

**AUDIT OF SBA'S FY 2003
FINANCIAL STATEMENTS
AUDIT REPORT NUMBER 4-10
JANUARY 30, 2004**

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U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

AUDIT REPORT

Issue Date: January 30, 2004

Number: 4-10

To: Hector V. Barreto, Administrator
Tom Dumaresq, Chief Financial Officer

/S/ original signed

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

Subject: Audit of SBA's FY 2003 Financial Statements

Pursuant to the Chief Financial Officers Act of 1990, attached are the Independent Auditor's Report and accompanying reports on internal control and compliance with laws and regulations issued by Cotton & Company LLP. The auditors disclaimed an opinion on the FY 2003 and the restated FY 2002 financial statements. The auditors noted that the scope of their examination was limited because SBA was late in completing development and testing of certain credit program subsidy models, completing its credit program subsidy reestimates, and preparing its financial statements. As a result, the auditors were unable to apply all necessary auditing procedures or dispose of reservations identified during their work which prevented them from expressing an opinion on the financial statements. In addition to the scope limitation, the auditors expressed reservations regarding (1) the secondary market guarantee subsidy cost and liability, (2) credit programs receivables in guaranteed loan programs, (3) restated gain or loss on asset sales, (4) footnote disclosures, (5) liabilities for loan guarantees and credit program receivables and related foreclosed property, net, (6) adjustment to interest expense on borrowing, net, and (7) Small Business Investment Company Participating Securities reestimates.

The Independent Auditor's Report on Internal Control discusses three matters considered to be reportable conditions, two of which the auditors considered to be material weaknesses. The two materials weaknesses were noted by the auditors in the following areas: (1) SBA's credit reform controls, and (2) SBA's financial management and reporting controls. The reportable condition noted that SBA's information system controls continue to contain areas for improvements. These reportable conditions are further described in the Independent Auditor's Report on Internal Control. The auditors found other management and internal control issues that will be communicated in a separate management letter.

The Independent Auditor's Report on Compliance with Laws and Regulations disclosed that SBA was not in substantial compliance with the Federal Financial Management Improvement Act (FFMIA) because of the following: (1) SBA's financial management systems did not substantially comply with FFMIA; (2) SBA is not in substantial compliance with federal accounting standards; and (3) SBA is not in substantial compliance with the United States Standard General Ledger at the transaction level. As discussed in more detail in the Independent Auditor's Report on Internal Control, the auditors also noted instances of noncompliance with the Prompt Pay Act and noted limitations on the scope of their examination which prevented them from completing their testing of SBA's compliance with the Antideficiency Act.

The Chief Financial Officer (CFO) generally agreed with the auditor's findings and recommendations. He acknowledged that SBA did not meet key milestone dates and accepts responsibility for not providing sufficient time for the auditor to complete its work. He said that the ambitious schedule they developed to develop new subsidy models required more time than was available which left insufficient time for SBA to complete its quality review process prior to the completion of the financial statements which SBA submitted to the auditor on December 22, 2003. The CFO said that SBA made changes to their financial statements based on auditor input and he feels that the revised financial statements provided to the auditor on January 16, 2004 provide a fair representation of SBA's financial condition. However, the CFO acknowledges that the auditor had insufficient time to complete its review of the revised statements in the time available.

The findings in this report are based on the auditor's 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 us your proposed management decisions within 30 days on the attached SBA Form 1824, Recommendation Action Sheet.

Should you or your staff have any questions, please contact Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-7577.

Attachments

AUDIT OF SBA'S FY 2003 FINANCIAL STATEMENTS

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COTTON & COMPANY LLP

auditors • advisors

DAVID L. COTTON, CPA, CFE, CGFM • CHARLES HAYWARD, CPA, CFE, CISA • MICHAEL W. GILLESPIE, CPA, CFE • CATHERINE L. NOCERA, CPA, CISA
MATTHEW H. JOHNSON, CPA, CISA, CGFM • SAM HADLEY, CPA, CGFM • COLETTE Y. WILSON, CPA • ALAN ROSENTHAL, CPA • LOREN SCHWARTZ, CPA, CISA

Independent Auditor's Report

Inspector General
U.S. Small Business Administration

We were engaged to audit the accompanying consolidated balance sheets of the U.S. Small Business Administration (SBA) as of September 30, 2003, and 2002; related consolidated statements of net cost, changes in net position, and financing; and combined statements of budgetary resources for the years then ended. These financial statements are the responsibility of SBA management.

The scope of our examination was limited, because SBA was late in completing development and testing of certain credit program subsidy models, completing its credit program subsidy re-estimates, and preparing its financial statements. As a result, adequate time did not remain to obtain sufficient, competent, evidential matter; apply auditing procedures necessary to conduct an audit in accordance with generally accepted auditing standards and generally accepted government auditing standards; and form a reasonable basis for an opinion on the financial statements by the January 30, 2004, reporting deadline specified by the Office of Management and Budget (OMB) Memorandum titled Fiscal Year (FY) 2003 Financial and Performance Reporting (August 13, 2003.)

Because we were unable to apply all necessary auditing procedures to conduct an audit in accordance with generally accepted auditing standards or dispose of reservations identified during our work, we are not able to express, and we do not express, an opinion on SBA's FY 2003 and 2002 financial statements.

Cotton & Company identified certain matters causing us reservations regarding whether particular financial statement amounts and disclosures are presented fairly in accordance with prevailing federal accounting standards. Because of the time delays discussed above, we were not able to apply all of the auditing procedures that may have allowed us to resolve our reservations before the due date specified in OMB's August 13, 2003, memorandum. These reservations are discussed below.

Secondary Market Guarantee Subsidy Cost and Liability

During FY 2003, SBA developed a model to forecast the residual liability or asset in the Master Reserve Fund maintained by SBA's fiscal and transfer agent to facilitate operation of the Section 7(a) secondary market guarantee program. As a result of both SBA's internal testing and independent verification and validation of the model, the original estimated liability was materially revised several times, indicating high control risk regarding this estimate. In addition, SBA did not have sufficient time to complete its model documentation or perform and document an analysis to ensure the completeness and accuracy of data used in the model, which is provided by its fiscal and transfer agent. Model documentation and the data analysis are required evidential audit matter to support the estimate. As a result, we were not able to satisfy ourselves regarding the estimate and related liability for the secondary market guarantee program.



Credit Program Receivables in Guaranteed Loan Programs

SBA records an adjusting journal entry to realign its balances between the Liability for Loan Guarantees and the Allowance for Subsidy accounts to properly value its credit program receivables on defaulted guaranteed loans. We noted problems with the quality of the analysis used to determine the realignment entry. In response to our concerns, SBA revised its analysis and posted a revised realignment entry. Time limitations precluded us from reviewing SBA's revised analysis and accounting entry.

SBA did not record a required adjusting journal entry to realign its balances in the Liability for Loan Guarantees and Allowance for Subsidy accounts related to prioritized payments made to investors under the Small Business Investment Company (SBIC), Participating Securities program, before issuing its draft financial statements on December 22, 2003. At our request, SBA estimated the realignment amount and recorded an adjusting entry for its final financial statements; time limitations precluded us from reviewing it.

Restated Gain or Loss on Asset Sales

SBA conducted an analysis to calculate revised gain/loss on loans sold during FYs 1999 through 2003. SBA computed a revised net book value using various assumptions depending on the program and available data. The revised net book value was subtracted from the loan sale proceeds to calculate a revised gain/loss. We noted concerns with the data used in this analysis for the Section 7(a) and 504 guaranteed business loan programs and communicated our concerns to management. SBA did not respond to our concerns in time for us to complete our review of the revised gain/loss calculation. SBA disclosed a \$163 million and \$126 million change between previously reported losses and revised gains in its Section 7(a) and 504 credit programs.

Footnote Disclosures

SBA provided Cotton & Company with a draft of its financial statements on December 22, 2003; these statements and related footnote disclosures contained substantial errors, omissions, inconsistencies, and other inadequacies. Although SBA addressed some of our concerns, we continue to have reservations regarding footnote disclosures, particularly the disclosures related to subsidy re-estimates, asset sales, and adjustments to the restated FY 2002 financial statements. We did not have sufficient time to satisfy ourselves as to the accuracy, completeness, and adequacy of the disclosures.

We noted three additional matters causing us reservations regarding the fair presentation of SBA's financial statements.

Liabilities for Loan Guarantees and Credit Program Receivables and Related Foreclosed Property, Net

SBA made noteworthy strides toward accomplishing its objectives to develop new or enhance existing models to improve the reasonableness of its credit program estimates during FY 2003. SBA was not, however, able to complete an analysis to ensure that its financing fund account balances are fairly stated.

We noted that SBA's general ledger account balances comprising Liabilities for Loan Guarantees and Credit Program Receivables and Related Foreclosed Property, Net, were not in alignment with the present value of forecasted cash flows produced by the credit program subsidy models. Our preliminary analysis shows substantial differences in the Small Business Investment Company Participating Securities, Section 7(a) and 504 Business, and Disaster Loan programs. In addition, account balances for some cohorts are not plausible based on re-estimated subsidy rates and the nature of the programs.

Adjustment to Interest Expense on Borrowing, Net

SBA performed an analysis of its financing account balances for the Disaster Loan program and found an inconsistency between the interest rate(s) used to discount cash flow estimates (used for subsidy rates and re-estimates) and the interest rate(s) used to compute interest earnings on cash balances and interest expense on borrowings from Treasury. The equality of these rates is required specifically in the Federal Credit Reform Act, as amended, and is fundamental to achieving the proper balance in the financing fund. This stems from using different tools to discount cash-flow estimates and calculate interest transactions with Treasury; each tool computes the cohort weighted average rate(s) using different schemes.

SBA determined that interest expense paid to Treasury (net of interest earned on uninvested funds) since the inception of credit reform, has been consistently overstated; SBA estimated that the excess interest expense compounded to account for lost interest earnings on uninvested funds was \$128.7 million. SBA treated this overstatement as a current-year re-estimate, which overstates the cost of the Disaster assistance program, rather than as a decrease in current and prior year interest expense transactions with Treasury. As a result, subsidy costs were overstated in FY 2003, and interest expense for FY 2003 and prior years was overstated.

SBIC Participating Securities Re-estimates

SBA made enhancements to its SBIC Participating Securities credit subsidy model, which uses both historical data and expert opinion to estimate program subsidy cost. SBA increased its default assumptions (on guaranteed securities) and decreased its recovery assumptions based on a portfolio analysis and an increase in actual defaults resulting in part from the substantial economic downturn experienced by the venture-capital industry over the past several years.

We have reservations, however, about the reasonableness of other assumptions in the model, particularly the forecast for reimbursement by SBICs of prioritized payments (interest payments made by SBA to investors) and SBA's profit participation in SBIC returns on investments. These forecasts do not appear reasonable based on program experience to date and the revised assumption for net defaults. Accordingly, the subsidy cost, credit program receivables, net, and liabilities for loan guarantees may be misstated.

Information presented in SBA management's discussion and analysis, required supplementary stewardship information, required supplementary information, and other accompanying information are not required parts of the financial statements, but are additional information required by the Federal Accounting Standards Advisory Board and OMB Bulletin 01-09, *Form and Content of Federal Financial Statements*. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued reports dated January 28, 2004, on our consideration of SBA's internal control and on its compliance with laws and regulations. Those reports, which disclose material weaknesses and reportable conditions in internal control and non-compliance with certain laws and regulations and the Federal Financial Management Improvement Act, 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

[FOIA Ex. 6]

Charles Hayward, CPA

January 28, 2004
Alexandria, Virginia

COTTON & COMPANY LLP

auditors • advisors

DAVID L. COTTON, CPA, CFE, CGFM • CHARLES HAYWARD, CPA, CFE, CISA • MICHAEL W. GILLESPIE, CPA, CFE • CATHERINE L. NOCERA, CPA, CISA
MATTHEW H. JOHNSON, CPA, CISA, CGFM • SAM HADLEY, CPA, CGFM • COLETTE Y. WILSON, CPA • ALAN ROSENTHAL, CPA • LOREN SCHWARTZ, CPA, CISA

Independent Auditor's Report on Internal Control

Inspector General
U.S. Small Business Administration

We were engaged to audit the financial statements of the U.S. Small Business Administration (SBA) as of and for the years ended September 30, 2003, and 2002, and have issued our report thereon, dated January 28, 2004, in which we disclaimed an opinion on those financial statements. Such financial statements are the responsibility of SBA management.

In planning and performing our work, we considered SBA's internal control over financial reporting 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. We limited internal control testing to those controls necessary to achieve objectives described in the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. 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 control. 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 control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants (AICPA) and OMB Bulletin No. 01-02, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect SBA'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 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 three matters involving internal control and its operation that we consider to be reportable conditions. These matters are described below under the captions: Credit Reform Controls, Financial Management and Reporting Controls, and Agency-Wide Information Systems Controls. We consider the first two matters to be material weaknesses under standards established by AICPA and OMB Bulletin No. 01-02.



1. CREDIT REFORM CONTROLS

SBA's credit reform environment lacks the following key controls:

- Standard operating procedures for the re-estimate process.
- Documentation supporting cash flow models.
- Procedures to ensure completeness and accuracy of historical accounting data used in the cash flow models.
- Control over valuation of the Fiscal Year (FY) 2003 Small Business Investment Company (SBIC) Participating Security (PS) program subsidy re-estimate.
- Procedures to ensure the accuracy of inputs and outputs for the Credit Subsidy Calculator and Consolidated Credit Tools.
- Procedures to identify and explain unusual subsidy balances.

STANDARD OPERATING PROCEDURES FOR THE RE-ESTIMATE PROCESS

The Office of Chief Financial Officer (OCFO) does not have documented standard operating procedures (SOPs) to address SBA's current subsidy re-estimate process. The internal control procedures within SBA's subsidy re-estimate preparation process are, for the most part, not documented—thus undermining their effectiveness by:

- Creating possible process and procedural inconsistencies among programs.
- Increasing the potential for inaccurate subsidy re-estimates due to incomplete/inadequate review.

SBA made noteworthy accomplishments in developing new or enhancing existing credit subsidy models during FY 2003 to improve the reasonableness of its credit program subsidy estimates. While SBA was able to develop, test, and implement significant model changes, it did not have sufficient time and resources to fully develop and document standard operating procedures for calculating re-estimates and establishing other internal controls.

The Federal Accounting Standards Advisory Board's (FASAB) Credit Reform Task Force (Accounting and Auditing Policy Committee), Technical Release No. 3, Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act (Tech Release No. 3), states that agencies should:

"Document the procedures and flow of information used in developing the agency's subsidy estimates at a high level, e.g., flow chart with supporting narrative. These documents should be used to establish consistent procedures for developing the subsidy estimates across funds/programs/cohorts. These documents should also include a discussion of who is responsible for each step of the estimate as well as the review and approval process followed."

Recommendation

- 1A. We recommend that the Chief Financial Officer (CFO) develop a comprehensive SOP detailing the subsidy re-estimate process, including related internal controls, that reflects SBA's current re-estimate preparation processes and any proposed improvements. The new SOP should be updated at least annually to capture significant changes such that it reflects the current operating process.

DOCUMENTATION SUPPORTING CASH FLOW MODELS

SBA's cash flow models for its following material credit programs were not adequately documented:

- Section 7(a) Business Loan Guarantee Program
- SBIC Program

Computer-based model documentation is a critical control to ensure that models are usable and understandable to both technical and non-technical users and that they are adequately maintained over time. In addition, model documentation serves as a required audit trail to facilitate internal and external verification and validation functions. Tech Release No. 3 provides that agencies should:

"Document the agency's cash flow model(s) used, the rationale for selecting the specific methodologies, and the degree of calibration within the model(s). Also, document the sources of information, the logic flow, and the mechanics of the model(s) including the formulas and other mathematical functions. In addition, document the controls over the model(s) used by the agency in preparing cash flow worksheets. Further, document that the cash flow model(s) reflect the terms of the loan contracts and, in a loan guarantee program, the loan guarantee contracts."

Documentation deficiencies are detailed below by program.

Section 7(a) Business Loan Guarantee Program

OCFO contracted with an outside entity to develop its Section 7(a) econometric model, which was first used to develop the 2003 cohort execution subsidy rate and later used for the FY 2003 re-estimates. It is our understanding that the majority of the resources provided to the model developer were used to develop the model; although documentation was prepared it contained the following deficiencies:

- The model version and history are not stated.
- The statistical routine used was not clearly identified or discussed in the documentation.
- No technical references exist. Specifically, there is no reference for the statistical method (multinomial logit) used for the performance model or for the JAVA code used to populate input to the performance model and convert performance model output into cash flows.
- Several important variables are not clearly identified. Units of measure for some key variables are not specified.
- There is no mathematical specification of the models.

- The results of the default and prepayment model (computed default and prepayment conditional probabilities) are not shown or discussed, and the manner in which recovery and cash flow projection components use these results is neither shown clearly nor explained.
- There is no discussion of the assumptions and limitations of a multinomial logit approach.
- The documentation is self-contradictory about the quality of the default and prepayment model.
- The documentation on model performance contains graphs that are mislabeled; in addition, there is no discussion of what the observations shown by the graphs (which are questionable due to the mislabeling) signify in assessing model quality.

Aside from the above shortcomings, we could not determine if analyses generally performed in developing multinomial logit models were completed by SBA or its developer with respect to the Section 7(a) model, because documentation did not exist. For instance, a likelihood ratio test of the model with most variables omitted, or constrained to be zero, versus the selected model and comparisons of predicted versus actual default and prepayment probabilities for subgroups of the population are part of standard practice for this type of model as recommended in the statistics package utilized by the developer. Documentation of these analyses was not available.

SBIC Program

Except for documentation regarding the default and recovery expert opinion assumptions revised during FY 2003, documentation generally was not sufficient to support the SBIC cash flow models' data sources, logic flow, mechanics, and explicit assumptions developed historically by the Investment Division.

Recommendations

We recommend that the CFO:

- 1B. Complete the Section 7(a) model documentation in accordance with Tech Release No. 3 and assure that the shortcomings we identified are addressed by the documentation. In addition, perform and document the likelihood ratio test and comparison of predicted versus actual default and prepayment probabilities for subgroups of the population.
- 1C. Direct a coordinated effort among OCFO (the Office of Financial Analysis) and Investment Division to fully document the SBIC program models in accordance with Tech Release No. 3.

PROCEDURES TO ENSURE COMPLETENESS AND ACCURACY OF HISTORICAL ACCOUNTING DATA USED IN THE CASH FLOW MODELS

Historical loan-level transactional data (or "actuals") are an integral element of SBA's cash flow models. SBA's controls were, however, insufficient to ensure that such historical data were reliable and complete. We noted the following control deficiencies.

Loan Accounting System Actual Cash Flow Transactions Were Unreliable [Disaster Assistance and Section 7(a)]

The Disaster Assistance and Section 7(a) loan programs both use historical loan-level transactions extracted from SBA's Loan Accounting System (LAS) to populate "actuals" in the subsidy re-estimate model. SBA lacked effective internal control to ensure the completeness and accuracy of historical transactions used in the cash flow models. The following errors were noted:

- Section 7(a) Supplemental Terrorist Activity Relief (STAR) program accounting transactions were improperly included in the Section 7(a) program re-estimate for the 2002 and 2003 cohorts. The initial re-estimates, including STAR data, resulted in downward re-estimates of \$93 million. The revised re-estimates without STAR data resulted in a net upward re-estimate of \$14 million for a combined change of \$107 million.
- OCFO did not include \$8.4 million of actual defaults in the 2002 cohort Section 7(a) re-estimate as the result of a programming error.
- SBA did not include actual sale proceeds that had previously been reserved to cover potential claims for representations and warranties in its initial Disaster Assistance program re-estimate. During FY 2003, SBA determined that its reserve was no longer needed and recorded the cash transaction in the financing fund at a summary-versus-loan-level. This summary level cash inflow was not picked up in the cash flow model, because the model generally is only populated with loan-level detail. Persons responsible for calculating the re-estimate were not aware that this summary-level cash transaction had been recorded in the Financing fund. SBA recorded an adjustment to correct this \$58 million error in its Disaster re-estimate.

Tech Release No. 3, states:

"The budget and accounting offices should work together to ensure that cash flow models are updated to reflect the actual cash flows and terms of the loan program recorded in the accounting records."

Recommendations

We recommend that the CFO:

- 1D. Direct the Office of Financial Analysis to clearly define which programs (subprogram codes) should be included in the Section 7(a) re-estimate actuals.
- 1E. Direct the Office of Financial Analysis and applicable personnel in the Office of the Chief Information Officer to develop a quality assurance system to ensure that data extracted from LAS for inclusion in the subsidy re-estimate models are complete and accurate.

SBIC Program Data Used for Modeling Not Reconciled to Accounting System

SBA does not have effective internal control to ensure the completeness and accuracy of historical accounting transactions used in the SBIC credit subsidy models to calculate re-estimates. SBA's LAS does not contain the necessary level of detail to produce historical loan transactions for subsidy re-estimates for the SBIC program, because:

- Many transactions processed in LAS are not cohort specific (re-estimates must be calculated at the cohort level).
- The timing of cash flows is often not correct as the result of SBA's practice of recording SBIC cash transactions into clearing accounts until the proper accounting treatment can be identified.

Shortcomings in LAS transactional data prompted the Office of Financial Analysis personnel to use program data provided by the Investment Division for calculating subsidy re-estimates. Because data from Investment Division were not derived from LAS, they were not subject to OCFO's system and manual data controls. To ensure the reliability of Investment Division data, the Office of Financial Analysis attempted to reconcile SBIC PS program data per Investment Division records to LAS. Unexplained reconciling items remained in several cash flow categories. The Office of Financial Analysis did not perform a similar reconciliation for the SBIC debentures program.

We performed a reconciliation of Investment Division data for both SBIC programs with LAS data, and noted that data were consistent at the program level; they were, however, inconsistent at the cohort level or within activity year. These differences are most likely the result of processing issues noted above.

Tech Release No. 3, states:

"The budget and accounting offices should work together to ensure that cash flow models are updated to reflect the actual cash flows and terms of the loan program recorded in the accounting records."

"The accounting office should maintain detailed subsidiary accounting records by program, cohort, and case."

Although we were able to perform other procedures to draw conclusions about the reasonableness of Investment Division data, it is management's responsibility to develop a system of control to ensure that data used to produce estimates are complete and accurate. Without such a control, SBIC subsidy re-estimates could be questionable, and cash flow projections produced by the subsidy model could differ from the expected value of future cash flows in the accounting system.

Recommendations

We recommend that the CFO:

- 1F. Direct the Office of Financial Analysis to develop, as an interim measure, an internal control procedure to reconcile the Investment Division SBIC PS and Debenture transaction data to LAS at the cohort and activity-year level; research and fully explain all variances; and determine if Investment Division data are appropriate for use in subsidy re-estimates.

- 1G. Begin recording all SBIC transactions in the proper fiscal year and cohort and add SBIC-specific transaction codes to LAS, as necessary, to better identify SBIC activity, so that SBIC subsidy re-estimate actuals can be derived from LAS in the future.

Secondary Market Guarantee Data Not Validated

SBA could not provide sufficient evidential matter in a timely fashion to support either the completeness or the accuracy of data provided to SBA by its fiscal and transfer agent; these data were used in SBA's model to project the future cash flows of existing loans and investment pools and in turn the shortfall in the Master Reserve Fund maintained by the fiscal and transfer agent to facilitate operation of SBA's Secondary Market Guarantee program. While SBA provided a document titled *Secondary Market Guarantee Model Data Sources and Validations*, this document did not sufficiently describe or provide evidence of procedures performed to establish the completeness and accuracy of data used.

Statements of Federal Financial Accounting Standards (SFFAS) Number 2, *Accounting For Direct Loans and Loan Guarantees*, states:

"The effort to make accurate projections should begin with establishing and using reliable records of historical credit performance data."

Recommendation

We recommend that the CFO:

- 1H. Develop, document, and implement data quality assurance procedures to establish the completeness and accuracy of data provided by SBA's fiscal and transfer agent for Secondary Market Guarantee estimation purposes.

CONTROL OVER VALUATION OF THE FY 2003 SBIC PARTICIPATING SECURITY PROGRAM SUBSIDY RE-ESTIMATE

SBA could not support the reasonableness of the FY 2003 SBIC PS program re-estimate (\$1.8 billion upward re-estimate), because the basis for selecting and developing the forecast assumptions for reimbursement of prioritized payments and SBA profit participation in SBICs' returns on investments was not sufficiently reviewed and documented.

Tech Release No. 3 provides:

"The cash flow estimation process, including all underlying assumptions, should be reviewed and approved at the appropriate level including revisions and updates to the original model. Cash flow models should be tested for reliability as part of the approval process by comparing estimated cash flows to actual cash flows and assessing the model's ability to replicate a credit program's performance."

SBA incurred far greater defaults under the SBIC PS program than were anticipated in its budgetary baselines, because of the substantial economic downturn experienced by the venture capital industry in recent years. As a result of these higher default levels, SBA performed a portfolio analysis and increased the expert opinion default assumptions and decreased the recovery assumptions used in the FY 2003 re-estimate cash flow model. SBA did not, however, revise its methodology or assumptions to reduce forecasts for reimbursements of prioritized payments or profit sharing in light of its increased net default

projections and market volatility. Although SBICs are required to pay all leverage, reimbursements of prioritized payments may only be repaid out of profits, making reimbursement from defaulted SBICs unlikely. Both prioritized payments and profit sharing are material cash inflows that reduce the subsidy cost of the program.

In addition, SBA's projections of reimbursed prioritized payments appear unreasonable when compared to actual amounts that SBA experienced in prior years. We have concerns about the appropriateness of the outstanding leverage basis that was selected to forecast reimbursement of prioritized payments, as well as the method SBA used to calculate and apply its reimbursement curves. We recalculated reimbursement curves using the same outstanding leverage base and obtained a materially different result.

SBA's projections for profit-sharing participation are based on the SBICs' portfolio values (underlying investments). SBA is only entitled to a certain percentage of a profitable SBIC's return on investment. It did not appear that SBA reviewed its current projections for profit participation in light of the increase in net actual and projected defaults under the program. We noted that in the past 3 years, SBA's projection for profit sharing was materially greater than actual amounts received.

Recommendation

We recommend that the CFO:

11. Determine if selection and development of the model's forecast assumptions are consistent with program guidelines and are reasonable in light of historical experience and current economic conditions and document the basis for such assumptions.

PROCEDURES TO ENSURE THE ACCURACY OF INPUTS AND OUTPUTS FOR THE CREDIT SUBSIDY CALCULATOR AND CONSOLIDATED CREDIT TOOLS

SBA did not have adequate controls to review and validate the accuracy of information input into the OMB Credit Subsidy Calculator (CSC), used to calculate the re-estimated subsidy rate and weighted average or single effective discount rate, and the Consolidated Credit Tool (Ccredit Tool), used to calculate the dollar amount of subsidy re-estimates and interest on re-estimates.

As part of the annual financial statement reporting process, SBA develops re-estimates for its material credit programs. It uses computer-based models to produce forecasted cash flows. The forecasted cash flows along with actual cash flows to date are then transferred to a spreadsheet (cash flow spreadsheet) suitable for use with CSC. The cash flow spreadsheets contain critical information necessary to calculate a proper re-estimated subsidy rate, such as the cohort year, convention for determining the discount rate ("use all" versus "90 percent"). In addition, SBA must update the CSC annually to reflect the most current actual versus budget assumption interest rates.

We noted that SBA's cash flow spreadsheets for the Section 7(a) business, Disaster Assistance, and SBIC programs contained errors. In addition, SBA did not update CSC for the most current interest rates before calculating some of its re-estimates.

SBA also uses the Ccredit Tool to calculate the subsidy re-estimate and interest on re-estimates for SBA's material credit programs. The following information, obtained from several sources, is input into the Ccredit Tool worksheets by SBA:

- Prior-year re-estimates (apportioned)
- Program disbursements
- Original (execution) subsidy rates

- Revised (re-estimate) subsidy rates from CSC
- Single effective interest rates from CSC

We noted that SBA made input errors, including incorrect disbursement amounts, incorrect re-estimated subsidy rates, and incorrect single effective discount rates.

As a result, SBA had at least two and sometimes three versions of re-estimates for various programs and/or cohorts within a program; changes were material to SBA's total re-estimates and impacted delays encountered in preparing timely financial statements. The problems stem from human error in performing a relatively detailed function and the lack of an effective quality assurance review process.

OMB Circular A-123, Management Accountability and Control, provides that:

"...agencies and individual federal managers must take systematic and proactive measures to develop and implement appropriate, cost-effective management controls...."

Recommendation

We recommend that the CFO:

- 1J. Instruct the Office of Financial Analysis to develop a quality assurance review process (to be included in SBA's standard operating procedures) to minimize errors in calculating re-estimates and/or ensure that errors that do occur are detected and corrected in a timely manner. The review process should include steps to document validation results by noting that correct information has been reviewed and accepted, and that errors have been identified, corrected, and revalidated until ultimately accepted.

PROCEDURES TO IDENTIFY AND EXPLAIN UNUSUAL SUBSIDY BALANCES

SBA cannot fully support the reasonableness of its valuations for Credit Program Receivables and Related Foreclosed Property, Net and Liabilities for Loan Guarantees, for its 504, SBIC PS, Section 7(a), and Disaster Assistance programs. We performed an analysis of the present value of future cash flows in the underlying accounting records and noted account balances that do not appear plausible given (1) the nature of the particular program, (2) the program subsidy rates (re-estimated), and (3) the discounted present value of cash flow projections contained in the computer-based models. We noted material differences for the programs listed above.

SFFAS No. 2, states:

"Direct loans disbursed and outstanding are recognized as assets at the present value of their estimated net cash inflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recognized as a subsidy cost allowance."

"For guaranteed loans outstanding, the present value of estimated net cash outflows of the loan guarantees is recognized as a liability."

"These standards should apply to a cohort (or risk category) of direct loans or loan guarantees in the aggregate."

Tech Release No. 3 states:

"The agency should review trends in the direct loan subsidy allowance account balance and/or the liability for loan guarantees account balance as compared to the outstanding balances of loans and/or guarantees. Any unusual fluctuations identified should be investigated and explained. When unusual fluctuations occur, an analysis by cohort may be helpful to identify the causes."

SBA devoted substantial resources and made noteworthy accomplishments in developing, implementing, and testing a revised approach to estimating cash flows for the Disaster Assistance program. In short, the modeling methodology effectively builds on available Disaster Assistance program data and takes a long-term view on performance through time. In addition, the approach supports the separate estimation of cash flows associated with loans sold and remaining loans and takes into account original term to maturity and other characteristics that influence program costs. As a result, SBA was able to restate the loss incurred under its asset sales program and more reasonably calculate subsidy re-estimates. In addition, the model output facilitates an analysis of the direct loan subsidy allowance account balance as compared to outstanding loan principal balances.

SBA began such an in-depth analysis of its Disaster Assistance program financing account balances, but did not provide similar analyses for its other credit programs. Although the Disaster Assistance program analysis proved meaningful, SBA fell short of completing it in time to produce its financial statements. In fact, SBA identified an important inconsistency in the application of credit reform concepts that creates a disconnect between outputs from its subsidy models, which assume transactions at one interest rate, and transactions recorded in its accounting system, which are calculated using a different interest rate. SBA recorded a \$128.7 million adjustment to its Allowance for Subsidy Account to account for this inconsistency.

While much progress has been made, additional efforts are needed. SBA should develop a well-defined process that includes appropriate and systematic analyses, involving a broad array of OCFO and program managers, to continue to critique model results and reconcile results to the underlying accounting data embodied in the financial statements and footnotes. The process should be such that it can be performed for all programs routinely or at least annually when re-estimates are made.

Recommendations

We recommend that the CFO:

- 1K. Direct a coordinated effort among applicable OCFO branches, including the Office of Financial Analysis and the Office of Financial Administration, to identify potential disconnects between the agency's subsidy models and accounting records. Based on review results, make refinements to subsidy models and post correcting entries to the general ledger as appropriate.
- 1L. Implement a system of internal control in which the Office of Financial Analysis and the Office of Financial Administration monitor the direct loan subsidy allowance account balance (Account 1399) and the liability for loan guarantees account balance (Account 2180) as compared to the outstanding balances of loans and/or guarantees, at the program and cohort levels monthly. Maintain documentation that (a) explains unusual fluctuations determined to be appropriate, (b) supports any adjusting entries to the general ledger and (c) details revisions made to subsidy models and/or assumptions.

- 1M. Ensure that the Financial Reporting Information System (FRIS) general ledger and subsidiary feeder systems are properly accounting for credit reform activities at the program and cohort levels in accordance with SFFAS No. 2.

2. FINANCIAL MANAGEMENT AND REPORTING CONTROLS

SBA's financial management and reporting lack key controls, as follows:

- SBA management did not meet milestone dates and required excessive time to address audit questions
- Draft financial statements were unauditible.
- Funds control management needs improvement.
- Antideficiency Act internal control needs improvement.
- Prompt Payment Act control was inadequate.

We discuss SBA's substantial control weaknesses on the following pages under their respective captions.

SBA MANAGEMENT DID NOT MEET MILESTONE DATES AND REQUIRED EXCESSIVE TIME TO ADDRESS AUDIT QUESTIONS

SBA was unable to provide its FY 2003 draft financial statements and footnotes, the supporting trial balance, and key audit evidence in a timely manner. SBA's inability to meet agreed-upon milestone dates, submit timely and complete responses to our requests, and produce auditible draft financial statements in a timely fashion were, in part, a direct cause of our disclaimed opinion.

OMB Circular A-127, *Financial Management Systems*, states:

"The agency financial management system shall be able to provide financial information in a timely and useful fashion to...comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury."

As stated earlier, SBA made noteworthy accomplishments in developing and testing three new subsidy models and enhancing others during FY 2003. SBA was not able, however, to meet all of its own planned completion dates. As a result, SBA either could not perform or lacked due care in applying essential quality assurance procedures within its financial reporting environment. Once behind schedule, SBA could not respond to audit inquiries and follow-up requests for additional documentation in a timely manner. SBA's inability to provide adequate audit evidence was pervasive and prohibited us from completing our audit in accordance with auditing standards.

SBA's quality control procedures need major improvements in light of difficulties experienced in completing the FY 2003 financial statements and accelerated deadlines for submitting interim and final FY 2004 financial statements to OMB. SBA's quality control improvements must include controls for resource management to ensure that sufficient resources with the requisite qualifications and skill sets are assigned to the critical quality assurance tasks. In addition, SBA management must implement a well-thought-out critical-path approach for assessing timeframes for completing reconciliations; calculating accruals, re-estimates, and other manual adjustments; and closing the general ledger so that accurate financial statements can be prepared in time to complete appropriate analytical procedures and evaluate fluctuations in account balances.

Recommendation

We recommend that SBA's Administrator, in conjunction with the CFO:

- 2A. Assess whether SBA has devoted sufficient and qualified resources to adequately address its current financial reporting shortcomings and determine if the current process is in need of re-engineering to meet accelerated financial reporting deadlines in future years.

We also recommend that the CFO:

- 2B. Develop a comprehensive plan with firm milestone dates to meet the FY 2004 accelerated financial reporting date of November 15th.

DRAFT FINANCIAL STATEMENTS WERE UNAUDITABLE

SBA maintained insufficient and ineffective quality control over its December 22, 2003, draft Performance and Accountability Report. The report contained numerous, pervasive, and obvious errors involving inconsistency among the principal financial statements, footnote disclosures, required supplementary information (Intragovernmental Assets and Liabilities), and required supplementary stewardship information.

OMB Circular A-127, *Financial Management Systems*, states:

"The agency financial management system shall comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury."

The December 22, 2003, draft financial statements were unauditible for the reasons discussed below, among others. SBA submitted revised financial statements on January 9 and 16, in which most of the issues and concerns identified during our review were corrected. In some instances, however, we were precluded from reviewing the corrections due to time constraints.

Subsidy Re-alignment Entry

SBA recorded an off-line journal entry to properly align subsidy costs between Balance Sheet line items *Liabilities for Loan Guarantees* and *Credit Program Receivables and Related Foreclosed Property, Net*, for defaulted loan principal; it was improperly valued by a known amount of \$61.9 million, because the underlying analysis to prepare the entry contained numerous errors as detailed below:

- The analysis for the Section 7(a) program estimated potential recoveries in excess of the total recovery rate resulting in an understatement to Account 1399, *Allowance for Subsidy*, of \$15.5 million.
- The analyses for the Section 7(a), 504, and SBIC programs did not use the lesser of outstanding principal balances at September 30, 2003, or estimated recoveries remaining, as the result of cell reference errors, resulting in an understatement to Account 1399 of \$46.4 million.

- Data used in the analysis to compute recoveries to date for the Section 7(a) and 504 programs were incomplete as the result of exclusion of asset sale proceeds (treated as recoveries) of \$65 and \$16.9 million, respectively. In addition, the Section 7(a) analysis included invalid loan sale activity in the recovery categories "Collections" (increase recoveries) and "Expenses" (reduce recoveries) of \$63 million and \$375 million respectively. In summary, recoveries as of September 30, 2003, included in the analysis were understated by \$377 million for Section 7(a) and \$16.9 million for 504. We did not quantify the misstatement resulting from use of improper data.

SBA provided a revised analysis; we did not have sufficient time to audit the revised analysis and resulting accounting entries or determine the magnitude of misstatements on the financial statements.

These widespread errors occurred because the Office of Financial Analysis did not take measures to ensure that data used in the analysis were complete, accurate, and appropriate for the purpose. Although SBA applied quality assurance procedures to the analysis, they were not comprehensive or effective to detect such errors before SBA recorded the transactions in its accounting system.

Loan Sale Reversal Entries

SBA reversed its prior-year loan sale audit adjustments in error, which created an understatement of \$148 million on the Statement of Budgetary Resources line items *Spending Authority from Offsetting Collections* and *Obligations Incurred*. SBA did not have a process in place to detect this error.

Disaster Re-estimate Misstated

SBA's disaster loan re-estimate was improperly recorded in the general ledger, resulting in misstatements on the December 22, 2003, draft financial statements as follows:

Account	Issue Description	Overstated Amount
7401 – Prior Period Adjustment	Prior Period Adjustment overstated due to an improper entry (Debit instead of Credit entry)	\$996 million
5105U – Subsidy Expense Unfunded	Entire Modification Adjustment Transfer was recorded in FY 2003, instead of applicable sale years.	FY 2001 = \$97 million FY 2002 = \$55 million FY 2003 = \$28 million
7401 – Prior Period Adjustment	OCFO did not reverse its previously recorded FY 2001 re-estimates in the accounting system	\$509 million

SBA's quality assurance review procedures were inadequate and did not detect these errors either before or after the re-estimate transactions were recorded in the accounting system.

As noted earlier, SBA determined that its interest expense payable to Treasury has been consistently overstated since the inception of credit reform as the result of inconsistencies between various credit reform tools and schemes for calculating cohort weighted average or single effective interest rates. SBA recorded a \$128.7 million adjustment to correct for these inconsistencies; it recorded the adjustment as a current-year re-estimate rather than as a current- and prior-period adjustment to interest expense payable to Treasury. As a result, Subsidy Expense and Interest Expense are overstated.

Inadequate Disclosures Associated with FY 2002 Restatements

SBA's footnote disclosures in its December 22, 2003, draft financial statements related to FY 2002 restatements for prior-period adjustments did not sufficiently describe the nature of errors in previously-issued financial statements.

During FY 2003, 12 issues were identified that required restatement of the FY 2002 comparative year balances. SBA's quality assurance procedures were not adequate to ensure that disclosures were meaningful, accurate, and sufficient in accordance with generally accepted accounting principles. To illustrate, SBA characterized an \$800 million restatement related to the Disaster Assistance program's allowance for subsidy as: "The SBA corrected some flaws in its Disaster model for FY 2002."

SFFAS No. 21, *Reporting Corrections of Errors and Changes in Accounting Principle* states:

"The nature of an error in previously issued financial statements and the effect of its correction on relevant balances should be disclosed."

Insufficient footnote disclosure related to prior-period adjustments impairs the usefulness of financial statements and may mislead those who rely on disclosures contained within.

Restated Gain or Loss on Asset Sales

SBA conducted an analysis to calculate revised gain/loss on loans sold during FYs 1999 through 2003. SBA computed a revised net book value using various assumptions depending on the program and available data. The revised net book value was subtracted from the loan sale proceeds to calculate a revised gain/loss. We noted concerns with the data used in this analysis for the 7(a) and 504 guaranteed business loan programs and communicated our concerns to management. Although SBA acknowledged an error in part of its analysis, the error did not affect the revised gain/loss reported in the December 22, 2003, draft financial statements, in which it disclosed \$163 million and \$126 million changes between previously reported losses and revised gains in its Section 7(a) and 504 credit programs.

No Allowance for Subsidy for SBIC Prioritized Payments

SBA did not have a process in place to identify the need for a valuation adjustment related to SBIC prioritized payments and thus omitted this material adjustment from its December 22, 2003, financial statements. SBA's failure to realign subsidy cost related to prioritized payments overstated *Credit Program Receivables and Related Foreclosed Property, Net*. SBA developed a methodology and prepared a material adjustment; we did not have sufficient time to evaluate the methodology or resulting accounting entries designed to correct the problem.

Secondary Market Guarantee Liability was Inaccurate

SBA included a preliminary estimate of the net present value of future cash flows related to the Secondary Market Guarantee program in its December 22, 2003, draft financial statements (\$93 million). The revised estimate (\$148 million) was not finalized until January 9, 2004, which did not allow us sufficient time to evaluate it.

Untimely Charge-off of Loans Receivable

SBA maintains purchased Section 7(a) loans that have been discharged in bankruptcy on its books at full (net book) value until SBA is able to conclude that it has no recourse against guarantee lenders. This practice overstates the valuation of the following two components of footnote number 6, *Credit Program*

Receivables and Related Foreclosed Property, because SBA does not have recourse against lenders in most instances.

- Defaulted Guarantee Loans Receivable, Gross
- Allowance for Subsidy Cost

Our random sample of all loans identified one loan matching the above condition. While our sampled loan transaction was not in itself material to the financial statements, the statistically-projected error had a material effect on SBA's footnote components. Generally accepted accounting principles require all economic events that have occurred to be recorded and reflected in the financial statements.

Recommendations

We recommend that the CFO:

- 2C. Design specific procedures to identify accounts requiring estimation or other adjustment in a timely manner to achieve proper valuation in the financial statements.
- 2D. Lead a collaborative effort between the Office of Financial Administration accountants and the Office of Financial Analysis analysts, such that sufficient knowledge transfer is achieved to enable SBA to design and implement comprehensive and effective analyses and review processes regarding estimates and other accounting adjustments.
- 2E. Complete the document titled *Checklist for Reports Prepared Under the CFO Act--Revised 2003*, as issued jointly by the General Accounting Office and the President's Council on Integrity and Efficiency, before submitting financial statements to help ensure the adequacy of financial statement presentation and disclosure.

FUNDS CONTROL MANAGEMENT NEEDS IMPROVEMENT

SBA's funds control management needs improvement because of two shortcomings. First, SBA is not detecting and correcting invalid *Budget Proforma* (defined below) entries. Second, SBA is not effectively monitoring undelivered orders (UDOs).

Invalid Budgetary Pro-Forma Entries

SBA uses an application called the *Budget Proforma* to record budgetary accounting entries based upon proprietary and memorandum transactions occurring in LAS. SBA uses this application, because LAS does not include budgetary accounting transactions.

SBA's budget proforma application uses improper posting logic; in addition, SBA management failed to review resulting transactions. These shortcomings resulted in numerous misstatements on the combined statement of budgetary resources, as discussed below.

Transaction Code 260 Produces Inaccurate Results

For LAS transaction code 260, Payment of Asset Sale Cost, SBA established two proprietary accounts (asset and liability) that when netted, approximates the UDO for asset sale administrative cost anticipated, but not incurred. These proprietary accounts are unnecessarily included in the budget proforma, thus creating erroneous budgetary entries. As noted in our FY 2002 audit report, SBA failed to detect this error. During FY 2003, the asset and liability accounts were reversed, again creating erroneous budgetary entries. Again, SBA failed to identify and correct the invalid entries, causing the Statement of Budgetary

Resources line items *Spending Authority from Offsetting Collections* and *Obligations Incurred* to be understated by \$138 million. SBA posted correcting entries after we brought the errors to its attention.

Liquidating Fund Transactions

SBA improperly posted accounting transactions in its liquidating fund due to invalid budget proforma posting logic. As a result, third-quarter Statement of Budgetary Resources line items were misstated as follows:

Line Item	Nature of Error	Overstated Amount
<i>Recoveries of Prior Year Obligations</i>	SBA recorded recoveries of prior year obligations based upon underlying transactions that were not obligations.	\$12 million
<i>Obligations Incurred</i>	SBA recorded upward adjustments of prior year obligations based upon underlying transactions that were not obligations.	\$5 million
<i>Net Transfers</i>	SBA utilized an improper Standard General Ledger (SGL) account to record repayments of debt to the Federal Financing Bank (FFB), resulting in payments being classified as <i>Net Transfers</i> instead of <i>Permanently Not Available</i> .	\$20 million

SBA posted adjusting entries to correct misstatements noted above, which were reflected in its December 22, 2002, financial statements.

Substantial compliance with the SGL at the transaction level, as mandated by the Federal Financial Management Improvement Act (FFMIA), requires that SBA record financial events consistent with applicable posting models/attributes reflected in the SGL. Generally accepted accounting principles require that transactions be recorded based upon events that actually occurred.

Monitoring Undelivered Orders

SBA’s monitoring of UDOs needs improvement to address control deficiencies, as discussed below:

Invalid Disaster Assistance Program Loan Financing Fund Undelivered Orders

Outstanding disaster loan approvals represent UDOs in SBA’s disaster loan financing fund. We tested 83 outstanding disaster loan UDOs established before FY 2003 and determined that 61 (or 74 percent) were invalid at September 30, 2003. These invalid UDOs overstated the statement of budgetary resources line item *Undelivered Orders* by \$3.2 million.

The 61 invalid UDOs were the result of:

- Duplicate loan approvals entered in the accounting system (36).
- Invalid posting logic, which created UDOs when SBA cancelled borrower checks (9).
- Failure to de-obligate un-needed obligations in a timely manner (16).

OMB Circular A-11 defines a valid obligation as a binding agreement that will result in outlays, immediately or in the future. The UDOs detailed above would not have been liquidated via outlay in the future.

Administrative Undelivered Orders Overstated at Year End

SBA maintained invalid or unneeded administrative UDOs in its general ledger, because they were not liquidated in a timely manner as the result of improper cut-off procedures, and SBA did not deobligate unneeded obligations. In addition, SBA was unable to provide support for one recorded administrative UDO. Consequently, administrative UDOs as of September 30, 2003, are overstated by a known amount of \$178,110 and a projected amount of \$52,836,526. As a result, the following financial statement line items are misstated:

Financial Statement	Line Item	Effect	Amount
Budgetary Resources	<i>Undelivered Orders</i>	Overstated	\$53 million
	<i>Accounts Payable</i>	Understated	\$20 million
	<i>Unobligated Balances</i>	Understated	\$33 million
Net Cost	<i>Gross Costs</i>	Understated	\$20 million
Balance Sheet	<i>Accounts Payable</i>	Understated	\$20 million
Changes in Net Position	<i>Appropriations Used-Cumulative Results</i>	Understated	\$20 million
	<i>Appropriations Used-Unexpended Appropriations</i>	Understated	\$20 million

Generally accepted accounting principles require that all economic events that occur in the current period be recorded in the current period.

This condition was attributable to SBA’s inability to provide adequate supporting documentation to substantiate one UDO and the following SBA control weaknesses:

- Noncompliance with Year-End Closing Instructions to properly monitor existing obligations for inactivity or continuing need.
- No system (except for grant accruals) to accrue for goods and services received and not yet invoiced as of September 30.

Recommendations

We recommend that the CFO:

- 2F. Correct known budgetary proforma errors and perform a complete analysis of posting logic to ensure compliance with the SGL at the transaction level.
- 2G. Coordinate with the Office of Disaster Assistance to develop and implement procedures to review and determine the validity of outstanding disaster Loan UDOs quarterly. Invalid UDOs should be de-obligated to ensure efficient use of funds.
- 2H. Coordinate with the Director of the Office of Procurement and Grants Management to develop additional or strengthen existing internal controls to identify administrative obligations with no activity and process de-obligations in a timely manner.

- 2I. Develop procedures to ensure proper cut-off to ensure completeness of administrative transactions for financial reporting.
- 2J. Ensure that adequate supporting documentation is maintained to substantiate recorded administrative obligations.

ANTIDEFICIENCY ACT CONTROL NEEDS IMPROVEMENT

SBA's controls to ensure compliance with the Antideficiency Act need improvement, because management did not detect the potential violations discussed below.

Expired Salary and Expense Funds

SBA does not have sufficient funds control to ensure that activity affecting expired salary and expense funds is valid and does not result in Antideficiency Act violations. This is evidenced by the fact that SBA had obligation activity in expired funds during FY 2003 that could not be explained in a timely fashion by SBA management.

OMB A-11, *Preparation, Submission, And Execution of the Budget*, states that agencies may "disburse against obligated balances and adjust obligated balances to reflect actual obligations during the period of availability."

SBA posted invalid administrative recoveries of prior-year obligations and obligations incurred due to the correction of vendor administrative data for existing obligations and the transfer of summary-level obligations to the organizational level within its administrative general ledger. The deobligation of valid prior-year obligations created recovery transactions that map to the combined Statement of Budgetary Resources line item *Recoveries of Prior Year Obligations*. The subsequent re-establishment of the obligations created a transaction that mapped to the line item *Obligations Incurred*. These invalid transactions overstate the above line items by a known total of \$10 million. In addition to creating financial statement misstatements, these invalid postings created new obligations in expired funds, giving the appearance of Antideficiency Act violations. SBA did not have a process in place to identify this potential Antideficiency Act violation and only investigated this activity upon our request.

While management was able to determine that the invalid activity noted above did not cause an Antideficiency Act violation, there were additional postings to expired funds for which SBA was unable to provide sufficient detail. Consequently, we could not conclude if Antideficiency Act violations occurred.

Journal Vouchers in FRIS

During FY 2003, SBA developed and implemented a manual system of control to ensure that routine loan-related transactions (i.e. default claim payments) did not exceed the lesser of cash available (in the relevant fund) or realized apportioned authority. This manual system of control is inadequate, because it does not ensure against potential Antideficiency Act violations. An example follows.

SBA recorded an adjustment via journal voucher to increase obligations incurred to offset the invalid budgetary effects created by SBA's practice of tracking loan sale related administrative costs (transaction code 260). A portion of this invalid effect (\$17 million) had already been corrected before the adjustment was recorded, thus the adjustment overstated the obligations incurred line item by \$17 million. This created a situation in which obligations incurred in Fund X4154 exceeded apportioned authority in the fund. This invalid obligation and resulting potential Antideficiency Act violation were not detected by

SBA until we presented the results of our Antideficiency Act compliance test work. At that time, correcting entries were posted to properly state obligations incurred in Fund X4154.

Recommendations

We recommend that the CFO perform the following for administrative funds:

- 2K. Continue to review obligation activity posted against expired funds in FY 2003 and make a determination if the Antideficiency Act was violated. Maintain sufficient documentation to ensure a clear audit trail during FY 2004.
- 2L. Develop control techniques to ensure that only valid obligation activity is posted against expired funds and review transactional detail monthly to ensure no invalid activity was posted.

We also recommend that the CFO perform the following for loan funds:

- 2M. Investigate the possibility of implementing automated funds controls that allot the lesser of apportioned authority or realized resources at the fund level.
- 2N. Enhance its cash management tracking system by implementing a control technique to ensure that obligations incurred transactions entered via journal voucher do not exceed the lesser of apportioned authority or realized resources.

PROMPT PAYMENT ACT CONTROL WAS INADEQUATE

SBA does not pay interest on late payments (those over 30 days) to vendors that it has identified in its accounting system as "immediate pay." We identified four FY 2003 payments that did not include the interest penalty due on amounts paid late, because the vendor was identified as immediate pay.

In its accounting system, SBA denoted a number of vendors to receive payment for goods and services immediately; instead of waiting 30 days—the delay typically transpiring before Prompt Payment Act interest is required—and has designated all such vendors as immediate pay in the accounting system. SBA considers these vendors to have waived their rights to interest on late payments. These vendors, however, are not always paid within the 30-day prompt payment period, and they do not appear to have authorized or approved either SBA's immediate pay designation or SBA's withholding of interest on late payments because of this designation.

U.S. Code Part 1315.4(h) *Prompt Payment Standards and Required Notices to Vendors*, requires that "when payments are made after the due date, interest will be paid automatically...." SBA is not paying interest due to these vendors and is not complying with the Prompt Payment Act.

Recommendation

- 2O. We recommend that OCFO calculate and pay all interest due to immediate pay vendors for late payments in prior fiscal years. We also recommend that SBA begin paying Prompt Payment Act interest to these vendors on future late payments.

INADEQUATE CONTROL OVER ACCOUNTING ENTRIES RELATED TO TRANSACTION CODE 195

SBA's proforma accounting entries and financial statement reporting related to guarantee loan purchases (transaction code 195) resulted in departures from SGL posting logic and federal accounting standards with respect to determining the valuation of liabilities. Misstatements of interest revenue and default cost equaled \$65 million in FY 2002 and \$58 million in FY 2003, and the liability was overstated by about \$25 million.

Transaction code 195 incorrectly debits a revenue account (SBA Account 4020, Interest Income on Loans Receivable) at the time of purchase. This represents a cash outflow or program cost to reimburse the lender for accrued interest from the borrower at the time of default. SBA's account 4020 crosswalks to SGL account 5310, Interest Income - Loans Receivable; the debit transaction understates total interest revenue and understates total default costs.

In addition, transaction code 195 establishes a claim payable (SBA account 2832 – Due Bank Disallowed Purchased Interest) to guarantee lenders for disallowed purchased interest (accrued interest typically greater than 180 days) at 100 percent of the claim value. Contractually, these claims are only payable to lenders if the loan reaches paid-in-full status. Historical experience has shown that claims paid to lenders related to disallowed interest are far less than 100 percent.

SBA does not have a quality-assurance process in place to detect instances in which its accounting is not SGL compliant or its account balances are valued improperly or misstated. At our request, SBA established a valuation methodology to estimate the value of future claim payments for disallowed purchased interest and reflected adjustments in its accounting system for FY 2002 restated yearend balances and FY 2003 balances beginning in the third quarter.

Recommendation

We recommend that the CFO:

- 2P. Perform a thorough account analysis at the fund level to identify account and posting anomalies, such as accounts with unnatural balances. Any anomalies detected should be researched and subsequently corrected to ensure compliance with SGL posting logic and federal accounting standards.

3. AGENCY-WIDE INFORMATION SYSTEMS CONTROLS

SBA continued to improve internal control over its information system environment during FY 2003 in certain areas. Specifically, SBA:

- Conducted certification and accreditation (C&A) reviews for additional major applications.
- Continued to implement the Windows 2000 operating system at various field locations.
- Completed corrective actions to close 20 prior-year recommendations.

These accomplishments were, however, overshadowed by:

- Delays in timely implementation of corrective actions to resolve prior-year weaknesses by SBA's program offices.
- Implementation of ineffective controls to address previously-identified weaknesses.
- Inadequate participation by OCIO in the development of new systems to ensure that system security controls are addressed effectively and in a timely manner and to ensure that systems meet goals, objectives, and requirements of federal laws, regulations, and standards.
- Inadequate allocation of resources to support OCIO's security program.

SBA's OIG will issue a separate report titled *Audit of SBA's Information System Controls, FY 2003*, that will detail scope of work 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

The OIG's report will convey our findings and recommendations in these areas.

STATUS OF PRIOR-YEAR FINDINGS

As required by *Government Auditing Standards*, we provide the status of reportable conditions for the prior-year audit.

Description	Recommendation	Status
Disaster Loan Program Modeling	Revise the approach to estimating cash flows for the disaster loan program. (1A)	Implemented.
	Ensure that the Office of Financial Analysis adheres to documentation requirements of Federal Financial Accounting and Tech Release No. 3. (1B)	Partially Implemented.
Liability for Loan Guarantees and Related Accounts for Pre-1992 Loan Commitments	Estimate the Pre-1992 guarantee loan default liability utilizing risk factors in accordance with SFFAS No. 2. Maintain documentation. Perform analysis to assure estimate conforms to SFFAS No. 2. (2)	Implemented.
Financial Reporting	Assess whether SBA has devoted sufficient resources to adequately address its current financial reporting, and decide if it should be re-engineered. (3A)	Unresolved. Repeat Recommendation.
	Perform fluctuation analyses and correct obvious errors before submitting draft financial statements. (3B)	Unresolved. Revised Recommendation.
	Re-engineer and enhance the quality control process and continue to develop and document the financial reporting process. (3C)	Unresolved. Revised Recommendation.
Funds Control	Review obligated and unobligated balances remaining in liquidating funds. Deobligate where appropriate. (4A)	Implemented.
	Develop and implement an integrated funds control system. (4B)	Unresolved. Revised Recommendation.
	Develop and implement a process to record apportionment amounts accurately. (4C)	Implemented.
Master Reserve Fund	Develop a process for estimating SBA's ownership in earnings from the MRF that provided accurate, complete, and timely data for the financial statements. SBA's process should at least include a representative statistical sample to estimate the gain or loss on closed pools and extrapolation of such results, taking into account any differences in characteristics between closed and open pools. (5A)	Implemented.
Agency-wide Information Systems Control	Please refer to separate report.	Unresolved. Updated in Separate Report.

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 No. 01-02. Our objectives were not to provide assurance on internal control; accordingly, we do not provide an opinion on such control.

Finally, 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 No. 01-02. We concluded that SBA's control over performance measures must be enhanced to ensure accuracy and reliability as required by OMB Bulletin 01-09 and prevailing FASAB 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 also 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.

Very truly yours,

COTTON & COMPANY LLP

[FOIA Ex. 6]

Charles Hayward, CPA
Partner

January 28, 2004
Alexandria, Virginia

COTTON & COMPANY LLP

auditors ♦ advisors

DAVID L. COTTON, CPA, CFE, CGFM ♦ CHARLES HAYWARD, CPA, CFE, CISA ♦ MICHAEL W. GILLESPIE, CPA, CFE ♦ CATHERINE L. NOCERA, CPA, CISA
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Independent Auditor's Report on Compliance with Laws and Regulations

Inspector General
U.S. Small Business Administration

We were engaged to audit the financial statements of the U.S. Small Business Administration (SBA) as of and for the years ended September 30, 2003, and 2002, and have issued our report thereon, dated January 28, 2004, in which we disclaimed an opinion on those financial statements.

SBA management is responsible for complying with laws and regulations applicable to the agency. Except as noted in the following paragraph, we performed tests of SBA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, including requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to SBA.

Our Independent Auditor's Report on Internal Control describes, under the caption SBA Management Did Not Meet Milestone Dates and Required Excessive Time to Address Audit Questions, a number of conditions that adversely impacted the scope of our work. These conditions precluded us from completing our testwork of SBA's compliance with the Antideficiency Act.

Results of our tests of compliance disclosed instances of noncompliance with the Prompt Payment Act that are required to be reported under *Government Auditing Standards* and OMB Bulletin 01-02. Our Independent Auditor's Report on Internal Control describes this matter in detail and provides our recommendations for corrective action by SBA management.

Under FFMIA, we are required to report whether SBA's financial management systems substantially complied with federal financial management system requirements, federal accounting standards, and the United States Government Standard General Ledger (SGL) at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. Results of our tests disclosed instances, described below, indicating that SBA's financial management systems did not substantially comply with federal financial management system requirements, federal accounting standards, and the United States SGL at the transaction level.

Please see our Independent Auditor's Report on Internal Control (applicable section cited) for details regarding each of the matters discussed below.



SBA is not in substantial compliance with federal financial management system requirements, because:

- Its core financial system was not able to provide complete, reliable, timely, and consistent financial management information on programs to enable management to fulfill its responsibility to the public and provide timely financial information for preparing financial statements and footnotes and managing current operations, as required by OMB Circular A-127, *Financial Management Systems*. (SBA Management Did Not Meet Milestone Dates And Required Excessive Time To Address Audit Questions)
- Access control, segregation-of-duty, and other general-control weaknesses existed, which will be described in the Office of Inspector General report titled *Audit of SBA's Information System Controls, FY 2003*. (Agency-Wide Information Systems Control Environment)
- Security weaknesses and nonconformances with OMB Circular A-130, *Management of Federal Information Resources*, continued to exist in certain major applications and general support systems. (Agency-Wide Information Systems Control Environment)
- SBA maintained insufficient funds control over obligations entered via journal voucher in the Financial Reporting Information System (FRIS). (Antideficiency Act Control Needs Improvement)

SBA was not in substantial compliance with federal accounting standards, because it:

- Could not support the valuation of subsidy-related balances for the Disaster Assistance, 504, Small Business Investment Company, Participating Security and Section 7(a) loan programs. (Procedures to Identify and Explain Unusual Subsidy Balances)
- Improperly reversed prior-year audit adjustments, misstating current-year budgetary collection and disbursement activity. (Invalid Budgetary Pro-Forma Entries)
- Overstated loan and administrative undelivered orders at September 30, 2003, when it failed to deobligate unneeded obligations and properly accrue for goods and services received as of September 30, 2003. (Monitoring Undelivered Orders)
- Improperly valued the entry to realign subsidy costs from the consolidated balance sheet line item *Liabilities for Loan Guarantees to Credit Program Receivables and Related Foreclosed Property, Net* for defaulted guarantee loans. (Subsidy Realignment Entry)
- Recorded invalid budgetary transactions based upon improper budgetary posting logic for asset-sale administrative costs and liquidating fund transactions. (Invalid Budgetary Pro-Forma Entries)
- Improperly recorded Disaster Assistance program subsidy re-estimates. (Disaster Re-estimate Misstated)
- Disclosed insufficient detail about prior-period adjustments and credit subsidy matters. (Inadequate Disclosures Associated with FY 2002 Restatements)

SBA was not in substantial compliance with the United States Government SGL at the transaction level, because:

- Its combined statement of budgetary resources reflected line item misstatements resulting from failure to record Federal Financing Bank repayment transactions in accordance with SGL criteria. (Invalid Budgetary Pro-Forma Entries)
- SBA's program for posting budgetary transactions to FRIS (known as "Budget Proforma") which is based upon proprietary and memorandum events in the Loan Accounting System, recorded numerous transactions that did not comply with SGL posting logic. (Invalid Budgetary Pro-Forma Entries)
- SBA's automated transaction code used to record default payments to guarantee lenders, improperly recorded purchased interest as contra revenue instead of an expense. This treatment understated program revenues and expenses. (Inadequate Control Over Accounting Entries Related To Transaction Code 195)
- SBA recorded invalid recoveries of prior-year obligations and obligations incurred as the result of conversion problems from its Federal Financial System to its current Oracle-based administrative accounting system. (Monitoring Undelivered Orders)

SBA's Office of the Chief Financial Officer is responsible for financial management systems within SBA. SBA should assign priority to corrective actions for these FFMLA-related matters consistent with requirements of OMB Circular A-50, *Audit Followup*.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our work; 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.

COTTON & COMPANY LLP

[FOIA Ex. 6]

Charles Hayward, CPA

January 28, 2004
Alexandria, Virginia



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

CFO Reply

DATE: January 23, 2004
TO: Robert Seabrooks, Assistant IG for Auditing
FROM: Thomas Dumaresq, Chief Financial Officer
SUBJECT: FY 2004 Financial Statement Audit Report

[FOIA Ex. 6]

The Small Business Administration (SBA) is in receipt of the draft Independent Public Accountant (IPA) reports from Cotton and Company, LLP, that include the auditor's opinion and separate reports on internal controls and compliance with laws and regulations. As you know, the IPA audit of the Agency's financial statements and related processes is a core component of SBA's financial management program.

Unfortunately, the results of this year's audit process indicate that despite SBA's significant improvements over the past year, our efforts have not been sufficient to meet existing financial management standards. The auditor has indicated that it is unable to satisfy itself that the SBA's financial statements fairly present the financial position of SBA as of September, 2003 and 2002. The audit report states that because SBA was late in completing its budgeting and accounting work for certain credit programs and preparing its financial statements, the auditor did not have sufficient time to complete the auditing procedures necessary to form a reasonable basis of opinion on the statements.

SBA acknowledges that key milestone dates were not met and accepts responsibility for not providing sufficient time for the auditor to complete its work. The ambitious subsidy model development agenda we developed to address last year's audit findings ultimately required more time than was available, which left insufficient time for the SBA to complete its established quality assurance review process prior to the completion of the financial statements. Therefore, the draft financial statements delivered to the auditor on December 22nd did not have the benefit of our planned review process. Many of the issues included as audit findings were corrected in revised statements submitted on January 3rd. Pursuant to our agreement with Cotton, we submitted a third version of the financial statements on January 9th that included almost all of Cotton's audit findings as of December 22nd. The final statements submitted on January 16th did include a few additional changes recommended by Cotton at the time. SBA believes the final statements delivered on January 16th provide a fair representation of the Agency's

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financial condition including the restatement of fiscal 2002 results. Unfortunately, the auditor did not have sufficient time to complete its review of those materials.

Last year three key items were identified in the disclaimer opinion: the disaster loan and sales program cost estimates, the Master Reserve Fund Secondary Market Guarantee (MRF SMG) residual value estimate, and the liability for loan guarantees for pre-1992 loans. SBA developed new subsidy estimate models for the Disaster and the MRF/SMG programs as recommended by the auditor last year. The auditor's report acknowledges that the work was completed but indicates Cotton & Co. did not have sufficient time to review all of the relevant materials. We also addressed the pre-1992 loan guarantee issue, and Cotton & Co. was able to review that and agree that the issue had been resolved.

The IPA's Report on Internal Control identifies two material weaknesses: the credit reform control environment and the financial management and reporting control environment. The audit identifies numerous examples of inconsistencies and errors in our credit reform modeling and reporting environment. Many of these issues were contributing factors to the weaknesses in our financial management and reporting results. Overall, we agree with Cotton & Co.'s findings that we need better internal controls over these processes to ensure higher quality results. As noted above however, because of the subsidy model development and restatement related work that had to be completed this year, we were unable to conduct sufficient quality assurance prior to submitting our financial statements. We believe that if we had been able to carry out our quality assurance process as planned, our December 22nd financial statements would have been much better. Instead, it took us a few more weeks to reach that point, which was too late for our auditors to review.

For FY04, we will develop a comprehensive plan with firm milestone dates to meet the accelerated reporting date of November 15th. We will again assess whether we have committed adequate resources to the task. However, we believe that the work we did last year – building three new subsidy models, substantially modifying two others, and resolving major prior year restatement problems – will put us in a much better position this coming year. We anticipate doing only minor model development work this year which will allow us to focus more on our internal control and review processes. We look forward to the opportunity to actually fully implement our quality assurance review process in FY04 and believe that will make a major difference in addressing the types of errors and misstatements identified by Cotton & Co. this year.

We also agree with Cotton & Co.'s recommendation that we take steps to identify and understand unusual subsidy and related account balances. We did make substantial progress on this for the disaster program this year, but there is still work to be done, particularly for SBA's other loan programs. This will be a top priority for SBA in FY04.

Cotton & Co. also recommends improving our standard operating procedures and subsidy model documentation, doing more data reconciliation and quality assurance for the MRF SMG and the SBIC programs, and improving the estimation process for various loan

accounts. These are all fundamentals of good financial management and SBA is committed to accomplishing as many of these items as possible in the coming year. Improving funds control management continues to be an issue for SBA. We made important strides in this area over the past year but we agree with Cotton & Co. that further improvements are necessary.

We appreciate all of your efforts and those of your colleagues in the Office of the Inspector General as well as those of Cotton & Co. While the audit process was again very challenging this year, we believe our efforts and the assistance we received from you and Cotton & Co. resulted in substantial improvements in the quality of our financial statements. Overall we feel our financial management capacity has improved considerably this year and we are proud of what we have accomplished. While we are disappointed that the audit results do not reflect an overall improved financial position for the Agency, we believe the work we completed this year was very significant and puts us in a strong position for the coming year. We continue to be committed to excellence in financial management and look forward to making more progress in the months ahead.

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