

AUDIT OF SBA'S FY 2005
FINANCIAL STATEMENTS – MANAGEMENT LETTER
AUDIT REPORT NUMBER 6-10
JANUARY 18, 2006

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
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

AUDIT REPORT
Issue Date: January 18, 2006
Number: 6-10

To: Jennifer Main,
Chief Financial Officer

Herbert Mitchell
Associate Administrator for Disaster Assistance

Michael W. Hager
Associate Deputy Administrator for Capital Access

From: /S/ **Original Signed**
Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2005 Financial Statements Management Letter

Attached is the Management Letter issued by the independent certified public accounting firm, Cotton & Company LLP (Cotton) which identifies non-reportable conditions that came to Cotton's attention during its audit of SBA's fiscal year (FY) 2005 and FY 2004 financial statements. We contracted with Cotton to audit those statements on which Cotton issued its reports on November 15, 2005, including its reports on internal control and compliance with laws and regulations. The contract required that the audit be done in accordance with generally accepted government auditing standards; the Office of Management and Budget's bulletin, *Audit Requirements for Federal Financial Statements*, and the GAO/PCIE *Financial Audit Manual*.

Cotton noted 17 areas for improvement, four of which were reported last year. According to Cotton, these four areas are repeated this year because the conditions, as well as the need for implementing enhanced controls, continue to exist. The four repeat conditions noted are:

- Accountable Property Controls
- Untimely Recording of Obligations
- Entry to Align Statement of Financing with Statement of Net Cost
- Monitoring of SBIC Participating Securities Reimbursement Assumptions

In addition, Cotton noted the following areas for improvement that were not reported last year:

- Operating Expenses Recorded in the Incorrect Period
- Guarantee and Disaster Loan Charge-off Controls
- Failure to Retain Supporting Documentation to Substantiate Loan Transactions
- Noncompliance with the Prompt Payment Act
- Obligation Controls
- Guarantee Loan Purchase Controls
- Inadequate Travel Expense Controls
- Validation of Source Data Used in Model
- Intragovernmental Activity and Balances Classification, Confirmation and Reconciliation
- Noncompliance with the Single Audit Act
- Improper Payments Information Act Report Missing Required Disclosures
- Subsidy Realignment Entry
- Accounting Structure SOP

One recommendation is directed to the Associate Administrator for Disaster Assistance, one recommendation is directed to the Associate Deputy Administrator for Capital Access and eighteen recommendations are directed to the Chief Financial Officer, six of which require coordination with various program offices, including the Office of Administration (1) and the Office of Field Operations (6).

SBA management generally agreed with the auditor's findings and recommendations and noted they were pleased in the slight reduction of items reported from the previous year. Management believes that remediation actions already underway will address the issues noted in the report. Additionally, management noted that the Office of Disaster Assistance (ODA) is undergoing a transformation of its entire operations that should allow it to address the travel related recommendation in the report.

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 Jeff Brindle, Director, Information Technology and Financial Management Group at (202) 205-[FOIA Ex. 2].

Attachments

REPORT DISTRIBUTION

<u>Recipient</u>	<u>No. of Copies</u>
Chief Operating Officer	1
Associate Administrator Office of Congressional & Legislative Affairs	1
Associate Deputy Administrator Office of Management and Administration	1
Associate Administrator Office of Field Operations	1
Associate Administrator Office of Financial Assistance	1
Associate Administrator Investment Division	1
Chief Information Officer	1
Chief Financial Officer Attn: Jeff Brown	1
General Counsel.....	3
Government Accountability Office.....	2



Cotton & Company LLP
635 Slaters Lane
4th Floor
Alexandria, VA 22314

P: 703.836.6701
F: 703.836.0941
www.cottoncpa.com

Inspector General
U.S. Small Business Administration

Cotton & Company LLP audited the financial statements of the U.S. Small Business Administration (SBA) as of September 30, 2005, and for the year then ended and has issued our reports thereon dated November 15, 2005, under separate cover. Our reports included those on SBA's internal control and compliance with laws and regulations. Our compliance report includes comments on the Federal Financial Management Improvement Act.

The purpose of this management letter is to communicate "non-reportable conditions" to SBA management. This letter is intended solely for the information and use of SBA management.

We would like to express our appreciation to the SBA representatives who assisted us in completing our audit. They were always courteous, helpful, and professional.

Very truly yours,

COTTON & COMPANY LLP

/S/ Original Signed

Charles Hayward, CPA
January 13, 2006

MANAGEMENT LETTER REPORT
U.S. SMALL BUSINESS ADMINISTRATION
FISCAL YEAR 2005 FINANCIAL STATEMENT AUDIT

Cotton & Company LLP audited the financial statements of the U.S. Small Business Administration (SBA) for Fiscal Year (FY) 2005. This document discusses matters we noted involving internal control that warrant management attention.

We noted 17 areas for improvement. The following four areas, which were reported last year, are repeated this year because the conditions, as well as the need for implementing enhanced control, continue to exist.

- Accountable Property Controls
- Untimely Recording of Obligations
- Entry to Align Statement of Financing with Statement of Net Cost
- Monitoring of Small Business Investment Company (SBIC) Participating Securities Reimbursement Assumptions

In addition, we noted the following areas needing improvement that were not reported last year:

- Operating Expenses Recorded in the Incorrect Period
- Guarantee and Disaster Loan Charge-Off Controls
- Failure to Retain Supporting Documentation to Substantiate Loan Transactions
- Noncompliance with the Prompt Payment Act
- Obligation Controls
- Guarantee Loan Purchase Controls
- Inadequate Travel Expense Controls
- Validation of Source Data Used in Model
- Intragovernmental Activity and Balances Classification, Confirmation, and Reconciliation
- Noncompliance with the Single Audit Act
- Improper Payments Information Act Report Missing Required Disclosures
- Subsidy Realignment Entry
- Accounting Structure Standard Operating Procedures (SOP)

1. Accountable Property Controls

Internal control over accountable property at field and headquarters locations was inadequate. We tested a randomly-selected sample of 80 property items and noted the following:

- The physical locations of 8 property items were not accurately recorded in the accountable property system.
- 7 property items located at field offices were not listed in the accountable property system.
- 3 property items were assigned to retired and/or former SBA employees.
- 1 field office did not perform annual inventories in 2 separate years to update the accountable property system.

- 1 property item did not contain a bar code.
- 1 property item listed in the accountable property system could not be located.
- 1 property item was excessed but was not removed from the accountable property system.

Field and headquarters Accountable Property Officers did not follow procedures to update the accountable property system in a timely manner when accountable property was acquired, transferred, or excessed. The ineffective operation of internal controls over accountable property creates a potential for misappropriation of assets.

Government Accountability Office (GAO) standards for internal control in the federal government require agencies to establish physical control to secure and safeguard assets. In addition, such assets should be periodically counted, and compared to control records. Accountable property includes items valued at \$50 or over and that can be easily pilfered, such as computers and related equipment and cameras. Entering such items in the property records is an important step to help ensure accountability and financial control over assets and to deter theft or improper use of government property.

Recommendation

- 1A. We recommend that the Chief Financial Officer (CFO) coordinate with the Office of Administration and Office of Field Operations (OFO) to implement controls to ensure that the accountable property system remains current and accurate throughout the year, not only after completion of the annual inventory.

2. Untimely Recording of Obligations

SBA incurred costs before recording corresponding obligations during FY 2005. The Atlanta Disaster Area Office (DAO) incurred \$62,952 of travel expenses paid through the Bank of America Centrally Billed Account in excess of the quarterly blanket amount obligated for such expenditures. In making its quarterly blanket purchase agreement for travel, DAO underestimated first-quarter travel expenses by approximately 21 percent, making it necessary to obligate an additional amount near the end of the quarter. DAO staff, however, waited for the Bank of America billing statement listing travel charges incurred to determine the additional amount to obligate. This billing statement was received approximately 30 days after the travel occurred.

The Birmingham Home Loan Servicing Center incurred \$21,101 of network maintenance costs before recording the obligation in the accounting system; it recorded the corresponding obligation after the vendor invoice was received. The Birmingham field office similarly waited for a vendor statement outlining charges before establishing an obligation for services. The vendor submitted the statement approximately 120 days after the start of the purchase-order service period. In this case, the purchase order was approved on April 26, 2005, for services that started on January 1, 2005.

GAO *Standards for Internal Control in the Federal Government*, page 15, states the following:

Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help to ensure that all transactions are completely and accurately recorded.

Office of Management and Budget (OMB) Circular A-127, Financial Management Systems, paragraph 6, states that:

...financial management systems must be in place to process and record financial events effectively and efficiently, and to provide complete, timely, reliable and consistent information for decision makers and the public.

The GAO *Red Book*, Volume II, Chapter 7, page 6, states that:

If a transaction meets the criteria for recording an obligation, the agency not only may but must at that point record the transaction as an obligation.

Recommendation

2A. We recommend that the CFO coordinate with OFO to train SBA field office administrative and accounting staff in procedures for requisitioning services and obligating funds.

3. Entry to Align Statement of Financing with Statement of Net Cost

SBA recorded unsupported entries totaling \$3,472,379 in General Ledger Account 6999A, *Financing Adjustments-Line 16*, to ensure that the net cost of operations total shown on its Statement of Financing agreed with the net cost of operations total shown on its Statement of Net Cost. SBA was unable to fully reconcile net obligations to net cost of operations, thus it utilized General Ledger Account 6999A. The use of General Ledger Account 6999A misstated the Statement of Financing line item *Other Resources that Do Not Affect Net Cost of Operations* and gives the appearance that SBA has fully reconciled its budgetary and proprietary accounting when in fact an actual difference of \$3,472,379 existed.

OMB Circular A-123, *Management's Responsibility for Internal Control, Section II, Establishing Management Controls: Recording and Documentation*, states that:

Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports.

In addition, OMB Circular A-136, *Form and Content of the Performance and Accountability Report, Section 7, Statement of Financing*, states that the consolidated Statement of Financing:

...articulates the relationship between net obligations derived from an entity's budgetary accounts and net cost of operations derived from the entity's proprietary accounts by identifying and explaining key differences between the two numbers.

Recommendation

- 3A. We recommend that the CFO fully reconcile net obligations to net costs of operations as part of the consolidated Statement of Financing compilation process and discontinue using unsupported entries.

4. Monitoring of SBIC Participating Securities Reimbursement Assumptions

The base used by SBA to calculate the prioritized payment reimbursements historical average curve was not intuitive, and resulting estimates of future reimbursements were not consistent with actual program experience.

The historical average curve is developed by dividing amounts collected for reimbursements of advanced prioritized payments in each year of a cohort's life by the principal balance of loans outstanding at the end of the previous year of a cohort's life and calculating the weighted average for each year across all cohorts. The amount of advanced prioritized payments that an SBIC reimburses SBA is contingent upon the SBIC's profitability and allocation of its distributions and is not relevant to the principal balance outstanding for that SBIC.

According to Investment Division records, SBA has made approximately \$1.3 billion in advanced prioritized payments (FYs 1994-2005), collected approximately \$338 million in reimbursements (about 26 percent of advances made), and charged off approximately \$325 million (about 25 percent of advances made). The FY 2005 model estimates a total of \$745 million of future advances (FYs 2006-2015) and \$710 million of future reimbursements (FYs 2006-2014). When added to historical advances and reimbursements, this yields total advances of \$2 billion (actual plus forecasted) and total reimbursements of \$1 billion (actual plus forecasted). Thus, the model is projecting (using outstanding principal balances as a base) that SBA will be reimbursed about half of the advances it makes. This is double the historical reimbursement average. This assumption appears to overestimate future reimbursements of advanced prioritized payments as compared to the historical reimbursement rate.

The Federal Accounting Standards Advisory Board's (FASAB) Credit Reform Task Force (Accounting and Auditing Policy Committee), Technical Release No. 6, *Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, paragraph 40, states that:

...cash flow models should be tested for reliability by comparing estimated cash flows to actual cash flows and assessing the model's ability to replicate the credit program's performance.

Recommendation

- 4A. We recommend that the CFO continue to monitor reimbursement assumptions used in the SBIC Participating Securities model to estimate future reimbursements of advanced prioritized payments to ensure that future reimbursements estimated by the model are reasonable given actual program experience and expectations.

5. Operating Expenses Recorded in the Incorrect Period

SBA recorded prior-year administrative expense activity as current-year expenses in the general ledger. We noted instances in which expenses were reported in the improper period at nine of the offices where we conducted interim field site testing. Expenses reported in the wrong accounting period were incurred

for technology consulting services, non-DAO travel, credit card expenditures, IT equipment, document shipping, and copier maintenance.

Due to delays in receiving source documentation, SBA accounting staff did not enter transactions into the Joint Administrative & Accounting System (JAAMS) in time to meet the fiscal yearend cut-off. SBA did not establish a yearend accrual for these types of operating expenses because, based on SBA's estimates, amounts were not material to the financial statements.

FY 2005 Operating Expenses were overstated by a known amount of \$1,807,150 as of May 31, 2005, and prior FY 2005 Operating Expenses were understated by the same amount. Because the test sample was statistically selected, we projected this known misstatement to the population as of May 31, 2005, resulting in a projected overstatement of FY 2005 Operating Expenses of \$12,460,794. Additionally, General Ledger Accounts 2110, Accounts Payable, and 4901, Delivered Orders – Unpaid, were understated, Account 4801, Undelivered Orders – Unpaid, was overstated by a known amount of \$1,807,150 as of September 30, 2004.

Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting Concepts and Standards*, paragraph 15, states that:

In financial accounting and reporting, the costs that apply to an entity's operations for the current accounting period are recognized as expenses of that period.

Recommendation

5A. We recommend that the CFO implement functionality in the FRIS general ledger to identify and summarize expense items by the effective date of the transaction. This will enable SBA to monitor cutoff activity and develop an accrual methodology to adequately estimate and record non-grant operating expenses in the proper accounting period.

6. Guarantee and Disaster Loan Charge-Off Controls

SBA's controls over the loan charge-off process were not operating effectively to ensure that the amount approved for charge off per the SBA Form 327, *Modification or Administrative Action*, agrees with the outstanding principal balance to be charged off per the Loan Accounting System, and that the charge off is reviewed for legal sufficiency. Additionally SBA did not record accruals for loan charge offs that were approved but not yet recorded in the accounting system.

We tested 161 loan charge-off transactions as of May 31, 2005, at field and headquarters sites and noted the following:

- SBA did not record loan charge offs in the Loan Accounting System in the fiscal year in which the charge offs were approved. SBA did not record a loan charge-off accrual (7 instances).
- Amounts to be charged off were not accurately reflected on SBA Form 327 used to approve the charge-off action (11 instances).
- The charge off was not reviewed for legal sufficiency before the transaction was processed (1 instance).

Charge-off transactions are typically approved on one day and recorded in the Loan Accounting System the following day, because approval and recording of the charge off are separated between the Denver Finance Center and the approving field/program office. If the approval is made on a Friday, the charge off is not recorded in the Loan Accounting System until Monday. During the fiscal year, this 1- or 2-day delay between approval and recording does not present a problem. SBA, however, approved many of the above-noted charge-off transactions at the end of the fiscal year. Consequently, the delay between the day the charge off was approved and the day the charge off was recorded in the Loan Accounting System resulted in charge offs not being recorded in the same fiscal year in which they were approved.

In addition, the SBA Form 327 is typically prepared several days in advance of final approval. Transactions affecting the principal balance of the loan may be posted during the same time period in which the charge off is being approved, resulting in a difference between the outstanding principal balance per the Form 327 and the outstanding principal balance recorded in the Loan Accounting System. SBA approving personnel do not typically compare the amount listed for charge off on the Form 327 to the outstanding principal balance per the Loan Accounting System to ensure consistency. In the case of SBIC guaranteed loans charged off, Form 327 is prepared based on principal balances per Investment Division records, which may differ slightly from the principal balances per the Loan Accounting System.

General Ledger Accounts 1510, Loans Receivable Gross, and 1610, Judgments Receivable Gross, were overstated by known amounts of \$789,005 and \$2,302,756, respectively, at September 30, 2004. The related Balance Sheet line item, Credit Program Receivables and Related Foreclosed Property, Net, are not affected, because a charge off results in a debit to the allowance account and a credit to the loan receivable account, which both map to the Credit Program Receivables line item. Additionally, no monetary misstatements occurred as of May 31, 2005, because the balances were charged off during FY 2005.

There is no effect on the financial statements related to instances in which amounts to be charged off were not accurately reflected on the SBA Form 327 used to approve the charge-off action. This occurs because SBA always charges off the full amount of the outstanding principal balance per the Loan Accounting System regardless of the amount recommended for charge off per the Form 327. SBA does not process partial charge offs. The authorizing document should, however, contain information consistent with the accounting system to assist with management decisions and to ensure appropriate legal counsel review and approval. In addition, legal counsel's failure to approve charge-off transactions could lead to the improper disposition of SBA assets.

OMB Circular A-123, Section II, *Reasonable Assurance and Safeguards*, states:

Management controls must provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use, and misappropriation. Management controls developed for agency programs should be logical, applicable, reasonably complete, and effective and efficient in accomplishing management objectives.

OMB Circular A-123, Section II, *Recording and Documentation*, further states:

Transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports.

Recommendations

- 6A. We recommend that the CFO coordinate with OFO to review yearend charge-off activity and consider recording an accrual to properly reflect the charge off in the general ledger in the same fiscal year in which the charge off was approved.
- 6B. We recommend that the CFO work with OFO to enhance existing controls over the loan charge-off process to ensure that proper approval, including legal review, is evidenced on the authorizing document, and information recorded on the authorizing document is consistent with information recorded in the Loan Accounting System.

7. Failure to Retain Supporting Documentation to Substantiate Loan Transactions

SBA did not provide sufficient support for certain loan transactions recorded in the general ledger, because either the loan file was missing or certain required documents were not present in the loan file and could not be located. We examined 173 guarantee-loan purchase transactions, 5 guarantee-loan cancellation transactions, 138 disaster-loan cancellation transactions, and 157 disaster-loan approval transactions and noted the following:

- SBA was unable to locate guarantee-loan files (4 instances).
- SBA was unable to locate the lender transcript used to verify the outstanding principal balance of the guaranteed loan at the time of purchase (2 instances).
- SBA failed to retain supporting documentation substantiating guarantee-loan cancellation transactions (2 instances).
- SBA was unable to locate a disaster-loan file (1 instance).

SBA loan service center personnel stated that loan files are logged in and out of the computerized tracking system, and a notation is made in the system to indicate which field office has possession of the file. Even with these procedures, a loan file may occasionally be misplaced. We were unable to determine why files were missing and why lender transcripts were not included in loan files.

Additionally, SBA personnel stated that there is no SBA requirement to file guarantee cancellation requests received from the lender in the loan file once the transaction has been recorded in the general ledger.

The inability to locate the disaster-loan file precluded us from substantiating a disaster-loan approval transaction of \$509,800 and a subsequent cancellation transaction of \$234,800. This results in a net unsupported balance of \$275,000 (known) and \$2,415,662.89 (projected) in General Ledger Account 1510, Loans Receivable, Gross.

There is no monetary misstatement associated with SBA's failure to retain adequate supporting documentation for the guarantee-loan purchase transactions and guarantee-loan cancellation transactions. We were able to review input into the Guaranteed Purchase Tracking System (GPTS) at the time of purchase to ensure proper approval and accounting treatment of the loans. In addition, subsequent to our site visit, SBA obtained source documentation from the lenders to substantiate purchase and cancellation transactions. SBA should, however, maintain adequate supporting documentation for all transactions recorded in the general ledger.

OMB Circular A-123, Section II, states:

The documentation for transactions...must be clear and readily available for examination.

Recommendations

- 7A. We recommend that the CFO retain and have readily available for review supporting documentation for all transactions recorded in the general ledger, including guarantee cancellation requests received from the lenders.
- 7B. We recommend that the CFO coordinate with the OFO to enhance controls over shipping and tracking loan files to ensure that loan files can be accounted for and are readily available for examination.

8. Noncompliance with the Prompt Payment Act

SBA did not always pay correct interest amounts in FY 2005 and thus did not comply with Prompt Payment Act (PPA) provisions. In addition, SBA did not have adequate procedures in place to minimize the amount of interest required to be paid under PPA.

We sampled 217 vendor payments and noted the following:

- SBA did not make payments by required due dates to avoid paying interest (104 items).
- SBA overpaid interest penalties (12 items).
- SBA underpaid interest penalties (9 items).
- SBA should have paid interest and did not (7 items).

The primary cause of late vendor payments is the extensive time required to complete the current invoice approval process. All invoices are first received by the Office of Procurement and Grants Management and then forwarded to the office originating the purchase for approval. Once approved, the invoices are forwarded to the Denver Finance Center (DFC) for payment.

SBA paid incorrect interest amounts, because it recorded incorrect invoice receipt dates within the ORACLE payment system at time of processing. When SBA did not use a date stamp or annotate a receipt with a date, accounting staff incorrectly entered the date the invoice was processed rather than the actual printed invoice date, as required by PPA guidelines.

Based on our sample, SBA overpaid interest during FY 2005 by a known amount of \$3,165 and underpaid interest by a known amount of \$93.

Code of Federal Regulations (CFR), Title 31, Subtitle III, Chapter 39, § 3903, Regulation, states:

The regulations shall provide that the required payment date is (a) the date payment is due under the contract for the item of property or service provided; or (b) 30 days after a proper invoice for the amount due is received if a specific payment date is not established by contract;....

Also, 5 CFR Part 1315, Section 1315.4(b), *Prompt Pay Standards and Required Notices to Vendors*, states that:

...an invoice shall be deemed to be received: on the later of ...the date a proper invoice is actually received by the designated agency office if the agency annotates the invoice with date of receipt at the time of receipt or... on the date placed on the invoice by the contractor when the agency fails to annotate the invoice with date of receipt...

Recommendations

- 8A. We recommend that the CFO implement training for all payment processing staff to ensure that proper procedures are followed for entering the effective date of invoice receipts into the ORACLE system.
- 8B. We recommend that the CFO review the current invoice approval process and determine if efficiencies can be added to ensure that vendor payments are made in a timely manner and to reduce the number of instances and amount of PPA interest.

9. Obligation Controls

The Sacramento Preferred Lender Program (PLP) loan processing center incurred shipping charges against the Fresno Commercial Loan Service Center (FCLSC) bulk-fund obligation without first verifying that funds were available. This occurred when SBA headquarters granted the Sacramento PLP loan processing center a special dispensation from adhering to SBA's mandated funds control process related to the FCLSC bulk fund obligation.

Because the Sacramento office is the highest volume user of the Fresno UPS/FedEx shipping funds, a risk exists that shipping charges will exceed obligated funds. SBA's management override of Fresno's funds control process effectively returns SBA to the same risk condition identified in the FY 2003 audit.

According to SBA Procedural Notice 5000-925, *Procedures for Timely Obligation*, Effective Date: July 1, 2004, Page 1:

... no shipments of loan files will be allowed unless funds already have been obligated in sufficient amounts to cover the cost of such shipments.

Because of this standard, Procedural Notice 5000-925, further directs that:

OFA and the Centers must closely monitor FedEx and UPS account usage. District Offices must provide an estimated cost and obtain written authorization via e-mail from a Center before using FedEx and UPS to ship files to that Center. No shipment may be made without the Center's authorization. Centers may authorize a shipment only after verifying that obligated funds are available based on activity to date.

Recommendation

- 9A. We recommend that the CFO enforce policies and procedures and funds control guidance set forth in SBA Procedural Notice 5000-925.

10. Guarantee Loan Purchase Controls

SBA's review and approval process (rule of two approvals) over guarantee loan purchases was not operating effectively to ensure that the outstanding principal balance per the lender transcript at the time a loan defaults was accurately entered into GPTS. During sampling control testing, we noted four instances in which the outstanding principal balance entered into GPTS did not agree to the balance per the lender transcript. Three differences appear to be keypunch errors; the reason for the fourth difference is unknown.

The supervisory reviewer of the purchase transaction does not typically ensure that amounts entered into GPTS agree with amounts per source documentation. The reviewer primarily reviews the transaction to ensure that the lender returned the completed purchase demand package and to ensure compliance with legal requirements. Consequently, any manual input errors would not be detected during the review process.

SBA underpaid the respective lenders by a net total of \$59,669. Because the test sample was statistically selected, we projected this known misstatement to the population, resulting in a projected understatement of FY 2005 purchases of \$556,182.

Generally Accepted Accounting Principles require transactions to be accurately recorded. Additionally, GAO's *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1), page 15, states:

Transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records. In addition, control activities help to ensure that all transactions are completely and accurately recorded.

Recommendation

- 10A. We recommend that the CFO in conjunction with OFO strengthen the review and approval process over guarantee purchases to ensure that amounts manually input into GPTS are accurate based on source documents.

11. Inadequate Travel Expense Controls

The Atlanta DAO did not have adequate supervisory review of employee travel during the period of intensive response in the months following the September 2004 hurricanes in Florida and the Gulf Coast. We tested 70 travel vouchers and noted the following:

- 1 of the travel vouchers used rates higher than per-diem rates allowed for meals and incidental expenses.
- 3 of the travel vouchers tested were computed incorrectly.

Due to the heavy volume of travel vouchers being processed at the Atlanta DAO during the first half of FY 2005, computational and other errors on travel vouchers submitted for reimbursement were not detected. Although the amount of exceptions noted was immaterial, SBA's procedures should be reviewed due to the increased volume of transactions that will be processed during FY 2006.

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

... control activities help to ensure that all transactions are completely and accurately recorded.

Recommendation

11A. We recommend that the Associate Administrator for Disaster Assistance strengthen the existing supervisory review process at the Atlanta DAO to ensure that all travel expenses are properly verified.

12. Validation of Source Data Used in Model

SBA used cash flow models to forecast future loan cash flows for input into the Balances Approach Reestimate Calculator (BARC) that relied on static and transactional loan cash-flow data maintained in the Electronic Loan Information Processing System (ELIPS). The Office of the Chief Information Officer (OCIO) provides quarterly updates of ELIPS data to the Office of Financial Analysis, and Accounting Liaison and Quality Assurance group (ALQA) validates ELIPS data to the loan general ledger to ensure accuracy and completeness of the source data used in the models.

During our review of ALQA's validation of source data, we noted the following items that could adversely affect data reliability:

- Documentation provided to support the Phase I comparison of source data used in the 7(a) model incorrectly identified programs that were included in the comparison.
- Two material differences identified during the Phase II comparison were not investigated further and adequately resolved.
- ALQA used incorrect unpaid principal and disbursement balances when performing the Phase I comparison of source data used in the 504 model.
- Phase II validation of source data used in the 7(a), 504, and Disaster models did not include a comparison of unpaid principal balances and total cash flows as of June 30, 2005.
- Explanations provided for material differences noted in the SBIC Participating Securities and Debentures Phase I validation were not sufficient to provide an understanding of the differences or determine if differences were acceptable or adequately resolved.
- Comparison of total cash flows for each program was not always performed at the transaction code and cohort levels, as specified in accompanying documentation supporting the validation methodology.

SBA's *Policies and Procedures for Budget Formulation Estimates and Reestimates*, maintained by the Office of Financial Analysis requires ALQA to compare the ELIPS data provided by OCIO to the loan

general ledger to ensure accuracy and completeness of the source data used in the cash flow models. Any differences in excess of one percent are to be researched and resolved.

In addition, the *Small Business Administration Quality Assurance Manual, Quality Assurance of OFA ELIPS Data*, requires that the comparison of total cash flows for each program be performed at the cohort and transaction code level and include a comparison of unpaid principal balances and disbursements by cohort year.

Recommendation

- 12A. We recommend that the CFO continue to enhance its quality assurance review process over ELIPS source data used in the cash flow models. Specifically, we recommend that the CFO:
- Perform the validation of total cash flows at the cohort and transaction code levels for each phase of the reestimate process when ELIPS source data are updated in the model.
 - Research and resolve all differences in excess of the established threshold and ensure that explanations are sufficient to provide an understanding of differences and determination of whether they are acceptable or adequately resolved.
 - Maintain adequate documentation to support the validation methodology and results.
 - Ensure that balances used in performing the validation accurately reflect ELIPS balances provided by the Office of Financial Analysis (OFA).

13. Intragovernmental Activity and Balances Classification, Confirmation, and Reconciliation

SBA misclassified \$662,732,000 of Financing Source Transferred-In by assigning Trading Partner 20, Department of Treasury, instead of Trading Partner 99, Treasury General Fund. Additionally, SBA did not perform intragovernmental account balance confirmations/reconciliations with Treasury's Federal Financing Bank and Treasury's Financial Management Service.

SBA did not effectively implement internal controls to ensure that trading partner classifications of Treasury-related intragovernmental balances were correct and did not perform quarterly intragovernmental confirmations/reconciliations. As a result, SBA cannot be assured that its intragovernmental activity and balances are accurately reported to Treasury and correctly summarized in the financial statements.

Treasury Financial Manual, Part 2, Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States (May 2005)*, requires agencies to fully reconcile differences with trading partners on a quarterly basis.

Additionally, according to the Treasury Financial Intragovernmental Transactions Accounting Policy Guide (July 1, 2005), page 31, the responsibility for reconciling an agency's activity and balances is with the agency regardless of the trading partner's involvement with the transaction.

Recommendation

- 13A. We recommend that the CFO strengthen internal controls to ensure that SBA correctly assigns all intragovernmental transactions to the appropriate trading partner and completes and reconciles all intragovernmental balances confirmations at least quarterly.

14. Noncompliance with the Single Audit Act

SBA program officials did not review Single Audit Act reports completed for loan guarantee recipients under the Section 504 Certified Development Company (CDC) program for which SBA is the assigned federal cognizant agency under the Single Audit Act.

SBA is assigned as the federal cognizant agency for four non-profit organizations that receive federal financial assistance under the Section 504/CDC program. As the designated federal cognizant agency, SBA is required to communicate Single Audit Act requirements, ensure audit completion, and review final audit reports. SBA headquarters officials in the Section 504/CDC Program Office were not, however, aware of this cognizant-agency designation and did not provide the appropriate cognizant agency oversight as required by the Single Audit Act.

The Single Audit Act, Title 31 USC Section 7504(b) states:

Each non-Federal entity shall have a single Federal agency, [the Federal cognizant agency] determined in accordance with criteria established by the Director (OMB), to provide the non-Federal entity with technical assistance and assist with implementation of this chapter [of the Single Audit Act].

Section 7504 (a) further states:

*Each Federal agency shall, ... with regard to Federal awards provided by the agency-
(1) monitor non-Federal entity use of Federal awards, and
(2) assess the quality of audits conducted under [the Single Audit Act] for audits of entities for which the agency is the [federal cognizant agency].*

Recommendation

- 14A. We recommend that the Associate Deputy Administrator for Capital Access implement training for CDC program staff on Single Audit Act requirements, and federal cognizant agency responsibilities.

15. Improper Payments Information Act Report Missing Required Disclosures

SBA's FY 2005 Improper Payments Information Act report did not identify the causes of the improper payments reported for the 7(a) Guarantee Purchase Program, as required. SBA did not conduct adequate quality assurance procedures on its FY 2005 Improper Payments report submission to ensure that all compliance requirements were met before final approval by SBA management.

As a result, SBA's report, which is part of the FY 2005 Performance and Accountability Report submission, is incomplete. Further, without identifying underlying causes of improper payments in the 7(a) loan program, SBA management will remain unable to implement specific corrective action and put in place an effective remediation plan.

The Improper Payments Information Act of 2002, Title 31, USC 3321 Section 2, Part (c), *Reports On Actions To Reduce Improper Payments*, states:

...the head of the agency shall provide...a discussion of the causes of the improper payments identified....

Further, OMB Circular A-136, Form and Content of the Performance and Accountability Reports, Section 12, Other Accompanying Information, Part 6- IPIA Reporting Details, requires agencies to:

Describe the corrective action plans for:

A. Reducing the estimated rate of improper payments. Include in this discussion what is seen as the cause(s) of errors and the steps necessary to prevent future occurrences.

OMB Memorandum M-03-13, *Implementation Guidance for the Improper Payments Information Act of 2002 (Public Law No: 107-300)*, further states:

For all susceptible programs/activities...with erroneous payments exceeding \$10 million, agencies shall identify the precise reasons its programs and activities are at risk.

Recommendation

- 15A. We recommend that the CFO strengthen quality control procedures to ensure that all required information is included in SBA's annual Improper Payments Information Act report, including underlying causes of any improper payments identified and steps necessary to prevent such occurrences.

16. Subsidy Realignment Entry

SBA recorded an offline journal entry to properly align the present value of future cash flows between the Liabilities for Loan Guarantees and Credit Program Receivables and Related Foreclosed Property, Net, balance sheet line items. It determined the amount of the alignment entry by identifying the estimated present value of future cash flows for loans with a guarantee still in force from each subsidy model. The balance in General Ledger Account 2180, Liability for Loan Guarantee, was then "aligned" with this estimate. We noted two exceptions with SBA's alignment entry.

The estimate provided for the 7(a) program included the present value of future cash flows for loans with a guarantee still in force for the 7(a) Regular and 7(a) Community Adjustment and Investment Program (CAIP). SBA inappropriately aligned the 7(a) Regular program balance in the general ledger to the combined 7(a) Regular and 7(a) CAIP estimate. In addition, when recording the alignment entry for the 7(a) Delta, 7(a) Supplementary Terrorist Activity Relief (STAR), and 504 Delta programs, SBA inadvertently increased the loan guarantee liability instead of decreasing the liability as intended. As a result, General Ledger Account 2180, Liability for Loan Guarantee, was overstated, and General Ledger Account 1399, Allowance for Subsidy, was understated by \$2,488,904 as of September 30, 2005. SBA's quality assurance and review process did not detect this misstatement.

Statement of Federal Financial Accounting Standard No. 19, Appendix B, *Accounting for Direct Loans and Loan Guarantees*, states:

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

OMB Circular No. A-127, *Financial Management Systems*, Section 6, states:

Financial management in the Federal government requires accountability of financial and program managers for financial results of actions taken, control over the Federal government's financial resources and protection of Federal assets. To enable these requirements to be met, financial management systems must be in place to process and record financial events effectively and efficiently, and to provide complete, timely, reliable and consistent information for decision makers and the public.

Recommendation

- 16A. We recommend that the CFO continue to enhance its quality assurance and review process to prevent and detect errors or misstatements in amounts recorded in SBA's financial accounting systems. Specifically, we recommend that OFA clearly identify the loan programs and amount of estimate associated with each, and that ALQA strengthen its controls to ensure that the alignment entry is recorded correctly.

17. Accounting Structure SOP

SBA's Accounting Structure Standard Operation Procedure (SOP) is currently maintained online and is accessible through the FRIS general ledger system. This SOP shows pro-forma posting logic (debit and credit pairs) for various standard accounting transactions, such as loan approvals, disbursements, and purchases, and is automatically updated each time SBA modifies the posting logic for certain transactions.

This document appears to be a summary of the accounting system posting logic rather than operating procedures to be used by SBA accountants. Even as a summary of the posting logic, it appears incomplete. It does not include the budget proforma posting logic used in the automated journal vouchers or posting logic for other automated journal vouchers, such as the credit reform conversion entries. In addition, the online SOP does not have sufficient explanations about the nature of transactions and when they should be used, for example, if specific to certain fund types or certain accounting periods. Finally, the updated SOP is not readily accessible in hard copy format and the most recent printer friendly version is dated June 1994.

SBA also did not have an SOP for preparing its financial statements and footnotes that included documentation regarding SBA's adherence to Treasury, OMB, and FASAB requirements or planned deviations from such guidance. In addition, it did not have documented procedures for running trial balances, populating and running the financial statement workbook, updating data for footnotes, or updating financial statement crosswalks. SBA appears to rely heavily on DFC staff that created the crosswalks and journal voucher logic for their institutional knowledge.

Documented standard operating procedures are a fundamental internal control and should be readily available for all personnel during the normal course of completing their assigned duties.

Recommendation

- 17A. We recommend that the CFO review and update its current accounting SOP to include SBA's policies and procedures for processing detailed accounting transactions, including automated and manual journal vouchers. This SOP should document the process for creating trial balances, updating financial statement crosswalks, populating and running the financial statement workbook, and preparing footnotes. This SOP should also discuss SBA's procedures to ensure adherence to specific Treasury, OMB, and FASAB requirements and justification for deviating from such.



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

JAN 3 2006

Date:

To: Robert G. Seabrooks
Assistant Inspector General for Auditing

From: Jennifer E. Main []
Chief Financial Officer ✓

] Ex. 6

Subject: Audit of SBA's FY 2005 Financial Statements – Draft Management Letter

The draft Management Letter for the FY 2005 financial statement audit dated December 20, 2005 contains 20 recommendations to improve the SBA's financial management. The Office of the CFO is in general agreement with the findings and recommendations included in the draft Management Letter. We are pleased to note a slight reduction in the number of items from last year, and we are confident that remediation activity already underway, including substantial progress on several recommendations, will successfully address these audit findings.

Thank you for the opportunity to provide comments to the draft Management Letter and I look forward to the receipt of the final Management Letter as soon as possible.

SBA IS AN EQUAL OPPORTUNITY EMPLOYER AND PROVIDER



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

Date: JAN - 4 2006

To: Robert G. Seabrooks
Assistant Inspector General for Auditing

From: Cheri L. Cannon [] Ex 6
Deputy Associate Administrator for
Disaster Assistance

Subject: Audit of SBA's FY 2005 Financial Statements Management Letter - Office of
Disaster Assistance Response to Recommendation

The following is the Office of Disaster Assistance's (ODA) response to Cotton & Company's audit of SBA's FY 2005 Financial Statements Management Letter.

Recommendation:

- 11A. We recommend that the Associate Administrator for Disaster Assistance strengthen the existing supervisory review process at the Atlanta DAO to ensure that all travel expenses are properly verified.

The Office of Disaster Assistance (ODA) agrees that some errors were made with the crush of business; and has already taken steps to address the recommendation.

ODA is undergoing a Transformation of its entire operation. Administrative support, including travel processing will no longer be performed in the Atlanta Office.

As a part of the Transformation, ODA is establishing a new Personnel and Administrative Support Center (PASC) which will undertake the provision of most of ODA's backroom operations in a centralized operation. Travel management and processing for ODA is a part of those backroom operations.

In the past, the four ODA Area Offices each had their own administrative offices including travel processing sections and reported to that Area Office Director. Each one conducted business slightly differently. Part of the reason for centralizing the Administrative operations is to eliminate the problems that come as a result of conducting business in a number of different locations with different supervisory chains.

SBA IS AN EQUAL OPPORTUNITY EMPLOYER AND PROVIDER

Because this Recommendation is directed at the travel process, only that is being addressed here although a similar process will be undertaken for many of the other administrative processes.

We have begun the process of identifying in detail all of the steps involved in travel processing, including the review and verification of travel expenses, as performed in all of the former Area Offices. Once that review is completed, we will select the best practices and pull them together into one process, making additional modifications if necessary to assure sufficient supervisory controls. New written guidance will be then be prepared, including checklists, detailed explanations, etc., to assist travel review employees in performing their jobs. During this process we will also consult with the CFO's Denver Finance Center travel processing group to gather any additional information that would be useful. We welcome their recommendations.

cc: Peter McClintock