AUDITOR'S REPORT ON INTERNAL CONTROL

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL

Inspector General
U.S. Small Business Administration

We audited the 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 and have issued our report thereon, dated November 15, 2005. In that report, we issued an unqualified opinion on the Fiscal Year (FY) 2005 consolidated balance sheet; FY 2005 consolidated statements of net cost, changes in net position and financing; and FYs 2005 and 2004 combined statements of budgetary resources, and a qualified opinion on the FY 2004 consolidated balance sheet and consolidated statements of net cost, changes in net position, and financing.

Except as described in our November 15, 2005, Independent Auditor's Report, we conducted our audits in accordance with auditing standards generally accepted in the United States; 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*.

In planning and performing our work, we considered SBA's internal controls over financial reporting by obtaining an understanding of SBA's internal controls, determining if internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our audit procedures for the purpose of expressing our opinion on the financial statements. We limited internal control testing to those controls necessary to achieve objectives described in OMB Bulletin 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our work was not to provide assurance on internal controls. Consequently, we do not provide an opinion on internal control.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal controls over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants (AICPA) and OMB Bulletin 01-02, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal controls that, in our judgment, could adversely affect SBA's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more internal control components does not reduce to a relatively low level the 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. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

We noted matters involving internal control and its operation in the three areas, discussed below, that we consider to be reportable conditions:

1. Financial Management and Reporting Controls
2. Office of Disaster Assistance Administrative Expenditure Controls
3. Agency-Wide Information System Controls

We consider combined matters described in the first area to be a material weakness under standards established by AICPA, as discussed below.

1. FINANCIAL MANAGEMENT AND REPORTING CONTROLS

SBA made substantial and noteworthy improvements to its internal control and quality assurance procedures over financial management and reporting and was able to provide its FY 2005 interim and yearend financial statements, footnotes, supporting trial balances, and key audit deliverables in accordance with agreed-upon milestone dates. In addition, we noted much improvement in the quality, accuracy, and reliability of its financial reports and supporting documentation. SBA's financial management and reporting controls, however, continue to need improvement in the following areas:

- Funds Management
- Financial Accounting Transactions and Review of Account Balances
- Financial Statement Preparation and Quality Assurance

We discuss SBA's control weaknesses and areas needing improvement on the following pages under their respective captions.

Funds Management

We noted two areas of funds management that need improvement.

Loan Undelivered Orders

SBA continues to experience difficulty in monitoring disaster loan program undelivered orders. During FY 2005, SBA included a clause in its standard Loan Authorization and Agreement (LAA) stating that the loan must be disbursed within 6 months from the date on the LAA, or the loan will be cancelled. In addition, another clause requires the borrower to return the signed LAA and other loan closing documents within 2 months from the date on the LAA, or the loan will be cancelled. SBA stated that these administrative requirements are used to expedite the loan application and disbursement process.

During our interim testing at June 30, 2005, we noted instances in which the loan disbursement period had expired and other instances in which the loan should have been cancelled because the borrower had not returned the loan closing documents. Due to the significant increase in the volume of loan approval activity resulting from the hurricanes occurring at the end of FY 2004, SBA was not able to process loan cancellation or extension actions in a timely manner or monitor loan approval status to determine if cancellations or extensions were warranted. The Office of Chief Financial Officer (OCFO) was not aware of the LAA clauses, and its process to monitor undelivered orders was not effective in identifying unneeded undelivered orders in a timely manner.

OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, Section 20, Terms and Concepts, defines a valid obligation as a binding agreement that will result in immediate or future outlays.

In response to our interim testing results, OCFO initiated an effort to ensure that the Office of Disaster Assistance processed as many cancellation and extension actions as possible by September 30, 2005. In addition, SBA developed a $95.5 million estimate to decrease undelivered orders no longer needed because the disbursement period had expired. It also recorded a $64.1 million audit adjustment, based on our yearend testing, that disclosed instances in which the loan should have been cancelled because the borrower had not returned the signed loan closing documents within the 2-month period, and SBA had not extended the closing period.

Grant Undelivered Orders

During sample testing of administrative undelivered orders, we identified a $492,000 undelivered order for a grant obligated in FY 2001. The grant period of performance had expired in August 2003. To date, the grantee has not sought reimbursement for any incurred expenditures, and SBA's Office of Procurement and Grants Management (OPGM) has not been able to confirm whether the grantee has incurred expenditures. Accordingly, SBA could not provide support to substantiate the need for this undelivered order.

SBA does not have a practice in place to ensure that grants are closed out in a timely manner. OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-profit Organizations*, Subpart D, After the Award Requirements, Paragraph .71 (b), states that a recipient shall liquidate all obligations incurred under an award not later than 90 calendar days after the funding period ends or the completion date specified in the award unless an extension is authorized.

Recommendations

We recommend that the Chief Financial Officer (CFO):

1.A Continue to enhance SBA's undelivered order monitoring process to include coordination with the Office of Disaster Assistance to ensure that its monitoring takes into consideration processing backlogs and administrative practices having an effect on management's financial statement assertions.

1.B Coordinate with the Director, OPGM, to implement timely closeout procedures and strengthen monitoring procedures to ensure that all grant undelivered orders are supported by evidence as to their need and validity.

Financial Accounting Transactions and Review of Account Balances

SBA's internal control and quality assurance review processes continue to need improvement to ensure that accounting transactions are recorded accurately and in a timely manner and in accordance with accounting standards and guidance, and that resulting general ledger account balances are proper. We noted the following matters.

Improper Accounting Treatment

We noted the following instances in which SBA's accounting transactions were not recorded, processed, summarized, and reported in accordance with the United States Standard General Ledger (USSGL); OMB Circular A-136, *Financial Reporting Requirements*; and federal accounting standards. Substantial compliance with the USSGL at the transaction level, as mandated by the Federal Financial Management Improvement Act, requires that SBA record financial events consistent with applicable posting models/attributes reflected in the USSGL. Generally accepted accounting principles require that transactions be recorded based upon events that actually occurred.

1. ***Proforma Credit Reform Accounting Transactions:*** SBA used improper posting logic when calculating an automated journal entry recorded as part of its month-end credit reform accounting transactions. The general ledger account used to record downward subsidy reestimates was erroneously closed, resulting in a zero versus $58 million account balance. In addition, SBA's expense account used to record interest accumulation on the liability for loan guarantees was misstated by $58 million. These errors were evident in SBA's June 30, 2005, trial balance because a valid relationship among various general-ledger accounts did not exist. SBA did not identify these errors during its review of the June 30, 2005, trial balance and financial statements. The posting logic was corrected for the yearend financial statement submission.

2. ***Treasury Borrowing Transactions:*** SBA incorrectly characterized $30.5 million as a decrease in Borrowing Authority Converted to Cash rather than Actual Repayment of Debt. On January 12, 2005, SBA executed Standard Form (SF) 1151, Nonexpenditure Transfer Authorization, and converted $500.3 million of its total $800.3 million borrowing authority to cash. On January 31, OMB approved an SF 132, Apportionment and Reapportionment Schedule, to reduce SBA's borrowing authority to $469.8 million, which resulting in SBA borrowing more than its revised authority. On February 9, SBA executed an SF 1151 to decrease amounts previously converted to cash by $30.5 million. SBA stated that it needed less borrowing authority than was originally approved on its SF 132 because of the decrease between the FY 2004 financial statement downward reestimate and the revised reestimate calculated for the President's budget.

The USSGL has the following specific general ledger accounts and provides standard posting logic for recording borrowing transactions:

4141 – Current Year Borrowing Authority Realized
4143 – Decreases to Indefinite Borrowing Authority
4145 – Borrowing Authority Converted to Cash
4146 – Actual Repayment of Debt, Current-Year Authority
4148 – Resources Realized From Borrowing Authority

Because SBA had already converted $500.3 million of the approved borrowing authority to cash, it should have treated the $30.5 million difference as a repayment. As a result, SBA's Statement of Budgetary Resources, line items *Borrowing Authority* and *Permanently Not Available*, were each misstated by $30.5 million. SBA did not correct this error.

3. ***Improper Automated Reversing Entries:*** SBA erroneously reversed certain accounting entries that had been previously recorded as part of a point-break cleanup project. SBA uses point breaks to distinguish its various loan program account balances within its credit reform financing funds, which account for multiple loan programs within the same fund. As part of an automated routine, the cleanup entries were reversed in error, resulting in a $26.3 million understatement of allowance for subsidy and a $26.3 million overstatement of liability for loan guarantee account balances within SBA's Business Loan Guarantee Program financing fund. In addition, these and other general ledger account balances were allocated back to the wrong point break. This error was identified during our audit by inquiring about the significant balance in the liability for loan guarantee general ledger account related to small programs. This error was also evident by reviewing the liability for loan guarantee and allowance for subsidy balances at the point-break level, within the trial balance. They were not identified by SBA as part of its yearend quality review process. SBA corrected this error after we brought it to its attention.

4. ***Loan Loss Allowances in Liquidating Funds:*** SBA modified its posting logic for recording its loan loss allowance in one of its pre-credit reform liquidating funds, which resulted in improper general ledger account balances. SBA recorded an accounting entry in its Pollution Control Liquidating Fund to record the use of its appropriation to cover its loss allowance expense. SBA did not have sufficient unexpended appropriations to cover this expense, resulting in improper balances in several general ledger accounts. These improper account balances were evident in SBA's September 30, 2005, trial balance, but were not identified by SBA as part of its yearend quality review process. SBA made a $10.6 million audit adjustment to correct the improper account balances, and stated that it will revise its posting logic.

5. ***Budget Proforma Entries:*** SBA used an application called Budget Proforma to post automated journal entries to record budgetary accounting transactions in its Financial Reporting Information System (FRIS) consolidated general ledger based upon proprietary and memorandum transactions occurring in the Loan Accounting System (LAS). This application is necessary because LAS does not include budgetary accounting transactions. We noted instances of improper proforma posting logic for multiple transaction codes that resulted in the following misstatements on the combined statement of budgetary resources:

Line Item	Misstatement
Spending Authority from Offsetting Collections	$4.8 million understatement
Obligations Incurred	$12.1 million understatement
Recoveries of Prior-Year Obligations	$4.3 million understatement
Unobligated Balances	$3.0 million overstatement

SBA did not reconcile all of its proprietary and related budgetary account balances to ensure that the results of its budgetary proforma posting logic were correct, and its quality assurance process did not detect these account balance errors. In addition, SBA does not have a change control process in place to ensure that changes made to its budget proforma entries are appropriate and accurate. SBA corrected most of these misstatements for its yearend financial statements.

Improper Loan Approval Amount

SBA does not have effective controls to ensure that loan approval amounts are recorded correctly in LAS. We noted one instance in which a loan approval was entered as $15 million instead of $1.5 million. The maximum loan approval amount for each disaster loan is $1.5 million.

During FY 2005, SBA processed loan approvals in both its legacy Automated Loan Control System (ALCS) and its new Disaster Credit Management System (DCMS). SBA representatives stated that the loan in question was entered directly into LAS because it was processed in ALCS rather than DCMS. Once DCMS went live, ALCS no longer has an automatic interface with LAS, thus requiring data entry into both ALCS and LAS.

SBA further represented that ALCS and DCMS have system edits to prohibit entering loan approvals exceeding $1.5 million. A similar edit does not exist in LAS. SBA does not have an effective reconciliation process in place to ensure that ALCS and DCMS agree to LAS or a process to review LAS loan approvals for reasonableness.

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1) requires control activities to ensure that all transactions are completely and accurately recorded.

Untimely Charge-Off of Loans Receivable

SBA does not have sufficient controls in place to ensure that approved charge-off actions are recorded in the general ledger in a timely manner. During our testing of loans receivable balances at June 30, 2005, we noted that SBA approved a loan for charge-off in April but did not record the $610,523 charge-off action until September 2005, after we brought this to SBA's attention. We calculated a $34.5 million statistically-projected error in the population of loans receivable. Based on this projection, the valuation of the following two components of Footnote No. 6.D, Post-1992 Direct Loans and No. 6.J, Defaulted Guarantied Loans (Guarantied after FY 1991), were overstated:

- Loans Receivable, Gross
- Allowance for Subsidy Cost

SBA adjusted its September 30, 2005, financial statement footnote disclosures.

Generally accepted accounting principles require all economic events that have occurred to be recorded and reflected in the financial statements. In addition, GAO's *Standards for Internal Control in the Federal Government* require transactions to be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions.

Recommendations

We recommend that the CFO:

1.C Continue to develop, formalize, and document analytical procedures and quality assurance tools to conduct detailed reviews of general ledger account activity and balances to ensure that accounting events are appropriately recorded and reported in accordance with the USSGL, OMB Circular A-136, and federal accounting standards. In addition, we recommend that SBA accounting personnel continue to obtain training and develop skill sets to enable efficient, complete, and accurate analysis of detailed and summarized financial data.

1.D Implement a change control process requiring documentation, review and approval of all changes made to the automated proforma accounting entries recorded into FRIS.

1.E Coordinate with the Office of Disaster Assistance to implement a monthly reconciliation process to ensure data in both ALCS and DCMS agree to LAS and that data in LAS is accurate and complete.

1.F Coordinate with the Office of Financial Assistance to enhance existing controls over the loan charge-off process to ensure that loan charge-off actions are recorded in the general ledger in a timely manner.

Financial Statement Preparation and Quality Assurance

SBA made substantial improvements in its internal control and quality assurance processes designed to ensure that information provided in its interim and final financial statements, related footnote disclosures, and other sections of the Performance and Accountability Report is accurate, relevant, and useful and provided in a timely manner. We noted a few matters, however, in which SBA's footnotes did not contain essential disclosures required by generally accepted accounting principles.

Yearend Accrual to Decrease Undelivered Orders

SBA did not provide a footnote disclosure regarding its $95.5 million yearend accrual and $64.1 million audit adjustment necessary to decrease the Disaster Assistance Program undelivered order balance for loans that should have been cancelled as of yearend. This disclosure should have included the basis for making the accrual and audit adjustment and methodologies for determining estimated adjustments.

FY 2005 Subsidy Reestimates

SBA did not provide disclosures about its total subsidy-reestimate expense in Footnote No. 6, Section Q, Credit Program Subsidy Reestimates. SBA's FY 2005 subsidy-reestimate expense included two components:

- The deltas between the FY 2004 unfunded financial statement reestimates and amounts submitted for the FY 2006 President's budget and funded during FY 2005.
- The FY 2005 unfunded financial statement reestimates.

SBA only included the FY 2005 unfunded financial statement reestimates in footnote disclosures submitted with its September 30, 2005, financial statements. During audit planning, we had extensive discussions with SBA management regarding the treatment of the first item and agreed that it should be treated as FY 2005 subsidy-reestimate expense. Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*, and No. 18, *Amendments to Accounting Standards for Direct Loans and Loan Guarantees*, require entities to disclose interest rate and technical/default reestimates each year.

Reconciliation of Liability for Loan Guarantees

SBA's footnote disclosures submitted with its September 30, 2005, financial statements included a reconciliation schedule showing the beginning balance of the Liability for Loan Guarantees account, current-year activity by component, and ending balance. The reconciliation was not, however, accurate. It included $680.1 million of current-year activity in the component Amortization of Subsidy; only $50 million should have been included in this component. The difference should have been broken out into other components, such as fees received and claim payments made to lenders, in accordance with SFFAS No. 18. In addition, SBA included a component for Loans Written Off, which does not represent activity in the Liability for Loan Guarantees account.

Methodology and Assumptions for Calculating Reestimates

SBA's footnote disclosures submitted with its September 30, 2005, financial statements included a section in Footnote No. 6, Credit Program Receivables and Liability for Loan Guaranties [sic], that describes the valuation methodology for post-1991 direct loans and loan guarantees. This disclosure, however, omitted information regarding the time period for which actual cash flows were used and the periods for which estimated cash flows and cash balances were necessary to complete reestimates in a timely manner as of September 30, 2005.

Federal Financial Accounting and Auditing Technical Release 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, Paragraph 53, allows agencies to estimate current-year cash flows on a reasonable basis when computing reestimates as of the end of the fiscal year. It states, however, that an agency's policy should be disclosed in the footnotes to the financial statements.

Management Discussion and Analysis and Performance Measures

SBA's controls around the completeness, accuracy and timeliness of its Management Discussion and Analysis (MD&A) and Performance Measures portions of the Performance and Accountability Reports need improvement. SBA management submitted its second iteration of its MD&A and Performance Measures to us for review on November 8, 2005. The information was partially incomplete, however, and contained a variety of errors, inconsistencies, and ambiguities. SBA did not establish aggressive internal deadlines for the compilation of this information, and, therefore, had insufficient time to perform appropriate quality control procedures before submission to us for review.

Recommendation

We recommend that the CFO:

1.G Continue to review requirements and best practices for footnote disclosures and establish a process to ensure that required minimum disclosures and disclosures essential to the fair presentation of SBA's financial statements are provided. In addition, we recommend that SBA continue to require an independent review of its footnotes by an individual not involved in their preparation.

1.H Establish and meet an expedited timetable for preparing its MD&A and Performance Measures information, and develop a more rigorous quality assurance review process to ensure that information is accurate and complete by the time it is submitted to the auditors for review.

2. OFFICE OF DISASTER ASSISTANCE ADMINISTRATIVE EXPENDITURE CONTROLS

SBA did not maintain adequate controls at its Atlanta Disaster Area Office (DAO) over the time and attendance (T&A) reporting processes and Federal Express shipping processes during FY 2005. The T&A process is a critical input within the payroll cycle. In addition, SBA's policies and procedures for these processes were not documented. These processes have inherently high risk for abuse, which could result in improper payments or misuse of funds or assets. The processes are significantly vulnerable to abuse largely because:

- They are decentralized.
- SBA has added approximately 2,300 temporary personnel to administer disaster loans and is continuing to expand its resources.
- SBA's infrastructure of a full-time cadre of disaster assistance personnel is currently at capacity as a result of the significant number and severity of disasters occurring during FYs 2004 and 2005.

Time and Attendance Reporting

During our tests of controls, we noted that the DAO accepted either a sign-in sheet or a daily summary spreadsheet in lieu of employee timecards. These were submitted to the DAO by disaster field offices daily for compilation and input into the System for Time and Attendance Reporting (STAR) at the end of the pay period. This system generates a STAR report, which, based on standard operating procedures, should be reviewed for accuracy and signed by employees.

The STAR reports for 30 of the 45 sampled transactions contained a stamp of "Unavailable for Signature" in place of the required employee signature. This was often found in combination with missing employee signature on the timecard (in the form of either a sign-in sheet or summary spreadsheet). When the employee signature was missing from both the STAR report and timecard, the Atlanta DAO had no assurance that the employee had certified his/her T&A for that pay period. In addition, sign-in sheets or summary spreadsheets were missing for 4 of the 45 sample transactions.

Sign-in sheets or summary spreadsheets for 9 of 45 sampled transactions were not properly approved by the employee supervisor. During the period of peak activity in FY 2005, the Atlanta DAO permitted the disaster field offices to submit employee T&A using typed daily summary spreadsheets instead of submitting the individual employee sign-in sheets, which employees frequently sent by facsimile while on travel. Standard practice was for the supervisor to sign only the top page of the 20- to 30-page package of daily summary spreadsheets.

GAO's T&A guide, *Maintaining Effective Control over Employee Time and Attendance Reporting* (GAO-03-352G), page 5, states:

> *Supervisors and timekeepers should be aware of the work time and absence of employees for whom they are responsible. To help ensure proper recording of T&A information, completed T&A records should be reviewed and approved on an appropriate basis by the supervisor (or other equivalent official).*

In addition, GAO's *Standards for Internal Control in the Federal Government*, page 15, states:

> *Internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination.*

Federal Express Shipping Expenses

During our tests of controls, we noted that the Atlanta DAO was not able to validate electronic invoices for Federal Express shipping charges incurred by DAO and disaster field offices, and therefore, could not complete an effective review and approval process of amounts invoiced. Federal Express submits an electronic data file that is uploaded for payment into the Oracle accounting system. A DAO employee performed a comparison of the file uploaded into Oracle to an online Federal Express bill. This is not, however, an effective control to ensure the propriety and accuracy of amounts invoiced. DAO did not retain copies of Federal Express airbills used during the period or require field offices to maintain shipment logs that could be used for validating invoices.

In addition, DAO did not have controls in place to account for and safeguard unused airbills or airbills distributed to disaster field offices.

GAO's *Standards for Internal Control in the Federal Government*, page 15, states that control activities help to ensure that all transactions are completely and accurately recorded. Page 14 also states that an agency must establish physical control to secure and safeguard vulnerable assets.

Recommendation

2. We recommend that the CFO coordinate with the Office of Disaster Assistance to establish policies and procedures for processing T&A reports and Federal Express shipping charges that are effective under the current disaster assistance office environment and develop appropriate internal controls to minimize the risk of improper payment, abuse, or misuse of assets.

3. AGENCY-WIDE INFORMATION SYSTEMS CONTROLS

SBA continued to improve internal control over its information system environment during FY 2005 in certain areas. Specifically, SBA:

- Upgraded the Joint Accounting and Administrative Management System (JAAMS) database and application to include stronger logical access controls and auditing capabilities.
- Enhanced controls over its network by adding additional Intrusion Detection System sensors to the internal network.

These accomplishments were, however, overshadowed by the following weaknesses:

- Management did not take appropriate action to correct known prior weaknesses in a timely manner.
- Controls over administering network accounts remained weak.
- Controls over logging and monitoring activities at the network and application levels remained weak.
- Controls were not adequate to ensure that SBA's IT security awareness program included initial training for all new employees, contractors, and users and periodic refresher training thereafter.
- Independent risk assessments were not performed and documented when systems, facilities, or other major conditions changed. JAAMS did not undergo the recertification and accreditation process, which would include completion of a risk assessment, before being placed back into production after the upgrade to Oracle 11i.
- Controls were not adequate to ensure that Eagan mainframe terminals were automatically logged off after a period of inactivity.
- Management did not take appropriate action to ensure duties within the DCMS were adequately segregated.
- Controls were not adequate to ensure that FRIS backup files were created on a prescribed basis and rotated offsite often enough to avoid disruption if current files were lost or damaged.

SBA's Office of Inspector General will issue a separate report titled *Audit of SBA's Information System Controls, FY 2005*, which will provide additional detail of our scope of work, findings, and recommendations in the following categories:

General Control Categories

- Entity-wide security program control
- Access control
- Application software development and program change control
- System software control

- Segregation-of-duty control
- Service continuity control

Application Control Categories (Oracle administrative accounting system)

- Authorization control
- Completeness control
- Integrity of processing and data file control
- Accuracy control

STATUS OF PRIOR-YEAR FINDINGS

We provide the status of reportable conditions for the prior-year audit in the appendix.

OTHER MATTERS

We considered SBA's internal control over required supplementary stewardship information by obtaining an understanding of SBA's internal control, determining if internal control had been placed in operation, assessing control risk, and performing tests of control as required by OMB Bulletin 01-02. Our objectives were not to provide assurance on internal control; accordingly, we do not provide an opinion on such control.

With respect to internal control related to SBA performance measures, we obtained an understanding of the design of significant internal control relating to existence and completeness assertions, as required by OMB Bulletin 01-02. Based our limited tests, we concluded that SBA's control over performance measures did not ensure accuracy and reliability, as required by OMB Circular A-136 and prevailing accounting standards. Our procedures were not designed to provide assurance on internal control over reported performance measures; accordingly, we do not provide an opinion on such control.

We noted certain other matters involving internal control that we will report to SBA management in a separate letter.

This report is intended solely for the information and use of SBA management, OMB, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

COTTON & COMPANY LLP

Chris Hayward

Charles Hayward, CPA

November 15, 2005
Alexandria, Virginia

APPENDIX

STATUS OF FY 2004 AUDIT FINDINGS

Description	Recommendation	Status
Financial Management and Reporting Controls	We recommend that the CFO continue to develop new quality assurance review procedures and enhance existing procedures to ensure that all financial transactions are properly reflected in the financial statements, and that footnote disclosures are accurate and logical and contain comprehensive information essential to the fair presentation of SBA's financial condition. We recommend performing additional analytical procedures monthly or quarterly, developing and completing additional checklists, performing studies of best practices, having an independent review conducted by individuals not associated with SBA's daily financial management and reporting responsibilities, such as an outside peer reviewer. (1A)	Improvements Noted; Modified Repeat Condition
	We recommend that the CFO continue to develop new quality control procedures and tools and enhance existing procedures and tools to prevent and detect errors or misstatements in amounts recorded in SBA's financial accounting systems or in the accounting treatment and presentation of economic events and to ensure that underlying transactions in the financial statements are accurate, complete, and presented in conformity with federal accounting standards and principles. We recommend that procedures be included for assigning sufficient human resources to perform financial management and quality assurance functions, providing appropriate training and ensuring knowledge transfer among accountants and analysts responsible for recording, reviewing, and approving accounting transactions, and developing appropriate skill sets to enable efficient, complete, and accurate analysis of detailed and summarized financial data. (1B)	Improvements Noted; Modified Repeat Condition
	Continue to refine the review process implemented during FY 2004 to identify invalid or unneeded Disaster Program undelivered orders and develop a similar review process for the Business Direct Loan Program. (1C)	Modified Repeat Condition
	Coordinate with the Director of OPGM to ensure that a written grant amendment is issued to extend the performance period for the grant identified above. (1D)	Implemented
	Coordinate with OPGM to implement a control to ensure that all future administrative undelivered orders are supported by valid obligating documents. (1E)	Modified Repeat Condition

Description	Recommendation	Status
	We recommend that the CFO implement procedures to require senior management review and approval of all obligation activity in expired funds and maintain sufficient documentation to substantiate its validity and compliance with OMB Circular A-11 and the Anti-Deficiency Act. (1F)	Implemented
	We recommend that the CFO strengthen internal controls to ensure that all requisite trading partner data are fully captured in SBA's accounting system, and that all trading partners are contacted quarterly to reconcile differences. In addition, we recommend that CFO seek assistance from OMB to enhance cooperation from non-responsive trading partners. (1G)	Implemented
Credit Reform Controls	We recommend that the CFO investigate the feasibility of enhancing the agency's accounting data structure to include a program code within the financial reporting information system and update this new program code data element for existing financial records. If this is not feasible, we recommend that the CFO maintain an authoritative crosswalk between point breaks and programs and develop procedures to ensure accurate and consistent summarization of data at the program level. (2A)	Implemented
	We recommend that CFO continue to improve its quality assurance and review process to ensure that historical accounting data used in cash flow models are complete and accurate based on underlying accounting records. (2B)	Implemented
	We recommend that the CFO develop and implement procedures for ensuring consistency and a clear audit trail between the discount rate resulting from the interest rate re-estimate and discount rates used for both subsequent technical re-estimates and calculations of interest income and expense transactions with Treasury. (2C)	Implemented
	We recommend that CFO continue to refine its quality review procedures to ensure that it correctly applies procedures necessitated by the use of the balances approach, if restatements are required in the future. (2D)	Implemented
	We recommend that the CFO continue to develop and refine existing analytical tools and analyses to substantiate the reasonableness of forecasted cash flows and subsidy re-estimates produced by its models, including analytical analyses of actual plus projected cash flows over the cohort life, statistical methods for establishing the degree of uncertainty inherent in the subsidy models, and procedures	Implemented

Description	Recommendation	Status
	to determine model quality. (2E)	
	We recommend that the CFO develop and test an approach for quantifying the impact on re-estimates and account balances caused by differences between actual and projected cash flows if SBA continues to use interim data for computing its re-estimates. (2F)	Implemented
Agency-Wide Information Systems Control	Please refer to SBA's OIG report titled *Audit of SBA's Information System Controls, FY 2004.*	Unresolved. Updated in SBA's OIG report titled *Audit of SBA's Information System Controls, FY 2005.*