to be properly safeguarded. During our testwork at the Little Rock Servicing Center, KPMG noted the following:

- Reconciliations of the "Checks Received Report" and the "Checks Received Aging Report" to actual checks on hand are not being performed. Little Rock's "Checks Received Aging Report" as of July 19, 2006 contained 78 checks in the amount of $2,344,803. This total did not reconcile to the four checks physically on hand totaling $9,509. In addition, we noted that the July 19th report contained items that were duplicates or returned. As a result, inaccurate information was contained in the FCS at the date of our interim procedures. Per the "Checks Received Aging Report" as of September 5, 2006, all 78 items had been cleared from the report and the oldest check remaining on the report was 12 days old.

- Cash, checks, and negotiable instruments are not kept locked in a safe but rather are kept in the cashier's desk drawer. Improper safeguarding of cash, checks, and negotiable instruments may lead to the unauthorized use or misappropriation of assets.

OMB Circular No. A-123, *Management's Responsibility for Internal Control,* Section I states that an agency's control activities should ensure that: "(i) obligations and costs are in compliance with applicable law; (ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial statistical reports and to maintain accountability over the assets."

Further, Section II, Part E states that "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."

SBA SOP 20 05, revision 4, chapter 3, page 25 states that "the cashier must be able to reconcile the total of cash and checks received to the FCS 'Checks Received Report' on a daily basis. The reconciliation is to be signed and dated by the cashier and should be given to the Administrative Officer. The cashier must [also] reconcile the checks on hand to the combined total of the 'Aging Report' and 'Post Dated Payments Report'. Reconciliation should be conducted monthly at a minimum."

Further, SBA SOP 20 05, revision 4, chapter 2, page 14 states that "all cash, checks, and negotiable instruments [should be] safeguarded by placing them in one of the following: a) Fireproof safe; b) Fireproof cabinet with combination lock; c) Locking cabinet with sprinkler system or other fire prevention system; d) Financial institution safe deposit box; or e) A lockable metal cash box can be used to store cash or checks inside the safe or cabinet."

Recommendations:

KPMG recommends that the Associate Deputy Administrator for Capital Access, in coordination with the Director of the Little Rock CLSC should:

7. Perform, at a minimum, a monthly reconciliation of the checks on hand to the FCS "Checks Received Aging Report";

8. Perform a daily reconciliation of checks on hand to the FCS "Checks Received Report" and ensure that the reconciliation is signed and dated by the cashier and provided to the site's Administrative Officer; and

9. Improve the safeguarding of cash, checks, and negotiable instruments by storing them in a fireproof and locked safe or cabinet.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed in controls over the checks on hand at the Disaster loan processing center

SBA is not properly recording new loan receivable amounts and assessing interest on Treasury checks that have not yet been disbursed to the borrower. During KPMG's review of the FCS Aging Report of Checks on Hand at the Processing Center for the Fort Worth Processing Center at September 30, 2006, we noted SBA had a large number of Treasury checks on hand. Treasury checks represent paper checks ordered from the Department of Treasury by SBA for loan disbursements to borrowers. Based on discussion with SBA accounting personnel, these checks begin accruing interest five days after issuance by Treasury. The Processing Center held approximately $21.2 million of Treasury checks at September 30, 2006. Of this amount $10.2 million, or 210 checks, were five days old or less. The remainder, or 245 checks totaling $11 million, were older than five days and had already begun to accrue interest estimated to be approximately $10,500.

SBA SOP 50 30 5, *Disaster Assistance Program*, states that when making a loan disbursement, "they [disbursement checks] are sent directly from the Treasury Department to the borrower unless there is a compelling need for the disaster office to issue the check."

Statement of Federal Financial Accounting Standards No. 1, *Accounting for Selected Assets and Liabilities*, states that "interest receivable should be recognized for the amount of interest income earned but not received for an accounting period."

The Treasury checks on hand greater than five days can be attributed to a backlog. The Processing Center has a larger number of loan disbursements being issued through Treasury checks than it has historically experienced, and therefore an increased difficulty in keeping up with the actual timely release of the check to the borrower.

As a result of these aged Treasury checks not being released, SBA is recognizing new loans issued as receivables before the checks are sent to the borrower, which overstates the amounts reported as receivable and understates the related undelivered orders in the amount of $21.2 million at September 30, 2006. In addition, accrued interest is inappropriately being accrued on loan balances that do not technically exist because the checks have not been sent to the borrowers.

In addition, as of September 30, 2006, approximately $11 million in title fee and insurance checks were held by the Center, and of this amount, $3.8 million was held beyond 30 days. The Center identified that the majority of the checks held in the vault for long periods represent fees owed by the borrowers to outside entities such as title companies. These checks from the borrowers are made out directly to the title companies for services to be provided, but are processed and sent out by SBA. Due to the large amount of title checks coming in to the disaster center on a daily basis, the team processing the documents and checks does not consistently monitor the older checks; therefore, the checks remain in the vault unprocessed and unmonitored for extended periods of time.

SBA established the handling of the borrower fees to title companies as an additional service intended to expedite the loan approval and disbursement process. Although SBA created a title team to handle the activity, no formalized process was developed, resulting in a large backlog of unprocessed checks. In addition, the Center personnel explained that the checks over 30 days are not frequently monitored to ensure timely processing, but rather, the focus of the team is on recently received checks.

OMB Circular No. A-123, *Management's Responsibility for Internal Control,* Section I states that an agency's control activities should ensure that: "(i) obligations and costs are in compliance with applicable law; (ii) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial statistical reports and to maintain accountability over the assets."

Small Business Administration
Management Letter Comments

Recommendations:

KPMG recommends that the Associate Administrator for Disaster Assistance coordinate with the Directors of the Disaster offices to:

10. Ensure that Treasury checks are requested only when the disbursement is needed;

11. Ensure that Treasury checks on hand are monitored for proper and timely handling;

12. Ensure that loan balances are not established in the general ledger and interest is not accrued until Treasury checks have been disbursed from the disaster office to the borrower; and

13. Establish formal disposition and monitoring procedures to ensure that incoming checks are processed timely.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed in the guarantied loan charge-off process

During KPMG's testwork at the various SBA District Offices and Loan Centers, we performed dual-purpose tests on 46 statistically selected guarantied loan charge-offs. We noted two loans totaling $40,769, which were not charged off and processed timely after being recommended or approved for charge-off. In addition, we noted seven loan files that did not contain the necessary documentation, including the appropriate language regarding liquidation plans on the Form 327-Action or the final demand letter to the borrower. Two loans were inappropriately referred to the Treasury Offset Program, as determined by SBA's subsequent legal review.

SBA SOP 50 51 2, *Loan Liquidation and Acquired Property*, requires that to complete charge-off procedures, SBA must provide a statement as to the reason for the charge-off action, estimate of further recovery, and comment towards the lender's compliance with the liquidation plan that includes the required language identified above. In addition, the SOP states that "a referral is NOT made [to the Treasury Offset program] when the obligor has filed in bankruptcy or has been discharged in bankruptcy or otherwise legally relieved of the debt."

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, states that "transactions should be promptly recorded, properly classified, and accounted for in order to prepare timely accounts and reliable financial and other reports."

Based on discussions with SBA field site personnel, the errors were attributed to human error and supervisory oversight during the review process. The issues noted above are indicative of a lack of a comprehensive quality and control review regarding the guarantied loan charge-off process. This increases the chance that the loans are not properly charged off and in accordance with SBA's policies and procedures. Untimely processing of guarantied charge-offs increases the possibility that the loans are improperly reported in SBA's interim and year-end financial statements. The statistically projected error was calculated to be $574,160 of the guarantied loan principal charged off as of June 30, 2006, and indicates that the projected error amount was untimely or improperly reported in the financial statements and related footnote disclosure. The projected amount is less than 1% of the total principal charge-off population.

Recommendations:

We recommend that the Associate Deputy Administrator for Capital Access implement or enhance quality and control review processes to:

14. Ensure that charge-offs are recorded timely and in the proper fiscal year in accordance with SBA policies and procedures; and

15. Ensure that proper documentation is maintained in the loan files to support the charge-offs in accordance with SBA policies and procedures.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed in the guarantied loan purchase process

During KPMG's testwork at the various SBA District Offices and Loan Centers, we performed dual-purpose tests on 48 statistically selected defaulted guarantied loan purchases. During our testwork, we noted that field site personnel did not:

- Process one loan purchase timely after receiving the purchase demand letter from the lender.
- Perform a timely "post-purchase" review on five of the loans.
- Maintain proper documentation in the loan files for six of the loans tested, including the required Risk Management Database Information and documentation of the correct guaranty percentage.

SBA's SOP 50 50 4, *Loan Servicing*, identifies the documentation necessary to complete a purchase request. The required lender documentation includes a written demand letter, certified transcript of account, and copies of all loan closing instruments, which includes documents required in the authorization and applicable documents identified on the "Guaranty Purchase Checklist."

OMB Circular No. A-123, *Management's Responsibility for Internal Control,* states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports."

Based on discussions with SBA personnel located at the sites tested, the errors were attributed to human error and supervisory oversight during the review process. The issues noted above are indicative of a lack of a comprehensive quality and control review regarding the guarantied loan purchase process. This increases the possibility that the loans are improperly reported in SBA's interim and year-end financial statements. The statistically projected error is equal to $3,308,507, or 1%, of the total guarantied loan purchases.

Small Business Administration
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Recommendations:

KPMG recommends that the Associate Deputy Administrator for Capital Access implement or enhance quality and assurance procedures to perform the following:

16. Ensure that defaulted loan guaranty purchases are recorded timely and in the proper fiscal year in accordance with SBA policies and procedures;

17. Ensure that "post-purchase" reviews are performed timely; and

18. Ensure that proper documentation is maintained in the loan files to support the defaulted loan guaranty purchase in accordance with SBA policies and procedures.

Management's Response:

Except for the following, management concurs with this finding and recommendation. In FY 2004, guarantied loan purchases were centralized from district offices into the Herndon National Guaranty Purchase Center (NGPC). At that time, there were numerous purchase requests that were outdated. However, since that time, the Herndon NGPC has reduced the backlog of purchase requests and maintains purchase requests on a current basis. Aging of the purchase requests is closely managed to ensure that all purchase requests are processed in a timely manner.

Improvement is needed in the Disaster loan charge-off process

During KPMG's testwork at the various SBA District Offices and Loan Centers, we performed dual-purpose testwork on 62 statistically selected direct loan charge-offs. Three loan charge-offs were not timely recorded in LAS after receiving final approval for charge-off. In addition, two loans did not contain the required final demand letter to the borrower in the loan files.

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports."

Furthermore, SBA's SOP 50 52 1, *Consumer Loan Servicing and Collection for Disaster Home Loans,* states that SBA personnel "must maintain a record of all servicing requests, actions approved or declined and other communications regarding specific loans. Such a record is critical to loan servicing personnel in all offices that service loan accounts. "

Based on discussions with SBA personnel located at the sites tested, the errors were attributed to human error and supervisory oversight during the review process. The issues noted above are indicative of a lack of a comprehensive quality and control review regarding the disaster loan charge-off process. For the three aforementioned charge-offs recorded untimely, KPMG notes the loans were improperly reported in the FY2005 financial statements. Due to the untimely charge-off of the loans, the outstanding principal balance charged off was overstated in the current fiscal year by $681,909. The statistically calculated projection of these errors on the population amounted to $1,629,807, or 1%, of the total Disaster loan charge-off balance.

Recommendations:

KPMG recommends that the Associate Administrator for Capital Access, in coordination with management of the Disaster field offices, implement or enhance current quality and assurance processes to:

19. Ensure that charge-offs are recorded timely and in the proper fiscal year in accordance with SBA's policies and procedures; and

20. Ensure that proper documentation is maintained in the loan files to support the charge-offs in accordance with SBA's policies and procedures.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed in the Disaster loan modification process

During KPMG's interim direct loan modifications (e.g., cancellations, loan increases, loan decreases, reinstatements) testwork at the SBA Processing, Servicing, and Liquidation Centers selected, we noted that seven loans did not contain the required documentation in the loan files, including the cancellation letter to the borrower, the legal reviewer's signature on the Form 327-Action, and written requests from the borrower requesting a loan increase or reinstatement.

Pursuant to the Disaster Assistance Program SOP 50 30 5 Chapter 10: *Loan Servicing, Cancellation, Reinstatement, and Loan Modification*, cancellation of a loan in full or partial requires that "before we [SBA] initiate an action to cancel all or any funds, we must mail a letter giving 14 calendar days notice of the pending cancellation. The letter must specify the action the borrower can take to prevent the cancellation." A copy of this letter should be documented in the loan file or within the "scanned documents" in the Disaster Credit Management System (DCMS).

All loan modifications with the exception of minor typographical errors and similar minor modifications (i.e., misspelling of a borrower's name or change in address), require review and approval from a Loan Officer, Supervisory Loan Officer, and an attorney.

Per the SOP, all requests for increases [by the borrower] must be in writing and "all requests for reinstatement [by the borrower] must be in writing and be made within 6 months of the date of cancellation; and show that our [SBA's] cancellation action was in error; or provide justification that we [SBA] should reinstate the funds."

SBA employees "must make any necessary amendment(s) or modification(s) to any term or condition of a Loan Authorization Agreement on the appropriate loan modification form." SBA has created the 327-Action form to document modifications for legacy files or more recently within the electronic files in DCMS. The 327-Action documents the review and approval of the loan modification.

Small Business Administration
Management Letter Comments

Based on discussion with the Fort Worth Disaster Center management, the missing documentation is attributed to oversight or misplacement by the Fort Worth Disaster Center staff and insufficient training of employees as to the information that must be maintained in the loan file.

Regarding the missing cancellation letters, the Quality and Assurance Team (QAT) at Fort Worth indicated it has little recourse if the borrower states they never received the letter, in which case SBA may be forced to reinstate the loan. The QAT in Fort Worth indicated that they had discovered this oversight in the distribution process of the notification letters, and in response, the Loan Modification Letter Team underwent additional training. The QAT is also in the process of implementing a Quality Assurance Review process over the loan modification function to help ensure other missing documentation is identified.

Based on KPMG's statistical sample of the items selected, the projected results of the testwork indicates that 1,789 loan modification files, or 7.6% of all loan files, may have incomplete or missing documentation.

Recommendations:

KPMG recommends that the Associate Administrator for Disaster Assistance:

21. Enhance the SOPs to clarify the required reviews and approvals for loan modifications;

22. Continue the Quality Assurance Review activities over loan modifications to ensure SBA's SOPs are properly followed; and

23. Enhance training for SBA personnel involved in the loan modification process, specifically addressing the documentation that should be maintained in the loan file.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed in the Disaster loan disbursement process

During KPMG's testwork at the various SBA District Offices and Loan Centers, we performed dual-purpose tests on 52 statistically selected direct loan disbursements. We noted seven loan files did not contain the necessary documentation, including Form 1366, "Borrower's Progress Certification" and Form 1415, "Disbursement Instruction Sheet." In addition, one loan file contained inaccurate collateral information in the Loan Authorization and Agreement (LA&A).

Per the Disaster Assistance Program SOP 50 30 (5), Chapter 8, *Disaster Loan Closing and Disbursement*, "prior to any subsequent disbursement the borrower must complete and submit SBA Form 1366, 'Borrower's Progress Certification.'" In addition, the SOP states that the LA&A contains all terms and conditions applicable to the loan, including the collateral used to secure the loan. A Supervisory Loan Officer (SLO) is responsible for assuring that all conditions per the Loan Officer's Report (LOR) agree to the LA&A, which would include ensuring the collateral documentation agrees to the LA&A collateral information before it is signed by the borrower and SBA. (Chapter 7 – Processing of Application)

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* states that "control activities...include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the creation and maintenance of related records which provide evidence of execution of these activities as well as appropriate documentation." In addition, "access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained."

The findings resulted from management oversight during its review and approval process. The missing or inaccurate documentation increases the risk that a loan may be inappropriately disbursed or under-collateralized.

Recommendation:

24. We recommend that the Associate Administrator for Disaster Assistance in coordination with management at Disaster loan field offices enhance its Quality and Assurance process to ensure proper documentation is maintained in the loan files to support the direct loan disbursement in accordance with SBA policies and procedures and to identify areas where SBA personnel may require additional training.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed over the management and tracking of loan files

During our testwork at the various SBA Processing, Servicing, Liquidation, and District Offices, we identified three instances in which SBA was unable to locate the loan files selected for testwork.

GAO's *Standards for Internal Control in the Federal Government* states that "control activities...include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the creation and maintenance of related records which provide evidence of execution of these activities as well as appropriate documentation." In addition, "access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained."

In addition, the Department of Treasury's *Management of Federal Receivables* states that "accurate and complete documentation is critical to providing proper servicing of debt, pursuing collection of delinquent debt, and in the case of guaranteed loans, processing claim payments."

SBA does not have consistent, agency-wide policies and procedures over the management, tracking, and transferring of loan files. Each field office has its own procedures for the management of its respective loan files. The lack of a consistently applied loan file tracking and control process increases the risk that SBA will not be able to properly and consistently service its loan and loan guaranty programs when needed. In addition, missing files could lead to poor management decisions in the absence of accurate supporting documentation or unauthorized disclosure of confidential information.

Recommendation:

25. KPMG recommends that the Associate Administrator for Disaster Assistance and the Associate Deputy Administrator for Capital Access coordinate to develop agency-wide policies and procedures over the inventory, tracking, and shipping of loan files. These policies and procedures should cover both the sending and receiving offices, and should be clearly communicated to all field office personnel.

Management's Response:

Management concurs with this finding and recommendation.

Improvement is needed in controls over official personnel files

During our test workover the human resources process, we noted that for three sample items (covering two different employees), the latest SF-50 Notification of Personnel Action was not in the official personnel file (OPF). In addition, for one sample item, Office of Human Capital Management (OHCM) personnel could not locate the OPF.

GAO's *Standards for Internal Control in the Federal Government* states that "control activities...include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the creation and maintenance of related records which provide evidence of execution of these activities as well as appropriate documentation." In addition, "access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained."

Per discussion with OHCM personnel, management represents that the missing file documentation was caused due to a backlog of SF-50 filings and that the missing file is due to a misapplication of file maintenance process controls. A lack of proper documentation in the files could lead to an employee being inappropriately paid. In addition, missing files could lead to unauthorized disclosure of personal information.

Recommendations:

KPMG recommends that the Chief Human Capital Officer:

26. Ensure that approved SF-50 forms are promptly filed in the official personnel files;

27. Ensure that the backlog of SF-50 forms to be filed is addressed promptly; and

28. Maintain appropriate controls over the custodianship of official personnel files.

Small Business Administration
Management Letter Comments

Management's Response:

Management concurs with this finding and recommendation.

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

Date: 12-15-06

To: Debra S. Ritt
Assistant Inspector General for Auditing

From: Jennifer E. Main [Exemption 6]
Chief Financial Officer

Subject: Audit of SBA's FY 2005 Financial Statements – Draft Management Letter

The draft Management Letter for the FY 2006 financial statement audit contains 29 recommendations to improve the SBA's financial management, 7 of which were addressed to the CFO. The Office of the CFO is in general agreement with these 7 findings and recommendations except for the findings on recommendations 6 and 7 on the review of data used in the credit subsidy reestimate models. KPMG noted that ALQA did not review the Unpaid Principal Balance (UPB) for the 2006 Disaster cohort and that one other cashflow difference was not formally researched and documented.

Our position is that it was not necessary or appropriate to review the UPB for the Disaster 2006 cohort because:

- The majority of the loans were not repaying due to the 11 month grace period for Hurricanes Katrina, Rita and Wilma;
- Additional disbursements of $200 million were projected for the last two weeks of September and the cashflow UPB therefore would not tie to the general ledger UPB;
- FY 06 cashflow was tied to the MoCaMo report of 9/18/06.

Secondly, ALQA did research all of the cashflow differences between the loan accounting and modeling data. The one 7(a) program item noted by the auditor was examined and determined to be insignificant ~~by ALQA~~ staff and the Modeling Team. During FY 2007, one of our initiatives ~~is to~~ more formally document quality assurance results, and we think that this improvement will eliminate similar findings by the auditor in the future.

Thank you for the opportunity to provide comments to the draft Management Letter and I look forward to the receipt of the final Management Letter as soon as possible.

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

Date: December 18, 2006

To: Debra Ritt
Assistant Inspector General for Auditing

From: Associate Administrator
for Disaster Assistance

Subject: Audit of SBA's FY 2006 Financial Statements – Management Letter

In response to the draft Management Letter issued by KPMG LLP, the following comments are provided.

Recommendations:

- **Improvement is needed in controls over the checks on hand at the Disaster loan processing center.**
- **Improvement is needed in the Disaster loan modification process.**
- **Improvement is needed in the Disaster loan disbursement process.**
- **Improvement is needed over the management and tracking of loan files.**

Response: We agree with the finding and recommendations. The magnitude of the Gulf Coast hurricanes has tested our internal system's capacity in processing, modifying, disbursing and shipping files. While we have taken several steps to address of the recommendations, we will coordinate with our Disaster offices to ensure the recommendations are properly implemented.

Recommendation: Improvement is needed in the Disaster loan charge-off process.

Response: This recommendation should be directed to the Associate Administrator for Capital Access. The responsibility for Agency collection and charge-off resides in the Capital Access division.

[Exemption 6]

Herbert L. Mitchell

MEMORANDUM

December 15, 2006

TO: Debra Ritt
Assistant Inspector General for Auditing

FROM: Michael W. Hager
Associate Deputy Administrator for Capital Access

SUBJ: Response to Management Letter from Audit of SBA's FY 2006 Financial Statements

Thank you for the opportunity to respond to the Management Letter resulting from the Audit of SBA's FY 2006 Financial Statements. The following response from the Office of Capital Access (OCA) is provided.

Audit Recommendation 8. Perform, at a minimum, a monthly reconciliation of the checks on hand to the FCS "Checks Received Aging Report" at the Little Rock Commercial Loan Servicing Center (CLSC).

OCA Response. OCA concurs with this finding and recommendation and will take action to implement the recommendation.

Audit Recommendation 9. Perform a daily reconciliation of checks on hand to the FCS "Checks Received Report" and ensure that the reconciliation is signed and dated by the cashier, and provided to the Administrative Officer at the Little Rock CLSC.

OCA Response. OCA concurs with this finding and recommendation and will take action to implement the recommendation.

Audit Recommendation 10. Improve the safeguarding of cash, checks, and negotiable instruments by storing them in a fireproof and locked safe or cabinet at the Little Rock CLSC.

OCA Response. OCA concurs with this finding and recommendation and will take action to implement the recommendation.

Audit Recommendation 15. Ensure that charge-offs are recorded timely and in the proper fiscal year in accordance with SBA policies and procedures.

OCA Response. OCA concurs with this finding and recommendation. In fact, in FY2006, when OCA determined that there was a backlog in charge-offs, a major initiative was launched to reduce the backlog in charge-offs and implement the necessary steps to ensure that this activity was handled in a timely manner going forward. Procedures have been put in place to provide for more timely charge off and the planned liquidation regulations will further improve controls over this activity.

Audit Recommendation 16. Ensure that proper documentation is maintained in the loan files to support the charge-offs in accordance with SBA policies and procedures.

OCA Response. OCA concurs with the recommendation but is unsure what the basis is for the finding. The management letter indicates that test work was performed at district offices and loan centers. OCA is unsure the degree to which the documentation discrepancies related to district office files, loan center files or both. As the liquidation functions have been centralized in the loan centers, if the discrepancies were identified in the district offices, it would be considered a moot point since district offices no longer handle charge-offs. Further, as part of the project to reduce the backlog in charge-offs, some documentation may have been mishandled due to the large number of charge-offs being reviewed. In any event, OCA agrees that proper documentation to support charge-offs should be maintained in the file and will assess the degree to which procedures need to change to ensure compliance with established requirements.

Audit Recommendation 17. Ensure that defaulted loan guaranty purchases are recorded timely and in the proper fiscal year in accordance with SBA policies and procedures.

OCA Response. OCA does not concur with this finding and recommendation. In FY 2004, guaranteed loan purchases were centralized from district offices into the Herndon National Guaranty Purchase Center (NGPC). At that time, there were numerous purchase requests were dated. However, since that time, the Herndon NGPC has reduced the backlog of purchase requests and maintains purchase requests on a current basis. Aging of the purchase requests is closely managed to ensure that all purchase requests are processed in a timely manner.

Audit Recommendation 18. Ensure that "post-purchase" reviews are performed timely.

OCA Response. OCA concurs with this finding and recommendation and is already taking action to address this recommendation.

Audit Recommendation 19. Ensure that proper documentation is maintained in the loan files to support the defaulted loan guaranty purchases in accordance with SBA policies and procedures.

OCA Response. OCA concurs with the recommendation but would need additional information on the specific loans reviewed to ascertain whether we agree with the finding. In any event, OCA agrees that proper documentation to support guaranteed loan purchases should be maintained in the file and will assess the degree to which procedures need to change to ensure compliance with established requirements.

Audit Recommendation 20. Ensure that the charge-offs are recorded timely and in the proper fiscal year in accordance with SBA's policies and procedures.

OCA Response. OCA concurs with this finding and recommendation. In fact, in FY2006, when OCA determined that there was a backlog in charge-offs, a major initiative was launched to reduce the backlog in charge-offs and implement the necessary steps to ensure that this activity was handled in a timely manner going forward. Procedures have been put in place to provide for more timely charge off and the planned liquidation regulations will further improve controls over this activity.

Audit Recommendation 21. Ensure that proper documentation is maintained in the loan files to support the charge-offs in accordance with SBA's policies and procedures.

OCA Response. OCA concurs with the recommendation but would need additional information on the specific loans reviewed to ascertain whether we agree with the finding. In any event, OCA agrees that proper documentation to support disaster loan charge-offs should be maintained in the file and will assess the degree to which procedures need to change to ensure compliance with established requirements.

Audit Recommendation 26. KPMG recommends that the Associate Administrator for Disaster Assistance and the Associate Deputy Administrator for Capital Access coordinate to develop agency-wide policies and procedures over the inventory, tracking, and shipping of loan files. These policies and procedures should cover both the sending and receiving offices, and should be clearly communicated to all field office personnel.

OCA Response. OCA agrees with the finding and generally agrees with the recommendation, with the move to paperless files, particularly for disaster loans, the transfer of files is largely eliminated. However, OCA agrees that policies governing file inventory and tracking should be established.

Please note that OCA responded to Audit Recommendations 20 and 21 related to improvements in the Disaster loan charge-off process although the recommendations were made to the Associate Administrator for Disaster Assistance. Servicing, liquidation and charge-off of disaster loans are the responsibility of the OCA.

Please also note that the transmittal memo indicates that there are 13 recommendations for the Office of Capital Access. This response addresses 11 recommendations including two that are addressed to the Office of Disaster Assistance. No other recommendations appeared to be directed to OCA.