

Testimony of
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Subcommittee on Government Efficiency and Financial Management
Committee on Government Reform
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Good afternoon Chairman Platts, Congressman Towns, and members of the Subcommittee. I appreciate the opportunity to appear before you today to discuss the status of financial management at the Small Business Administration (SBA). Your letter of invitation requested that I address specific topics. This testimony is structured to respond to each topic identified.

U.S. General Accounting Office Report, “*Small Business Administration: Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain.*”

The General Accounting Office’s (GAO) report GAO-03-87, “*Accounting Anomalies and Limited Operational Data Make Results of Loan Sales Uncertain,*” identified significant issues in SBA’s accounting and budgeting for loan sales which may have affected the fair presentation of its fiscal year 2000 and 2001 financial statements. Accordingly, GAO recommended that the Inspector General, in conjunction with SBA’s financial statement auditors, assess the impact of any identified misstatements in the financial statements and determine whether previously issued audit opinions for fiscal years 2000 and 2001 need to be revised. Further, GAO made several recommendations to SBA’s Administrator to provide accurate and reliable information about how the sales affect SBA’s financial statements, budget, and operations. We agree with both the recommendation addressed to our office as well as those recommendations addressed to the Administrator.

Of the issues identified by GAO, we believe the disaster loan subsidy model shortcomings have the greatest impact on SBA, its reported financial results, and its ability to fulfill its mission. The subsidy estimates and re-estimates prepared by SBA directly or indirectly affect all the accounting anomalies noted by GAO. Based on the preliminary results of work performed by SBA and its contractor on these issues, it appears that the subsidy model for the disaster loan program needs to be modified to more accurately reflect disaster loan program costs. We agree with GAO that the errors and lack of appropriate analyses related to the disaster subsidy model mean that SBA and congressional decision makers are not receiving accurate financial data that they need to make appropriate decisions regarding SBA’s programs and budget. From the preliminary assessment of the work SBA is doing to overcome these shortcomings, it appears that SBA is taking appropriate steps to ensure it can produce reliable disaster subsidy

estimates and re-estimates in the future. However, until SBA completes its work in this area to identify the financial impact and the results are independently reviewed, we cannot provide any assurance that the results will address all of GAO's concerns.

Audits of SBA's Financial Statements for Fiscal Years 2000, 2001, and 2002

SBA's independent public accountant, Cotton & Company LLP (Cotton), issued a disclaimer of opinion on SBA's fiscal year 2002 financial statements. A disclaimer of opinion means that the auditors were unable to express an opinion on the financial statements due to limitations on the scope of their work. Cotton noted scope limitations in the areas of disaster loan program modeling, pre-1992 loan guarantees, and the Master Reserve Fund residual liability. In the area of disaster loan modeling, SBA had not fully assessed the impact of the issues noted by GAO; therefore, SBA was unable to determine what corrections were required to the fiscal year 2002 financial statements. Due to this uncertainty and the lack of evidence that showed the current disaster loan models produced accurate results, Cotton could not satisfy themselves as to the accuracy of related financial statement amounts. Regarding pre-1992 loan guarantees, SBA was unable to provide sufficient documentary evidence needed to satisfy Cotton that Liabilities for Loan Guaranties and related accounts were fairly stated. The Master Reserve Fund (MRF), which is used to facilitate operation of the Section 7(a) secondary market program, is also reported in SBA's financial statements. However, SBA used small, judgmental samples of MRF data to estimate the long-term excess or deficiency of MRF earnings over expected payments. The resulting estimates were statistically unsupported and may not be reliable. Based on our discussions with Cotton and our review of the work they performed, we believe that a disclaimer was the most appropriate result for the fiscal year 2002 audit.

On December 20, 2002, Cotton notified SBA and our office that SBA's financial statements for fiscal years 2000 and 2001 should no longer be relied upon due to "the possibility that material adjustments may be necessary for disaster loans sold, disaster loan subsidy expense, and other directly related accounts and footnotes corresponding to SBA's disaster loan program." Cotton withdrew its opinions on these statements based on the findings in GAO's report and the resulting uncertainty of many financial statement amounts. We agree with Cotton's decision to withdraw these opinions and their efforts to ensure that SBA made the appropriate disclosures to all parties who rely on SBA's financial statement information. As SBA moves forward with determining the magnitude of any misstatements in its financial statements, it will be necessary to assess whether SBA needs to restate its 2000 and 2001 financial statements or whether SBA's fiscal year 2002 and 2003 comparative financial statements should present the cumulative results of any errors. We will work with all interested parties, including GAO and OMB, to make this determination. Any corrections and adjustments that SBA makes, either as restatements to previous year financial statements or as corrections of errors in the current year financial report, will be validated by Cotton.

The issues noted by GAO and Cotton in its fiscal year 2002 audit increase the risk regarding SBA's ability to produce auditable financial statements for fiscal year 2003. SBA is required to prepare comparative financial statements for fiscal year 2003. In order to receive an unqualified opinion on those financial statements, SBA must complete its assessment of the necessary modifications to the disaster loan subsidy model, redesign and test the model as needed, quantify any errors, and correct the financial statement accounts for both fiscal years 2002 and 2003 in adequate time to be audited. SBA has identified many of the problems and has performed some of the work to rebuild the subsidy models. However, there will be very tight timeframes to complete the required tasks in time for proper quality assurance and for Cotton to perform their procedures. These timeframes are further complicated by SBA's plans to accelerate its reporting process this year to prepare for the aggressive fiscal year 2004 reporting timetable. While we believe that it is crucial for SBA to begin accelerating its financial reporting process, we also should recognize the additional risks that are likely to occur so these risks can be mitigated. As a result of our concerns, we have been in discussions with SBA's Office of Chief Financial Officer (OCFO) and have a verbal commitment from them that Cotton can perform as much of their test work as possible while SBA is in the process of correcting its disaster subsidy model problems. Cotton will be able to provide OCFO feedback as the process moves along and OCFO should be able to address any shortcomings noted by Cotton in ample time to prepare auditable financial statements.

SBA's 2002 Scoring in the President's Executive Branch Management Scorecard

We believe the scoring of SBA's financial management performance for fiscal year 2002 in the President's Executive Branch Management Scorecard is appropriate. One of the key factors used by OMB in its Scorecard for an agency to get a score of "green" in financial management is to receive an unqualified opinion on its financial statements. We believe OMB's lowering of SBA's score for its fiscal year 2002 financial performance was directly related to Cotton's disclaimer of opinion. However, it may have been appropriate for SBA to have received a "red" score in 2001. While SBA had received a clean opinion on its financial statements (since withdrawn) and a score of "yellow" on the OMB Scorecard, Cotton noted in fiscal year 2002, and over the past several years, material weaknesses^[1] and reportable conditions in SBA's financial reporting process and information system controls related to financial management activities. In addition, Cotton noted in fiscal years 2001 and 2002 that SBA was not in substantial compliance with the Federal Financial Management Improvement Act of 1996. These problems appear to meet the criteria for a "red" score. Accordingly, we believe that emphasis should be placed on material weaknesses, reportable conditions, and noncompliance with financial related laws and regulations noted by auditors in assessing the adequacy of an agency's financial management.

Actions Taken to Respond to the Credit Reform Issues Identified by GAO

OIG has taken several actions to respond to the issues identified in the GAO report, both reactive as well as proactive. Upon learning of the issues identified by GAO in their audit report, we met with Cotton to discuss the potential impact on prior year audit opinions. Cotton concluded that material adjustments may be necessary for disaster loans sold, disaster loan subsidy expense, and other directly-related accounts and footnotes for the fiscal years 2000 and 2001 financial statements. As a result, our office worked with Cotton and OCFO to ensure that applicable auditing standards governing a subsequent discovery of facts existing at the date of the auditor's report were both understood and met by both parties as they apply to this matter. Additionally, our office initiated a review to understand the process that had been used in the past concerning the accounting for loan sales. This review is ongoing.

While we continue to work with SBA management to determine the impact of the issues on SBA's financial results, we have also taken steps to strengthen the audit process to increase the likelihood that these types of issues will be recognized and addressed during future audits. First, we have asked Cotton to provide us with a plan which details their approach and proposed staffing for the fiscal year 2003 audit with specific emphasis on the credit reform aspects of the audit. Cotton has provided a plan for the fiscal year 2003 audit which includes retaining additional experienced credit reform experts to complement their existing credit reform resources, increasing involvement by one of their partners with recognized credit reform experience, and retaining an outside expert to review their credit reform testing.

Second, we have increased our monitoring and oversight of the annual financial statement audit. During fiscal year 2002, we improved our monitoring procedures in assessing the quality of Cotton's work. We also hired a senior auditor with financial audit experience and knowledge of federal accounting policies and procedures to assist in monitoring the annual financial statement audit. Further, we strengthened our oversight role and increased our knowledge of SBA's operations and systems by accompanying Cotton on many of their district office visits during the internal control phase of the fiscal year 2002 audit. We also performed some of the information systems internal control testing work in-house. While we acknowledge our progress in this area, we also recognize our weakness when it comes to our knowledge in the credit reform area. We plan on addressing this issue in the following two ways. We have elicited the help of the GAO to assist us in monitoring the credit reform aspects of the audit. Additionally, we will invest the time and resources to ensure that the appropriate OIG staff are trained and certified in federal credit reform accounting.

Third, we continue to strengthen our working relationship with SBA's OCFO to ensure that the issues in the credit reform area as well as SBA's overall financial reporting process are resolved in the most efficient and effective manner. For example, for the fiscal year 2003 audit, SBA's OCFO, Cotton, and our office will form an audit working group where all parties will participate in open and candid discussions about audit issues

that arise during the audit as well as ideas for improving SBA's overall financial management.

We also endorse the Administrator's recent commitment to create an Audit Committee to advise and oversee financial management activities at SBA. We believe the addition of an Audit Committee is an opportunity to bring added voices of expertise to the improvement of SBA's financial management operations and internal control system. The Audit Committee will highlight those issues that deserve management's attention, provide counsel on possible courses of action, and assist in resolving audit recommendations. We support the use of an Audit Committee and will work closely with the Administrator and Chief Financial Officer to identify the role and responsibilities of such a committee.

Challenges and Opportunities for Improving Financial Management at SBA

SBA faces a number of significant challenges for improving financial management and performance which are affected by the Loan Accounting System (LAS), the lack of a fully functioning integrated financial reporting system, and information system control weaknesses. SBA relies on LAS to account for and report on different aspects of SBA's loan portfolio. LAS, which has been in use since the 1970's, is comprised of approximately nine subsystems and is programmed in COBOL computer language. SBA incurs substantial risk relating to the continued use of LAS because it is close to the end of its useful life and SBA faces the loss of contractor support for the system within the next few years. Further, LAS cannot be easily modified to adapt to changes in accounting rules.

In fiscal year 2002, Cotton identified information security weaknesses in SBA's financial management system application controls related to authorization, completeness, accuracy, and integrity of processing data files. While SBA has made progress in improving its information security controls, this area requires continued vigilance to ensure that cyber security risks and threats which may disrupt business operations or lead to unauthorized access of important proprietary and other restricted information are reduced to a manageable level.

SBA continues to have difficulty implementing an accounting system that can produce timely, accurate and complete financial information. In October 2001, SBA implemented the Joint Accounting and Administrative Management System (JAAMS) to replace a previous mainframe based accounting system. While JAAMS has some improved features over the previous system, it lacks the necessary functionality to fully support the U.S. Standard General Ledger and provide for integration of SBA's many disparate accounting and financial management systems. Due to budgetary constraints, SBA only implemented selected components of the new JAAMS system. We have noted other problems with JAAMS in an ongoing audit relating to its selection, development, implementation, and functionality. While it is premature to discuss the details of those issues at this time, we expect a final report to be issued on or about June 30, 2003, and will provide the Subcommittee a copy of the report at that time. SBA has recognized

that JAAMS does not fully meet its needs and is in the process of identifying a contractor that can host the system in a more efficient and effective environment.

SBA continues to rely heavily on its Financial Reporting Information System (FRIS). FRIS was developed in April 2000 to consolidate the results of various accounting systems to generate required financial statements. The system consists of a number of automated and manual processes, which are performed monthly to create a combined general ledger. By design, the combined general ledger data cannot be viewed directly in FRIS. To view this data, users download FRIS data and analyze it using common desktop applications, such as Microsoft Excel. SBA's inability to integrate information from its various financial management systems is a significant barrier to SBA's ability to produce timely, accurate, and complete financial information for program management and financial reporting.

SBA has the opportunity to ensure that its new systems will provide the agency with a better and more efficient financial reporting process as they address the challenges with its financial management systems. One of these challenges has been that SBA experiences problems with its financial reporting process which result in delays in the preparation of important financial data and clear and understandable audit trails. Many of these financial reporting problems are related to SBA's outdated and inflexible systems. SBA must improve or replace these systems. As it does, SBA will be in a position to reengineer and rebuild its financial reporting process and provide a single integrated system that allows financial records to be readily auditable, thereby providing SBA with real time data for meeting its needs.

Again, thank you for the opportunity to discuss these issues and I would be pleased to answer any questions.

^[1] 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 of 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.