



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

January 6, 2003

See Addressee List Attached

The purpose of this letter is to make you aware that the U.S. Small Business Administration (SBA) has been advised by its independent auditor, Cotton & Company LLP (Cotton), "...that SBA's financial statements for fiscal years 2000 and 2001, and Cotton & Company's audit reports thereon, should no longer be relied upon." According to Cotton, those financial statements may need "material adjustments for...disaster loans sold, disaster loan subsidy expense, and other directly-related accounts and footnotes corresponding with the SBA's disaster loan program."

Current senior SBA management (including the new Chief Financial Officer team put in place by Administrator Barreto) became aware of this issue and was working to solve it prior to receiving Cotton's determination. SBA is closely examining its disaster loan subsidy cost calculation and is making every effort to resolve the issue by the end of March 2003. In addition to employing all available SBA staff, the Agency is contracting for assistance from outside experts to review and verify SBA's analysis. It is also important to recognize that the issue is limited solely to the disaster loan subsidy estimates and SBA's disaster loan sale results.

In short, at issue is the consistency and precision of SBA's methods for valuing its disaster loans sold through the asset sales program and those that are retained in the Agency's loan portfolio. SBA followed all of the guidance available in developing its cost models and validated that the models were consistent and satisfactory prior to beginning the sales program. However, over time the results have revealed inconsistencies between the model used to determine the loan "value to government" for sale purposes and the model required for measuring the program's budget and accounting cost under the Federal Credit Reform Act. The model used for disaster loan sales has shown a substantial gain while the model used for budgeting purposes has shown a loss. In addition, the models appear to lack the precision necessary for accurately valuing the impact of the asset sales on the disaster loan portfolio.

It is important to note that SBA's FY 2000 and FY 2001 financial statements both disclosed the accounting book losses associated with SBA's disaster loan sales.

SBA IS AN EQUAL OPPORTUNITY EMPLOYER AND PROVIDER



Furthermore, throughout the asset sales program, SBA has followed the budgeting and accounting guidance issued by the Office of Management and Budget and Financial Accounting Standards Advisory Board and sought outside experts to help develop the program and cost models.

SBA is committed to resolve the discrepancies as quickly as possible. The impact of our efforts to revise our disaster loan cost models and the related accounting, however, may affect the required appropriations for SBA's disaster loan program and the cost of SBA's disaster loan asset sales. Revised financial statements and audit reports will be issued upon completion, if necessary and appropriate.

If you have any questions or require any additional information, please do not hesitate to contact me at 202-205 6449.

Sincerely,


Thomas Dumaresq
Chief Financial Officer

Addressees:

The Honorable Ernest Hollings
Chairman
Subcommittee on the Commerce,
Justice, State, The Judiciary, and
Related Agencies
Committee on Appropriations
United States Senate
Washington, DC 20510

The Honorable Judd Gregg
Ranking Member
Subcommittee on the Commerce,
Justice, State, The Judiciary, and
Related Agencies
Committee on Appropriations
United States Senate
Washington, DC 20510

The Honorable Donald Manzullo
Chairman
Committee on Small Business
House of Representative
Washington, DC 20515

The Honorable Nydia Velazquez
Ranking Member
Committee on Small Business
House of Representative
Washington, DC 20515

The Honorable Frank Wolf
Chairman
Subcommittee on the Commerce,
Justice, State, The Judiciary, and
Related Agencies
Committee on Appropriations
House of Representative
Washington, DC 20515

The Honorable Jose Serrano
Ranking Member
Subcommittee on the Commerce,
Justice, State, The Judiciary, and
Related Agencies
Committee on Appropriations
House of Representatives
Washington, DC 20515

The Honorable Christopher Bond
Ranking Member
Committee on Small Business and
Entrepreneurship
United States Senate
Washington, DC 20510

The Honorable John Kerry
Chairman
Committee on Small Business and
Entrepreneurship
United States Senate
Washington, DC 20510

The Honorable Mitchell E. Daniels
Director
Office of Management and Budget
Washington, DC 20503