U.S. Small Business Administration
Washington, D.C. 20416

OFFICE OF
INSPECTOR GENERAL

AUDIT REPORT
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To: J. Larry Wilson
Chief Financial Officer

John L. Gray, Associate Deputy Administrator
Office of Capital Access

Bradley D. Douglas, Associate Administrator
Field Operations

Lawrence E. Barrett
Chief Information Officer

Johnnie L. Albertson, Associate Administrator
Office of Small Business Development Centers

Peter L. McClintock

From: Peter L. McClintock
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 1997 Financial Statements – Management Letter

Pursuant to the Chief Financial Officers Act of 1990, attached is the Independent Auditor's Management Letter (Attachment 1) issued by Cotton & Co., CPAs. The Management Letter includes conditions related to the internal control structure and other issues that we identified during the audit of SBA's Fiscal Year 1997 financial statements but were not required to be included in the Auditor's Report. SBA officials agreed with the findings and recommendations and, in some instances, have initiated corrective action. **The findings and recommendations are subject to review, management decision, and action by your office in accordance with existing Agency procedures for audit follow-up**. Please provide your management decisions on SBA Form 1824, Recommendation Action Sheet, also attached within 30 days.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations, on (202) 205-7204.

Attachments

COTTON & COMPANY LLP

CERTIFIED PUBLIC ACCOUNTANTS

333 NORTH FAIRFAX STREET • SUITE 401 • ALEXANDRIA, VIRGINIA 22314

DAVID L. COTTON, CPA, CFE
CHARLES HAYWARD, CPA, CPE
MICHAEL W. GILLESPIE, CPA, CFE
CATHERINE L. NOCERA, CPA
ELLEN P. REED, CPA
MATTHEW H. JOHNSON, CPA

February 27, 1998

MANAGEMENT LETTER COMMENTS
INDEPENDENT AUDIT OF FISCAL YEARS 1997 AND 1996
PRINCIPAL FINANCIAL STATEMENTS

Inspector General
Small Business Administration

We have audited the Small Business Administration's (SBA) principal financial statements as of September 30, 1997, and 1996, and for the years then ended, and have issued our report, dated February 27, 1998, to SBA under separate cover. That report also included our reports on SBA's internal control structure and compliance with laws and regulations.

The purpose of this management letter is to communicate seven non-reportable findings to SBA management. Of these seven, we reported Finding No. 1 in our FY 1996 report on SBA's internal controls and Finding No. 4 in our FY 1996 management letter.

This letter is intended solely for the information and use of SBA management.

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

Very truly yours,

COTTON & COMPANY, LLP

703/836-6701 • FAX 703/836-0941• HTTP://WWW.COTTONCPA.COM • E-MAIL: DCOTTON@COTTONCPA.COM

By ______________________
Matthew H. Johnson, CPA, CGFM

INDEPENDENT AUDIT OF FISCAL YEARS 1997 AND 1996
PRINCIPAL FINANCIAL STATEMENTS
U.S. SMALL BUSINESS ADMINISTRATION
NONREPORTABLE FINDINGS

Certain nonreportable findings came to our attention during the audit of the Small Business Administration's (SBA) Fiscal Year (FY) 1997 principal financial statements. All findings are related to SBA's internal controls.

We reported Finding No. 1 in our FY 1996 audit report and Finding No. 4 in the management letter accompanying our FY 1996 audit report. Where SBA partially addressed our recommendations, we modified our findings and recommendations.

1. Foreclosed Property Records and Valuation

Property acquired by SBA through enforcing payment on secured loans is referred to as "collateral purchased" (COLPUR), or foreclosed property. At September 30, 1997, SBA's recorded value for foreclosed property was $94 million. In FY 1996, we reported that SBA did not consistently value and maintain comprehensive inventory records for foreclosed property.

During FY 1997, SBA took several steps related to foreclosed property records and valuation:

- Revised standard operating procedures (SOPs) to include the requirement to value collateral at the net realizable value.
- Established the Liquidation Improvement Project (LIP) and updated a training program for field office personnel.
- Assembled Liquidation Improvement Field Teams (LIFTs) to review collateral records at selected field offices for compliance with the revised SOP requirements.
- Implemented the collateral tracking system, a Liquidation/Litigation Tracking System (LLTS) module.

We found that SBA field offices improved in the valuation of collateral property. We did note, however, that not all field office liquidation staff had received training on valuing collateral, and some continued to value it incorrectly. For example, we found that property with an appraised value of $700,000 was valued at $1,500,000, thereby overstating foreclosed property by $800,000 and making the loan receivable zero. Thus, SBA could no longer recognize a claim against the borrower for future recoveries. We also found that some field offices had not entered collateral data into the collateral tracking system. As a result, the system did not provide complete inventory of foreclosed property as of September 30, 1997.

Statement of Federal Financial Accounting Standards (SFFAS) No. 3, paragraph 81, requires property acquired on loans approved before 1992 to be recorded at cost and adjusted for the lower of cost or net realizable value; any difference should be carried in a valuation allowance. It also requires property acquired on loans approved from 1992 forward to be valued at the net present value of projected future cash flows associated with the property. Further, Office of Management and Budget (OMB) Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables, Appendix A, Chapter III, Section A.3.d, requires that comprehensive inventory records of all foreclosed property be maintained.

We recommend that the Office of the Chief Financial Officer (OCFO) coordinate with the Office of Capital Access and the Office of Field Operations to:

- Fully implement the LLTS module to maintain complete and accurate foreclosed property inventory records to ensure that the inventory system is in place during FY 1998 and reconciles to the general ledger.

- Ensure that all field office liquidation staff receive training and guidance on requirements for valuing foreclosed property and entering complete and accurate data into the LLTS module.

- Periodically review field office property documentation and LLTS module entries to ensure that property is properly valued and accurately entered into LLTS.

2. Statement of Differences Reconciliation

The Denver Finance Center (DFC) maintains two systems for reconciling cash transactions with the U.S. Treasury. The Statement of Differences (SOD) system itemizes differences between transactions reported on Standard Form (SF) 224 and Treasury's records. The G/L Rec system itemizes differences between transactions in the general ledger and those reported on the SF 224. The systems were designed to agree with each other for items greater than 6 months old. Because of manual entries to the SOD system, however, the two systems were not in agreement. In addition, the SOD system did not agree with Treasury's TFS 6653 balance.

DFC stated that manual entries were made to the SOD system to correct anomalies, such as schedule number changes, and to delete items previously written off in total rather than at the transaction level. Because the two systems do not agree, DFC could post erroneous items on its SF 224, thus compounding the differences between the two systems.

OMB Circular A-127, Section 7.j, Financial Management System Requirements, requires financial management systems to have internal controls in place to ensure the reliability of data.

We recommend that DFC:

- Reconcile the SOD and G/L Rec systems and bring them into agreement.
- Establish, document, and communicate procedures to ensure future agreement between the two systems.

3. Federal Financial System (FFS) Cash Reconciliation Procedures

DFC uses a spreadsheet application to compute cash balance differences between its FFS general ledger and Treasury's TFS 6653 report. DFC then itemizes differences for certain funds by month and nature of the difference. We noted several errors on the September 30, 1997, yearend spreadsheets. For instance:

- TFS 6653 amounts (labeled "SF224-Treasury") did not tie to the yearend TFS 6653 balances for all funds.
- General ledger amounts (labeled "SBA-Cash 1010–1026") did not tie to the yearend FFS general ledger balances for all funds.
- The sum of itemized differences did not agree with the total computed difference for all funds.

We also found that the reconciliation method did not identify differences by transaction and, thus, could not be used to research and correct differences.

Finally, the FFS reconciliation was not integrated with the G/L Rec system. G/L Rec was automated, validated for accuracy, and prepared on a transactional basis. SOD and other suspense-type transactions were tracked in G/L Rec, yet often needed to be corrected by an FFS general ledger or SF 224 entry. Because the two reconciliations are separate, DFC could not readily determine and analyze its agency-wide cash difference. Thus, it cannot ensure that internal control objectives are achieved, specifically that accounting transactions are recorded accurately and in a timely manner, and assets are safeguarded.

We recommend that DFC integrate its FFS and loan accounting system cash reconciliation processes. It should ensure that the integrated process produces an accurate calculation of FFS differences and itemizes them at the transaction level.

4. Reconciliation of SBIC Loans to the SBA Loan Accounting System

SBA's Loan Accounting System (LAS) continued to reflect inaccurate account balances related to the Small Business Investment Company (SBIC) program. In our FY 1996 management letter, we recommended that OCFO, in coordination with the Office of SBIC Liquidation:

- Review outstanding SBIC balances to ensure that they are recorded properly and accurately.
- Develop policies and procedures to notify OCFO of all financial management activities, thus ensuring that transactions and events are recorded accurately and in a timely manner.

In response to these recommendations, the Office of SBIC Liquidation engaged a contractor to review SBIC accounts and stated it would reinforce existing procedures to ensure that all transactions are properly recorded.

As part of our FY 1997 audit, we tested the 9 SBIC loans with a principal balance of $2 million or more, totaling $28.5 million. We found that 3 of the 9, totaling about $10.5 million, were fully liquidated and closed by the Office of SBIC Liquidation. As a result, Credit Programs Receivables were overstated by that amount.

We recommend that OCFO coordinate with the Office of SBIC Liquidation to ensure that transactions are reported and recorded accurately and in a timely manner.

5. Small Business Development Center Grant Expenditure Reporting

DFC did not record Small Business Development Center (SBDC) disbursements to the correct grants. SBA’s Central Office for SBDCs is responsible for awarding grants, and DFC is responsible for processing accounting transactions. DFC establishes obligations based on Letters of Credit from Central Office. The obligation number coincides with the fiscal year the grant was awarded. DFC then disburses funds based on requests by the grantees. It relies on grantees to identify the grant to which the disbursement should be applied.

DFC officials stated that grantees do not always identify grant numbers. When this happens, DFC applies disbursements against the oldest obligation with an available balance and, therefore, in some cases, did not charge the correct grant.

Grantees also submit final Financial Status Reports within 90 days of the end of the grant period, usually fiscal yearend. Based on this report, Central Office sends DFC a Letter of Credit indicating the amount to decrease from the prior authorized amount. Central Office and DFC do not reconcile actual grant disbursements and amounts reported by grantees on their final Financial Status Reports.

OMB Circular A-123, Management Accountability and Control, requires transactions to be promptly recorded and properly classified and accounted for to permit preparation of timely accounts and reliable financial and other reports.

We recommend that the Central Office for SBDCs require grantees to identify grant numbers to which disbursements should be charged on their requests for funds. We further recommend that DFC reconcile disbursements under each grant with the final Financial Status Reports.

6. Payroll Reconciliation

The Department of Agriculture's National Finance Center (NFC) processes SBA's payroll transactions. DFC is responsible for performing weekly and monthly reconciliations. The weekly reconciliation should validate input data with output data in preparation for updating the general ledger. Although the weekly reconciliation was being performed, it was incomplete, because it did not always document the comparison of the Schedule Report for Input from NFC (ADM-310 report) to the FFS interface report (RZPRADPRP). Additionally, DFC does not compare the Administrative Billings and Collections (ABCO) transactions from the ADM-310 report with the ABCO report from FFS.

The monthly reconciliation compares the NFC Abstract Report with the monthly payroll amount per FFS. This reconciliation is not effective, because, although total differences are calculated, they are not itemized by transaction or researched and explained. For example, the July 1997 payroll reconciliation showed a $10,062,707 difference between general ledger cash transactions and the NFC Abstract Report. DFC did not research this difference and could not be certain it was a timing difference. In addition, the monthly reconciliation was not performed on a year-to-date cumulative basis. Thus, differences due to timing were not offset, and a total yearend difference was not readily available.

OMB Circular A-123 establishes requirements for control objectives to ensure that transactions are promptly recorded and properly classified and accounted for to assure preparation of reliable financial reports. Internal control techniques, such as reconciliations, must be effective and efficient to ensure that control objectives are achieved.

We recommend that DFC:

- Revise its weekly payroll reconciliation to include procedures for reconciling the ADM-310 report to the FFS interface report and Administrative Billings and Collections reports.

- Prepare monthly payroll reconciliations on a cumulative year-to-date basis, itemize differences by transaction, and research and correct significant differences.

7. Collateral Cashier

Collateral Agent Cashier practices were not in compliance with SBA policies and procedures for cash receipts and collateral documents.

We reviewed the functions of the Collateral Agent Cashier at a Disaster Area Office, a Servicing Center, and 15 randomly selected field offices and noted various conditions of noncompliance. Specifically, we found that:

- Cash receipts were not always deposited in a timely manner.
- Cash receipts were not always recorded at a mail control point.
- Required collateral documents, described in the original loan authorization, were not always in the collateral files.

We reviewed a sample of 18 loan files at the Servicing Center and found that:

- The location of 5 corresponding collateral files was incorrectly input in the tracking system.
- Three collateral files did not contain required documents, such as titles and deeds.
- One collateral file did not contain a revised loan authorization document to support changes to the collateral file.

Also, review of the corresponding collateral files for the 18 sampled loan files showed that the Uniform Commercial Code (UCC) filings at three field offices had lapsed for the collateral held by SBA.

SOP 20-05-01, Imprest Fund and Cashier Procedures, states that all payments for $5,000 or more must be deposited to DFC on the day of receipt. Payments for less than $5,000 may be held up to one week. SOP 20-05-01, Item 33, states that at least two employees (if possible) should open mail daily at a designated mail control point and they should record all registered, certified, express, and insured mail and mail containing cash, checks, or other negotiable items on SBA Form 9, Incoming Negotiable Register and Insured Mail.

We recommend that OCFO reinforce its SOPs pertaining to the Collateral Agent Cashier position by issuing a procedural notice emphasizing the importance of following the SBA guidelines for controls over cash and collateral. Also, we recommend this area be included in Quality Service Reviews.

AUDIT REPORT DISTRIBUTION

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