



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

**OFFICE OF
INSPECTOR GENERAL**

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| AUDIT REPORT |
| Issue Date: February 29, 2000 |
| Number: 0-06 |

To: Joseph P. Loddo, Chief Financial Officer

From: Robert G. Seabrooks, Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 1999 Financial Statements

Pursuant to the Chief Financial Officers Act of 1990, attached is the Independent Auditor's Management Letter, issued by Cotton & Company, LLP. They concluded that the financial statements present fairly, in all material respects, the financial position of SBA as of September 30, 1999, and its net costs, changes in net position, budgetary resources, and financing for the year then ended in conformity with generally accepted accounting principles for the Federal government.

The section on SBA's internal control structure discusses problems related to (1) the financial reporting process and (2) information systems control. The section on compliance with laws and regulations indicates SBA's financial management system was not in compliance with the requirements referred to in the Federal Financial Management Improvement Act of 1996. The report also includes a disclaimer on information in the agency's Accountability Report that was not subject to audit procedures. The auditors also noted other management and internal control issues that will be communicated in a separate management letter.

SBA management stated that it is committed to maintaining an unqualified opinion on its financial statements and to making the improvements needed to remove the internal control findings. **The finding in this report are based on the auditors' conclusions, and the report recommendations are subject to review, management decision and action by your office, in accordance with existing Agency procedures for follow-up and resolution.** Please provide your proposed management decision on SBA Form 1824, Recommendation Action Sheet, also attached, within 30 days.

Should you or your staff have any questions, please contact me or John McCreary, Audit Manager (202) 205-7204.

Attachments

COTTON & COMPANY LLP

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February 14, 2000

Inspector General
U.S. Small Business Administration

Independent Auditors' Report on Financial Statements

We have audited the Balance Sheet and Related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing of the U.S. Small Business Administration (SBA) as of and for the year ended September 30, 1999. These financial statements are the responsibility of SBA management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 98-08, Audit Requirements of Federal Financial Statements, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures relating to 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 audit provides a reasonable basis for our opinion.


In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 1999, and its net costs, changes in net position, budgetary resources, and financing for the year then ended in conformity with generally accepted accounting principles for the Federal government.

The Required Supplementary Stewardship Information is not a required part of the basic financial statements, but is supplementary information required by OMB Bulletin 97-01, Form and Content of Federal Agency Financial Statements, as amended. We applied certain limited procedures that consisted principally of inquiries of management regarding methods of measurement and presentation of supplementary information. We did not, however, audit the information and express no opinion on it.

The information in the Agency Overview and SBA Program Description and Analysis sections is also not a required part of the basic financial statements, but is supplementary information required by OMB Bulletin No. 97-01, as amended. We reviewed this information to determine if it is materially inconsistent with the financial statements. In our tests, we identified no inconsistencies. We did not, however, audit the Agency Overview and SBA Program Description and Analysis sections and, accordingly, express no opinion on them.

In accordance with *Government Auditing Standards*, we have also issued reports dated February 14, 2000, on our consideration of SBA's internal control and on its compliance with certain provisions of laws and regulations.

COTTON & COMPANY LLP

By 
Matthew H. Johnson, CPA, CGFM

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February 14, 2000

Inspector General
United States Small Business Administration

Independent Auditors' Report on Internal Control

We have audited the Balance Sheet of the U.S. Small Business Administration (SBA) as of September 30, 1999, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources and Financing for the year ended September 30, 1999, and have issued our report thereon dated February 14, 2000. We conducted our audit in accordance with generally accepted auditing standards; standards applicable to financial audits contained in *Government Auditing Standards* (1999 revision), issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 98-08, Audit Requirements for Federal Financial Statements, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit, we considered SBA's internal control over financial reporting by obtaining an understanding of the agency's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls to determine our auditing procedures for the purpose of expressing an opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin 98-08, as amended. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

Under standards issued by the American Institute of Certified Public Accountants, 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 an agency's ability to record, process, summarize, and report financial data consistent with management assertions in the financial statements. 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 the risk that misstatements in amount that would be material in relation to the financial statement 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 controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed in the following paragraphs involving the internal control structure and its operation that we consider to be reportable conditions.

1. FINANCIAL REPORTING PROCESS

SBA's financial reporting process did not ensure that its financial statements were free of material misstatements. As a result of our Fiscal Year (FY) 1998 audit, we reported that SBA's financial reporting process was a material weakness and made three recommendations:

- SBA develop a detailed comprehensive plan for preparing the FY 1999 financial statement report.
- SBA obtain the resources necessary to ensure accurate and timely preparation of FY 1999 financial statements including adequate resources to conduct a thorough quality control review of the financial statements prior to submission to the auditors.
- SBA obtain training for all staff assuming financial reporting responsibilities.

SBA took several steps to respond to our recommendations. We found, however, that overall the quality control process was not adequate, and staff and management required additional training on both accounting requirements and SBA's processes. Several other factors that contributed to this weakness are discussed below.

During FY 1999, SBA moved its primary financial reporting responsibilities to the Denver Finance Center. Thus, staff had little or no experience with SBA's financial reporting process. This change by itself created obvious challenges which were magnified by the overly complex manual financial reporting process. Specifically, the financial reporting for the agency's loan and loan guarantee programs is performed by its Loan Accounting System (LAS) and an array of "off-line" general ledgers. LAS maintains records and balances for both loan guarantees and direct loans, but it does not provide complete general ledger accounting records. For the general ledger accounting performed through LAS, LAS produces an "on-line" trial balance (MARS-317) report.

Because LAS does not fully meet the agency's general ledger requirements, SBA uses Excel spreadsheets to maintain off-line general ledgers. For FY 1999, SBA used 68 separate Excel spreadsheets (one spreadsheet for each fund, applicable cohort year, and appropriation) to maintain its off-line general ledgers. Transactions were entered on the off-line general ledgers through the use of journal vouchers (JVs). Fund Accountants, who were assigned responsibilities by loan fund, prepared the JVs, and an accounting technician entered the JV into the applicable Excel spreadsheet through the use of "T" accounts. During FY 1999, over 3,200 JVs were prepared and entered into the off-line general ledgers. At a minimum, each JV affects two account balances and frequently more than six. The "T" accounts are summarized and produce off-line trial balances.

The on-line trial balance and the off-line trial balance data were then manually entered onto another Excel spreadsheet to get a "combined" trial balance. This combining process was used for all of SBA's loan funds, except for its Program Funds. Because of the considerable number of separate off-line general ledgers in this fund, an additional iteration of spreadsheets is completed prior to the combined trial balance. The Program Fund for business loans, for example, required 22 separate off-line general ledgers.

Combined trial balances for each of the funds were consolidated through an automated process, to produce a "consolidated" trial balance. This consolidated trial balance was then used to prepare the agency's financial statements. The statements were not, however, prepared in an automated manner; the amounts were manually entered from the consolidated trial balance to the financial statements.

Inherent to any manual processes is the susceptibility for errors. As described above, SBA is heavily reliant upon manual processes. Although automating and minimizing manual processes is preferred, the current process, nevertheless, is manual and the risks inherent to this process must be mitigated through compensating controls. The typical compensating controls that should be present include:

- Documentation of processes and procedures for activities, such as preparing journal vouchers, calculating loss allowances, preparing and updating trial balances, and preparing financial statements and footnotes.
- Trained and knowledgeable management and staff.
- Management reviews of staff performance.
- Timely and complete quality review process.

In conducting our FY 1999 audit, we found that the above control activities were not in place for SBA's financial reporting process. Because they were not in place, errors occurred, some of which we highlight below.

- On the Statement of Financial Position and the Statement of Changes in Net Position, SBA had incorrectly classified \$139 million as Unexpended Appropriation instead of Cumulative Results of Operations.
- In entering the adjustment for the FY 1999 subsidy re-estimate, SBA did not properly account for prior-year re-estimates. As a result, an adjustment of approximately \$97 million was required.
- In determining year-end adjustments for its allowance accounts, we found that SBA adjusted its balances incorrectly by over \$30 million.
- On the consolidated Statement of Changes in Net Position, SBA incorrectly reported \$16.5 million as Other Financing Sources.
- SBA reported asset accounts (advances and accounts receivable) with over \$25 million in credit balances. Asset accounts normally have debit balances, and SBA could not adequately explain why these accounts had credit balances.
- On numerous occasions, amounts entered onto the combined trial balance did not agree with the underlying on-line and off-line trial balances. We found, for example, instances in which amounts from an incorrect column on the off-line trial balance were entered on the combined trial balance. We also found instances where the underlying trial balances were known to contain errors. These errors were corrected on the Combined trial balances but not on the underlying records.

We recommend that the Chief Financial Officer (CFO):

- Ensure that adequate resources are provided to implement an effective internal control system over the financial reporting processes.
- Provide additional training to both staff and management responsible for the financial reporting process.
- Develop detailed procedures for activities, such as preparing journal vouchers, calculating loss allowances, preparing and updating trial balances, and preparing financial statements and footnotes.
- Require each fund accountant to process and maintain trial balances and reports in a consistent manner.
- Reduce the manual re-keying of data through automation. To the extent possible, automate the roll-up of data from the off-line and on-line trial balances to the combined and consolidated trial balances and the resulting financial statements.

2. INFORMATION SYSTEMS

SBA took significant and positive steps in FY 1999 toward improving general controls over its information systems. General controls are the policies and procedures that apply to all or a large segment of an entity's information systems and help ensure their proper operation. Even with FY 1999 improvements, significant general controls deficiencies continued to exist, resulting in a continuation of a material weakness, also reported as part of the FY 1998 audit. SBA's Office of Inspector General will issue a separate report titled Audit of SBA's Information Systems Controls, which will detail our findings and recommendations in this area. We recommend that SBA continue its efforts toward implementing an agency-wide information systems security program.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control structure over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We considered the above reportable conditions to be material weaknesses.


In addition, we considered SBA's internal controls over Required Supplementary Stewardship Information by obtaining an understanding of SBA's internal controls, determining whether those internal controls had been placed in operation, assessing control risk, and performing tests of controls as required by OMB Bulletin No. 98-08, as amended. Our procedures were not designed to provide assurance on these internal controls, and, accordingly, we do not express such an opinion.

Finally, with respect to internal controls related to performance measures reported in the sections titled Agency Overview and SBA Program Description and Analysis, we obtained an understanding of the design of significant internal controls related to existence and completeness assertions as required by OMB Bulletin No. 98-08, as amended. Our procedures were not designed to provide assurance on internal controls over reported performance measures, and, accordingly, we do not express such an opinion.

We also noted other matters involving internal controls over financial reporting and its operation that we consider nonreportable conditions. We will communicate these matters to 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. We caution that misstatements, losses, and noncompliance may occur and not be detected by the testing performed and that such testing may not be sufficient for other purposes.

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February 14, 2000

Inspector General
United States Small Business Administration

Independent Auditors' Report on Compliance with Laws and Regulations

We have audited the Balance Sheet of the U.S. Small Business Administration (SBA) as of September 30, 1999, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing for the year ended September 30, 1999, and have issued our report thereon dated February 14, 2000. We conducted our audit in accordance with generally accepted auditing standards; standards applicable to financial audits contained in *Government Auditing Standards* (1999 revision), issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 98-08, Audit Requirements for Federal Financial Statements, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

SBA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of SBA's compliance with certain provisions of laws and regulations. Noncompliance with these laws and regulations could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 98-08, as amended, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to SBA.

The results of our tests of compliance disclosed no instances of noncompliance with other laws and regulations discussed in the preceding paragraph, exclusive of FFMIA, which are required to be reported under *Government Auditing Standards* or OMB Bulletin 98-08.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with Federal financial management system requirements, Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08.

Test results disclosed instances, described below, in which the agency's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.


1. **Federal Financial Management Systems Requirements:** In conducting our audit, we found that security over financial information was not provided in accordance with OMB Circular A-130, Management of Federal Information Resources, Appendix 3, Security of Federal Automatic Information Systems.
2. **Federal Accounting Standards:** Test results disclosed that SBA's financial management systems did not substantially comply with Federal accounting standards criterion, because the audit disclosed a material weakness in internal control relating to SBA's ability to prepare auditable statements and related disclosures.
3. **United States Government Standard General Ledger (SGL) at the Transaction Level:** SBA's financial systems did not capture information using the same description and posting rules contained in the SGL. Specifically, SBA's loan accounting system does not adequately capture budgetary data in a manner that facilitates preparation of financial statements and reports. As a result, SBA developed a manual process whereby it develops balances for budgetary accounts based on summaries of various transactions. This manual process, while effective for preparing required reports, does not comply with SGL requirements at the transaction level.

For information required by OMB Bulletin No. 98-08 with respect to these noncompliance matters, please refer to the accompanying Independent Auditor's Report on Internal Control.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

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. We caution that noncompliance may occur and not be detected by the tests performed and that such testing may not be sufficient for other purposes.

COTTON & COMPANY LLP

By. 
Matthew H. Johnson, CPA, CGFM

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