AUDITOR'S OPINION

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INDEPENDENT AUDITOR'S REPORT

Inspector General
U.S. Small Business Administration

We audited the accompanying consolidated balance sheets of the U.S. Small Business Administration (SBA) as of September 30, 2005, and 2004 and the related consolidated statements of net cost, changes in net position, and financing; and combined statements of budgetary resources for the fiscal years 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 audits.

Except as explained in the following paragraph, we conducted our audits 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 audits 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 audits provide a reasonable basis for our opinions.

We were not able to satisfy ourselves as to the reasonableness of SBA's Fiscal Year (FY) 2004 subsidy reestimates pertaining to its Section 7(a), 504, Small Business Investment Company (SBIC) Participating Securities, and SBIC Debenture programs or to the value of SBA's Credit Program Receivables and Related Foreclosed Property, Net and Liabilities for Loan Guarantees, for these four programs. SBA forecasted its cash flow activity, including purchases for defaulted loans, recoveries on defaults, interest transactions on estimated cash balances, and other collection and disbursement activities for the second half of FY 2004. SBA consistently overestimated purchase activity, which in turn affected projections of other cash flow components. We were not able to determine the impact of this material overestimate of purchase activities on the reestimates of subsidy costs. In addition, the material overestimate of purchase activities directly affects SBA's valuation of its Credit Program Receivables and Related Foreclosed Property and Liabilities for Loan Guarantees, because SBA made adjustments between these two financial statement line items based on estimates of activity for the second half of FY 2004.

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 for the fiscal year then ended; and the combined statements of budgetary resources for the fiscal years ended September 30, 2005 and 2004, present fairly, in all material respects, the financial position of SBA as of September 30, 2005, and its net costs, changes in net position, and reconciliation of net costs to budgetary obligations for FY 2005 and its combined budgetary resources for FYs 2005 and 2004, in accordance with accounting principles generally accepted in the United States of America. Except for the effects of such adjustments, if any, that might have been determined to be necessary had we examined additional evidence related to the reestimates and financial statement line items explained in the previous paragraph, the consolidated balance sheet as of September 30, 2004, and statements of net cost, changes in net position, and financing for the period ended September 30, 2004, present fairly in all material respects, the financial position of SBA as of September 30, 2004, and the results of operations, changes in net position, and reconciliation of net costs to budgetary obligations for the period ended September 30, 2004.

At the end of FYs 2004 and 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 recent disasters.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Information presented in SBA's 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 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

Charles Hayward, CPA

November 15, 2005
Alexandria, Virginia