



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT MEMORANDUM REPORT

ISSUE DATE: DECEMBER 9, 2005

REPORT NUMBER: 6-07

TO: Michael W. Hager, Associate Deputy Administrator
Office of Capital Access

FROM: /s/ **Original Signed**
Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Review of the 1502 Reporting Process

Attached is a copy of the subject audit memorandum report. The report contains one overall finding and seven recommendations addressed to your office. You agreed with six of the recommendations and disagreed with one. You stated that you did not believe that the audit effort could be used to draw comprehensive inferences about the adequacy of the 1502 reporting process. A written evaluation of your comments is included as part of the report and your comments are included as an attachment.

The finding in the report is the conclusion of the Office of the Inspector General's Auditing Division. The finding and recommendations are subject to our review and corrective action in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response and actions to address the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation Action Sheet. The SBA Forms 1824 should be sent to:

Supervisory Auditor
SBA OIG/Auditing Field Office, Suite 1803
233 Peachtree Street, NE
Atlanta, Georgia 30303

Any questions you may have regarding this report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 2] or James Hudson at (404) 331-[FOIA Ex. 2].

Attachments

**AUDIT MEMORANDUM REPORT
REVIEW OF THE 1502 REPORTING PROCESS**

AUDIT REPORT NUMBER 6-07

DECEMBER 9, 2005

The finding in this report is the conclusion of the Office of Inspector General's Auditing Division based on testing of SBA operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.



U. S. SMALL BUSINESS ADMINISTRATION
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Washington, DC 20416

Date: December 9, 2005

TO: Michael W. Hager, Associate Deputy Administrator
Office of Capital Access

FROM: Robert G. Seabrooks
Assistant Inspector General for Auditing

SUBJECT: Review of the 1502 Reporting Process

As part of the overall evaluation of SBA's Lender/Loan Monitoring System (L/LMS), we have completed a review of the SBA Form 1502 Reporting Process (1502 Reporting Process) to determine whether reliable data was incorporated into the L/LMS. For the purposes of this report, reliable is defined as accurate, complete, and timely. The first phase of the audit was our review of the Process, its objectives, and the related internal controls. Based on our results, we elected not to continue further audit efforts. This report presents our survey results and discusses internal control weaknesses identified. Management's response to the report finding and recommendations is synopsized in the report and included in its entirety as Appendix B.

BACKGROUND

In response to its increasing reliability on private sector lenders to approve, service, and liquidate guaranteed loans, SBA established its current L/LMS to more effectively manage risk associated with its loan portfolio. The current system, which became fully operational as of September 30, 2003, focuses on risk at the loan and lender level and uses data from SBA's Loan Accounting System (LAS) to rate lenders and loans. Data within the LAS is updated monthly through a reporting process which requires lenders to report data about their SBA loan portfolios.

Beginning in 1996, SBA required lenders to report the status of all SBA 7(a) loans in their portfolio using SBA Form 1502, Guaranty Loan Status and Remittance Report. SBA designated Colson Services Corporation, the fiscal transfer agent, as the collection agent for lenders' monthly SBA Form 1502 submissions. To facilitate the collection of this data, at the beginning of each month Colson receives an SBA file to establish the population of loans expected to be reported during the month. The information Colson receives from lenders is then compared to SBA data using a series of edit checks to ensure accuracy and completeness. Colson notifies lenders of discrepancies identified by the edit checks so corrections can be made.

About the 20th of each month, Colson transmits loan information to SBA to update the LAS. During the same month, additional information is provided to SBA as lenders correct identified reporting errors or submit subsequent 1502 submissions to Colson. Prior to using any

of the loan data from Colson, SBA runs a series of edit checks to ensure that the information is valid. SBA personnel attempt to obtain corrections for loans with errors identified during the edit checks after the first of the next month.

OBJECTIVES, SCOPE, AND METHODOLOGY

The survey objective was to determine whether internal controls for the reporting of lender portfolio data ensured that the information was accurate, complete, and timely. We reviewed internal controls used by Colson to receive, process, correct and transmit data to SBA. In addition, we evaluated SBA's internal controls to verify the accuracy of the data received, correct errors in the data, and assess how well the 1502 Reporting Process functioned. Also, information in the LAS was traced to source data to verify its accuracy, completeness, and timeliness.

The survey effort included on-site work at SBA headquarters; Colson Services Corporation, located in New York, New York; and six lenders selected judgmentally located in Atlanta, Georgia, and Chicago, Illinois. We interviewed personnel at SBA's headquarters; SBA's commercial loan service centers at Little Rock, Arkansas; and Fresno, California; and selected district offices.

The survey encompassed transactions during the period October 2004 through May 2005. During this period, SBA's portfolio averaged 271,486 loans per month. The survey was accomplished in accordance with generally accepted Government Auditing Standards.

SURVEY RESULTS

Finding 1- Improvement Needed in Internal Controls over the 1502 Reporting Process

SBA had not established adequate internal controls to ensure that lender loan status data reported on the 1502 report was reliable. Specifically, management had not: (i) set formal control objectives; (ii) assessed the risk of reporting errors to users; (iii) established appropriate control activities addressing reliability; and (iv) adequately monitored the reporting process. These conditions occurred because a control environment that placed appropriate emphasis on the necessary procedures and practices needed to ensure data reliability had not been established. Consequently, the LAS contained inaccuracies in the status and outstanding guarantee loan balances that could potentially compromise the L/LMS risk assessment process.

Office of Management and Budget (OMB) Circular A-123, entitled Management Accountability and Control, revised June 21, 1995, states that management controls are the organization, policies, and procedures used to reasonably ensure that reliable and timely information is obtained, maintained, and reported for use in decision making. In addition, the U.S. Government Accountability Office's (GAO) Standards for Internal Control in the Federal Government, issued in November 1999, defines internal controls as an integral component of management that is designed to provide reasonable assurance regarding the achievement of the following objectives: (i) effectiveness and efficiency of operations; (ii) reliability of financial reporting; and (iii) compliance with applicable laws and regulations. The GAO standards go on

to state that management sets the objectives, puts the control mechanisms and activities in place, and monitors and evaluates the control.

Weak Internal Controls

Due to internal control weaknesses, the 1502 reporting process was inefficient and resulted in the LAS receiving unreliable loan data. Potentially, unreliable data in the LAS could impact SBA's assessment of risk in the loan portfolio, SBA's financial reporting and SBA's ability to manage its guarantee loan program. The specific internal control weaknesses identified during the survey were organized in the categories promulgated in OMB Circular A-123.

Formal Control Objectives

Formal objectives addressing the reliability of reported information were not established. OMB Circular A-123 states that one of the three objectives of internal control is the reliability of financial reporting and that management is responsible for communicating the objectives. A management official stated that accuracy, completeness, and timeliness are not considered as individual attributes, but collectively SBA desires to achieve a benchmark level of 100 percent. This desired benchmark, however, is not stated in standard operating procedures, policy and procedural notices, or other issued guidance.

Assessment of Risk

The impact of unreliable data on the various LAS users was not determined. One of the users, the Office of Lender Oversight (OLO), extracted data from the LAS for use in assessing SBA's loan portfolio risk level. Two of the elements used in their risk assessment process, loan status and outstanding loan guarantee balances, could be impacted by unreliable 1502 reporting data.

In an effort to assess the impact of control weaknesses identified, we judgmentally sampled six lenders for which reporting errors had been identified. Our primary goal was to assess the effectiveness of the error correction process both at SBA and Colson. During our detailed testing, we reviewed loans for which no errors were identified, as well as loans with identified errors. Discrepancies were found in both loan categories.

A review of 217 loans reported by six lenders in December 2004, showed that the LAS had the wrong status for 86 (40 percent) of these loans. In addition, for the same six lenders, the outstanding guaranty balances in the LAS, applicable to 129 of their 217 loans were inaccurate. Amounts for 45 loans were understated by \$7.3 million and amounts for 84 loans were overstated by \$2.2 million.

Control Activities

An organization's control activities should include policies, procedures, and mechanisms to help ensure that objectives are met. We identified the following problems with the control activities for the 1502 Reporting Process:

- (i) SBA had not issued adequate policies and guidance for the 1502 Reporting Process. As a result, SBA personnel were not clear on who was responsible for making corrections to errors identified during edit checks. Personnel at four district offices believed lender reporting errors assigned to their offices were being corrected by the service and liquidation centers. Service center personnel did not have access to 1502 errors assigned to the district offices and, therefore, were not correcting these errors. Also, the liquidation center had not assigned personnel to correct any lender reporting errors for loans assigned to district offices. Further, SBA personnel were not routinely determining why errors occurred so action was not taken to minimize future errors.
- (ii) A lack of formal training caused loan status reporting errors. Only two of the six lenders contacted had received formal training from either SBA or Colson. For example, one lender provided a 1502 report each time a loan payment was received instead of submitting a single monthly 1502 report, as required. The same lender also submitted no information on loans for which payments were not received during the month. Another lender incorrectly believed that reporting was not required for loans that were in “committed” status. The remaining four lenders made other types of reporting errors.
- (iii) Existing controls were not used to help minimize reporting errors. The most common error identified by SBA each month was lenders’ failure to report data on loans in “committed”, “disbursed”, and “in-liquidation” status. For the period October through November, unreported loans represented from 6.4 to 7.9 percent of the monthly errors. Because there was no SOP requirement for SBA personnel or Colson to determine the cause of errors, efforts were not made to reduce recurring errors.
- (iv) Maximum use of Colson was not made to address lender reporting errors. Colson performed edit checks on 15 attributes of the reported data to ensure reliability. The edit checks identified an average of 16,491 errors per month for the period October through December 2004. After receiving the data from Colson, SBA performed 38 edit checks including the 15 done by Colson. Errors identified by SBA included errors that should have been identified by Colson. SBA personnel began its correction process during the first of the following month. By having SBA personnel do the work that could be done by the contractor, the 1502 Reporting Process was not operating efficiently.
- (v) The procedure for penalizing those lenders, who did not report all applicable loans or consistently reported loans improperly, was flawed. A senior management official stated that unreported loans were supposed to be classified as delinquent (this requirement was not documented). A sufficient number of delinquent loans could result in a lender being classified as high risk. All six of the lenders reviewed reported late, improperly reported, or did not include all loans in their 1502 submissions during our review period. We found no evidence

of their loans being classified as delinquent or actions taken against these lenders because of their reporting deficiencies.

Monitoring the SBA and Colson 1502 Correction Process

Internal control monitoring assesses the quality of performance over time. Evaluations of internal controls should be performed periodically and deficiencies investigated. The edit checks by SBA and Colson were significant internal controls for the 1502 Reporting Process. To monitor these internal controls, management used the Summary Loan Reject Report issued by the Office of the Chief Information Officer and the Monthly Status Report issued by Colson. We concluded that SBA's monitoring efforts needed improvement.

- a. The Summary Loan Reject Report, while allowing management to measure successful updates to the LAS, did not permit the identification of the percentage of corrections made by each SBA office. At our request, SBA provided reports that showed the percentage of errors corrected by individual SBA offices for the 3-month period, March through May 2005. Historical correction rates were not available for months prior to March. The reports disclosed correction percentages ranging from 22 to 52 percent for the period. The service centers, who were responsible for resolving the bulk of all errors, resolved an average of about 52 percent of their errors monthly. We can not categorize these low percentages as deficiencies because management has not set a formal correction standard. As stated previously, however, management had an informal benchmark of 100 percent.
- b. Management did not sufficiently assess how well Colson performed its job. The Colson Monthly Status Report was used by management to oversee the contractor's efforts and identified the number of reporting errors at the end of each month. The report, however, did not identify the percentage of errors resolved by Colson in a given month. Also, Colson's contract required it to identify and correct errors but did not contain a benchmark for error resolution nor did it require the contractor to determine why the errors occurred. At our request, Colson provided detail reports for November through January indicating the percentage of error correction by error type. These reports disclosed that Colson corrected only 10 to 15 percent of the errors that were identified in any given month.

Improved Control Environment Needed

The internal control weaknesses identified existed because management had not established a control environment conducive to effective internal controls over the 1502 Reporting Process. The control environment is the organizational structure and culture created to sustain organizational support for effective internal controls. It should have a pervasive influence on (i) the way business activities are structured, (ii) how objectives are established and risks assessed, (iii) information and communication systems, and (iv) monitoring activities. The control environment for the 1502 Reporting Process was not sufficient and improvements were not made because management believed that reporting errors in the process were inconsequential

when compared to the reporting volume. Also, they believed that the reporting errors “cycled” themselves out-- that SBA would receive the appropriate loan status and guaranty balances in the next reporting cycle. One of the primary users of the 1502 data, OLO, viewed the reporting errors as immaterial because of mitigating factors, such as on-site reviews of lenders and 2- year trend analysis data that were used in assessing risk.

Recommendations

We recommend that the Associate Deputy Administrator for Capital Access take the following actions:

- 1A. Revise Standard Operating Procedures to include:
 - (i) a description, requirements, and the objectives of the 1502 reporting process, and
 - (ii) offices responsible for correcting identified 1502 reporting errors.
- 1.B. Conduct and document an assessment of the internal and external risks that would prevent 1502 Reporting Process objectives from being met.
- 1C. Ensure that SBA and lender personnel receive appropriate formal training regarding the 1502 reporting process.
- 1D. Ensure that an automated process is initiated to identify and re-classify all loans not reported on the monthly SBA Form 1502 submission to delinquent status.
- 1E. Modify the contract to require Colson to:
 - (i) expand the edit check system to encompass all edit checks currently being used by SBA,
 - (ii) meet benchmarks regarding the percentage of errors to be corrected monthly,
 - (iii) determine the cause of 1502 reporting errors, and
 - (iv) identify and report to SBA, lenders who consistently have reporting errors.
- 1F. Improve monitoring efforts over SBA and Colson by:
 - (i) establishing benchmarks for the correction of reporting errors by responsible offices and
 - (ii) monitoring field offices and Colson’s efforts to correct reporting errors to ensure the achievement of established benchmarks.
- 1G. Consider the internal control deficiency identified in this report as a material weakness that should be cited in the annual Federal Managers Financial Integrity Act (FMFIA) assurance statement and reported in the Agency’s annual Performance and Accountability Report (PAR).

Management Response

The Associate Deputy Administrator for Capital Access (ADA/CA) agreed with six of the recommendations. He disagreed with the recommendation to consider the deficiencies identified in the report as material weaknesses and to cite them in the Federal Managers Financial Integrity Act. He questioned the OIG's ability to make conclusions regarding the adequacy of internal controls surrounding the loan data without a random sample. He believed that the report should be revised to reflect that results presented are not based on a randomly selected set of lenders, but on a judgmentally selected set of lenders that were identified as having problems with the 1502 reporting process. For this reason, he does not believe the report reflects the overall adequacy of internal controls or the accuracy of the reporting.

OIG Evaluation of Management's Response

We accept the ADA/CA's response to recommendations 1.A through 1.F as responsive. The report was revised to show that the testing was based on a judgmental sample.

We do not agree with the conclusion concerning our evaluation of the internal controls surrounding the 1502 Reporting Process and the judgmental sample. Our conclusions were based on the examination of the internal control structure for the 1502 Reporting Process. As shown in the finding, the 1502 Reporting Process has one or more internal control weaknesses for each of the Government Accountability Office's and OMB Circular A-123 standards for internal controls. Thus, internal control weaknesses could impact SBA's ability to manage its portfolio and assess risk. The internal control weaknesses allowed loans to be reported with incorrect statuses and inaccurate outstanding balances for the six lenders audited. Our sample results are merely an example of the errors that occurred due to the weak controls and lead us to believe that similar errors are occurring monthly for other lenders. A random sample may have produced an even greater number of errors.

OCA also took issue with the fact that we chose lenders with known reporting errors. We deliberately chose lenders with errors, however, in order to assess the effectiveness of the error correction process both at SBA and Colson. We found that during the process some errors were not corrected timely and others were not corrected at all. As stated in the finding, these errors resulted in incorrect loan statuses, as well as the overstatement and understatement of loan balances.

Based on the systemic control weaknesses identified, and the lack of risk assessment to demonstrate that the errors do not have a detrimental effect on the use of the data in the portfolio risk assessment process, we continue to believe errors in the data and the surrounding controls should be considered a material weakness under the annual reporting of the Federal Managers Financial Integrity Act.

ATTACHMENT A

AUDIT REPORT DISTRIBUTION

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ATTACHMENT B



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF CAPITAL ACCESS
409 THIRD ST, SW
WASHINGTON, DC 20416

DATE: November 16, 2005

TO: Robert G. Seabrooks
Assistant Inspector General for Auditing

FROM: Michael W. Hager
Associate Deputy Administrator, Office of Capital Access

SUBJECT: Response to Draft Survey Report-Review of the 1502 Reporting Process

The purpose of this memorandum is to provide OCA's response to the OIG's draft Survey Report-Review of the 1502 Reporting Process. OCA recognizes that there are improvements that can be made to the 1502 Reporting Process. However, OCA believes that many of the findings included in the draft survey report are based on the results of a review of six participating lenders. Further, it is our understanding that these six lenders were identified by Colson/SBA to be lenders having problems with 1502 reporting and, thus, do not represent a random sample. A non-random sample of 6 lenders would not provide the basis for making comprehensive conclusions about the 1502 reporting process.

The report concludes that SBA has not established adequate internal controls to ensure that lender loan status data reported on the 1502 report was reliable resulting in data inaccuracies that could potentially compromise the Loan and Lender Monitoring System (L/LMS) risk assessment process. Without a random sample, OCA questions the ability of OIG to make conclusions regarding the adequacy of the internal controls surrounding SBA's loan data. OCA strongly supports the need for internal controls. In fact, we believe that there are internal controls in place as evidenced by our ability to achieve monthly reporting compliance in the 92-93% range. Nevertheless, given that the Fiscal Transfer Agent contract is scheduled for renewal in the spring of FY2006, OCA also believes that now is an appropriate time to assess the current internal control structure and evaluate the controls against the guidance provided by OMB Circular A-123, GAO's Standards for Internal Control, and OIG.

With regard to the report language itself, OCA believes that the draft report should be revised to reflect the fact that conclusions about the data, particularly in the section on Assessment of Risk, should note that the results presented are not based on a randomly selected set of lenders.

Rather, the report should reflect that the results are based on a judgmentally selected set of lenders that were identified as having difficulty with 1502 reporting and may not reflect the overall adequacy of internal controls or the accuracy of the reporting.

OCA's comments for each of the seven recommendations are provided below.

OIG Finding 1: Improvement Needed in Internal Controls over the 1502 Reporting Process.

OIG Recommendation:

1.A Revise Standard Operating Procedures (SOP) to include:

- 1. a description, requirements, and the objectives of the 1502 reporting process and**
- 2. offices responsible for correcting identified 1502 reporting errors.**

Last year, SBA completed the process of moving loan servicing and liquidation from the District Offices to centers that specialize in these functions. We agree that it is time now to update the SOPs to reflect the changes in the responsibility of the District Offices and the Servicing and Liquidation Centers. We will identify responsibilities and provide a description of the 1502 process and the reporting requirements in the SOP.

1.B Conduct and document an assessment of the internal and external risks that would prevent 1502 objectives from being met.

As noted above, OCA strongly supports the need for internal controls. We believe that there are internal controls in place as evidenced by our ability to achieve monthly reporting compliance in the 92-93% range. Nevertheless, OCA also believes that now is an appropriate time, given the expected re-procurement of Fiscal Transfer Agent services in the spring of 2006, to assess the current internal control structure and evaluate the controls against the guidance provided by OMB Circular A-123, GAO's Standards for Internal Control, and OIG. OCA will commit to undertaking an internal control assessment of the 1502 reporting process to clearly identify existing internal controls, evaluate their effectiveness, and identify any additional controls necessary to meet 1502 reporting objectives.

1.C Ensure that SBA and lender personnel receive appropriate formal training regarding the 1502 reporting process.

We agree that training is important and believe that we are in compliance with the recommendation. SBA District Offices and Colson have conducted a number of refresher classes in 1502 reporting. New participating lenders receive a new lender package from Colson which includes the 1502 reporting instruction and support software that contains programmed 1502 reports. Additional copies of the new lender information kit are available from Colson via the internet or lenders can request a disc by telephone, e-mail or regular mail. In addition, please

note that OCA estimates that over 50 percent of our lenders use third-party vendor programs that automate and/or support the processing and remittance of 1502 reports. We believe the level of training is adequate and there are sufficient resources available to any lender that needs help with its 1502. To resolve this recommendation, we will issue an Information Notice reminding lenders of the assistance available to help them complete the 1502.

1.D Ensure that an automated process is initiated to identify and re-classify all loans not reported on the monthly 1502 submission to delinquent status.

OCA agrees with this recommendation and will work with OFA, OLO and OCIO to develop an automated process which will change the loan status from current to delinquent on any loan where SBA is not provided a monthly update to the loan status if that loan was in current status the previous month. If the loan is already in delinquent status, it will remain in delinquent status and if the loan is in liquidation status, it will remain in liquidation status.

1.E Modify the Contract to require Colson to:

- 1. expand the edit check system to encompass all edit checks currently being used by SBA,**
- 2. meet benchmarks regarding the percentage of errors to be corrected monthly,**
- 3. determine the cause of 1502 reporting errors, and**
- 4. identify and report to SBA, lenders who consistently have reporting errors.**

The current Fiscal and Transfer Agent (FTA) contract expires in April of next year. We believe now is an appropriate time to identify and include performance provisions in the Request for Proposals that is currently being drafted. There are some barriers to achieving all of the modifications in the form recommended by OIG but OCA will ensure that the spirit of OIG's recommendations are addressed in the new procurement for the FTA.

- Colson's edits are aimed at identifying missing data and correcting data that are provided to Colson, but are clearly incorrect. The edits that are not currently on the Colson list relate to status code changes and other items that have historically been controlled by SBA staff. We will need to identify and evaluate these items to ascertain which are most appropriately assigned to the FTA.
- We believe that some form of performance goal is appropriate. However, it will need to be flexible since all the aspects of data collection that are not under the control of the Fiscal and Transfer Agent. For example, significant non-compliance issues may arise for lenders primarily located in the disaster areas. Performance goals will be identified and established once the internal control evaluation is completed.
- It is important to work closely with the FTA to understand trends and developing issues and their implications particularly as they relate to 1502 reporting and their

- impact on SBA's loan records. We will evaluate how to best achieve this recommendation and integrate it into the procurement planned for next year.
- We agree the recommendation to identify for SBA those lenders with ongoing problems and will add this requirement to the planned request for proposal.

1.F Improve the monitoring efforts over SBA and Colson by:

- 1. establishing benchmarks for the corrections of reporting errors by responsible offices and**
- 2. monitoring field offices and Colson's efforts to correct reporting errors to ensure the achievement of established benchmarks.**

1. We believe that some form of performance is appropriate. However, as noted above, it will need to be flexible. Performance goals will be identified and established once the internal control evaluation is completed.

2. As part of the review of internal controls in the area of 1502 reporting, we will establish a process for monitoring the correction of reporting errors.

1.G Consider the internal control deficiency identified in this report as a material weakness that should be cited in the annual Federal Managers Financial Integrity Act (FMFIA) assurance statement and reported in the Agency's annual Program Analysis Report (PAR).

OCA disagrees that the findings included in the draft survey report represent a material weakness and this recommendation should be dropped from the final report. As noted throughout management's response to the report, the sample selected is not a statistically valid random sample and the findings cannot be used to draw comprehensive inferences about the adequacy of internal controls and the accuracy of 1502 reporting as a whole. However, we do believe that now is an appropriate time, particularly given that FTA services will be re-procured, to evaluate internal controls and set expectations under a new FTA contract.

