Audit of SBA's FY 2007 Financial Statements – Management Letter

Report Number: 8-06
Date Issued: December 14, 2007

U.S. Small Business Administration
Office Inspector General

Memorandum

To: Jennifer E. Main
Chief Financial Officer

Eric R. Zarnikow
Associate Deputy Administrator for Capital Access

Napoleon S. Avery
Acting Chief Human Capital Officer

[Exemp 6]

From: Debra Ritt
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2007 Financial Statements – Management Letter

Attached is the Management Letter issued by KPMG LLP which identifies non-reportable conditions that came to KPMG's attention during its audit of SBA's FY 2007 financial statements. The audit was performed under a contract with the Office of Inspector General (OIG) and in accordance with *Generally Accepted Government Auditing Standards*; Office of Management and Budget's (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements*, the General Accountability Office (GAO)/President's Council on Integrity and Efficiency (PCIE) *Financial Audit Manual* and GAO's *Federal Information System Controls Audit Manual*.

KPMG addressed recommendations to SBA's Chief Financial Officer (CFO), Acting Chief Human Capital Officer, and Associate Deputy Administrator for Capital Access (ADACA). We provided a draft of KPMG's report to each of these officials or designees who concurred with all of the findings. These officials or designees agreed to implement the recommendations or have already taken actions to address the underlying conditions.

Should you or your staff have any questions, please contact Jeff Brindle, Director, Information Technology and Financial Management Group at (202) 205-[Exemption 2]

KPMG LLP
2001 M Street, NW
Washington, DC 20036

MANAGEMENT LETTER

November 14, 2007

CONFIDENTIAL

Office of the Inspector General,
U.S. Small Business Administration and
Administrator of the SBA:

We have audited the consolidated financial statements of the U.S. Small Business Administration (SBA) for the year ended September 30, 2007, and have issued our report thereon dated November 14, 2007. In planning and performing our audit of the financial statements of SBA, we considered internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

During our audit, we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies and are presented in Exhibit I. The status of prior year comments is presented in Exhibit II.

Our audit procedures are designed primarily to enable us to form an opinion on the financial statements and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of SBA gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

This report is intended solely for the information and use of the Office of the Inspector General, management, and others within the organization and is not intended to be, and should not be, used by anyone other than these specified parties.

KPMG LLP

Exhibit I

U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2007

Improvement is needed in the guarantied loan purchase process

Condition:

The testwork performed at the various SBA Loan Centers included interim control and substantive procedures on 51 statistically selected defaulted guarantied loan purchases. Based on the procedures performed, we noted one instance where an improper transaction code was used to record an overpayment made by SBA, thereby improperly recording the transaction as a purchase of a loan guaranty. In addition, we noted three instances where SBA did not perform a post-purchase review within 90 days of purchase, which is SBA's internal goal. As of the date of our testwork, the number of days elapsed after the purchase date for the three exceptions noted ranged from 97 to 193 days.

Criteria:

SBA Standard Operating Procedure (SOP) 20 03, *Accounting Structure,* indicates that the purpose of transaction code 195 is to record disbursements to a participant for purchase of a guaranty loan, and to reverse memorandum account balances. The SOP also provides that the purpose of transaction code 375 is to record collection amounts due to SBA from the original lender bank, where SBA has overpaid a secondary participant.

SBA SOP 50 51, Chapter 13, *Loan Guaranty Purchase Reviews, Denial of Liability on Guaranty Suit Against Participant to Recover Paid Guaranty,* Section 4, *Timely Processing,* states that "where SBA has purchased the guaranteed portion of a loan from the secondary market, financial and legal staff must always complete the post-purchase review prior to inclusion of a loan in an asset sale or prior to charge-off, preferably within 90 days of the purchase."

In addition, the Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Controls*, states "transactions should be promptly recorded, properly classified, and accounted for in order to prepare timely accounts and reliable financial and other reports."

Cause:

[Exemption 2]
Journal voucher # to record the collection amount due to SBA from an original lender bank was not adequately reviewed prior to approval by the DFC supervisory accountant.

Based on discussion with SBA personnel located at the National Guaranty Purchase Center (NGPC), the untimely post-purchase reviews were attributed to a backlog in the post-purchase review process. According to our discussions with NGPC management, the Center is working to implement a plan to use a special team of contractors to assist the Center in processing the post-purchase review backlog.

Effect:

The statistically projected amount of improperly recorded defaulted loan purchases is $7,019,686 of the total population of guarantied loan purchases subject to testwork at the NGPC of $325,499,516. In addition, the untimely completion of post-purchase reviews will result in balances reported in SBA's interim and year-end financial statements to be inaccurate if the transactions cross quarterly or year-end cutoff dates. The statistically projected amount of untimely defaulted loan post-purchase reviews is $21,059,058 of the total population of guarantied loan purchases subject to our testwork at NGPC of $325,499,516.

Recommendation:

We recommend that:

1. The Office of the Chief Financial Officer ensures that supervisory personnel exercise more caution during the review and approval of journal vouchers.
2. The Office of Financial Assistance finalize and issue the updated SOP 50 51, *Loan Liquidation and Acquired Property*, to reflect the established procedures for post purchase reviews.
3. The Office of Capital Access, in cooperation with NGPC management, continues to finalize the planned approach to address the backlog and to fully implement its plan.

Agency Response:

We concur with the finding and recommendations.

Improvement is needed in the guaranty loan charge-off and lender follow-up process.

Condition:

During testwork over guaranty loan charge-offs, KPMG noted that one loan was not charged off timely. The borrower completed bankruptcy proceedings in September of 2004, but the loan was not charged off until December of 2006 because SBA did not receive a liquidation status report from the lender until then. We noted that the servicing center did not begin following up with this delinquent lender until June of 2006.

Due to the above issue, KPMG reviewed the procedures performed by SBA to follow up with lenders on the liquidation progress of guaranty purchases. KPMG noted that the procedures required by SOP 50 51 were not being consistently followed at the field offices.

Criteria:

Per SBA Procedural Notice 5000-803, *Procedures for Expedited Purchase of SBAExpress, Export Express and CommunityExpress Loans in Liquidation*:

"When SBA purchases an SBA*Express* loan before the liquidation is completed, the lender must fully pursue the liquidation to conclusion and must provide SBA with a liquidation status report every 180 days until concluded."

"In addition, as part of its lender oversight and review responsibilities, the Agency will explicitly evaluate the timeliness and reasonableness of SBA*Express* lenders' liquidation activities."

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In addition, SOP 50 51, *Loan Liquidation and Acquired Property*, Chapter 8, states the liquidation officers' responsibility is to "make telephone, written, or face-to-face contact with the lender handling the liquidation of the account at least once every calendar quarter" (i.e. every 90 days). The SOP also states "a supervisory official must review the lender-serviced accounts using LLTS (Loan Litigation/Liquidation Tracking System) every calendar quarter on:

i) All liquidation accounts that have been in liquidation 180 days or more;

ii) Colpur accounts (described in SOP 50 51, Chapter 11, "Collateral Purchased by SBA and Lender."); and

iii)A random sample of 25 percent of all liquidation accounts less than 180 days.

The review may be conducted either electronically or face-to-face with the assigned liquidation official. If issues appear in the random review, a more detailed review is required."

Cause:

The lack of proper communication and follow-up with lenders is due in part to staff oversight and insufficient knowledge of the policies and procedures by field site personnel. In addition, the servicing center personnel stated they often do not receive the required 180-day liquidation status report from lenders, making it difficult for SBA to determine when to charge off guaranty loans.

Effect:

Improper or untimely lender follow-up on loans eligible for charge-off may result in uncollectible loans remaining on SBA's financial statements as a receivable.

Recommendation:

KPMG recommends that SBA Office of Capital Access and Office of Financial Assistance:

4. Ensure that field site personnel are aware of and adhere to the procedures documented in the Procedural Notice 5000-803 and SOP 50 51, *Loan Liquidation and Acquired Property.*
5. Implement procedures to evaluate lenders on a scheduled timeframe who are consistently delinquent in providing reports and documentation to SBA and consider taking remediation against those lenders.

Agency Response:

We concur with the finding and recommendations.

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Improvements are needed over development and communication of standard operating procedures

Condition:

SBA's business practices are constantly evolving to best serve its customers and comply with both internal policies and external accounting standards. As the process to formally update an SOP tends to be lengthy, in the interim, SBA communicates policy and procedure changes to their employees through periodic distribution of numbered memorandums and procedural notices. During our site visit testwork over direct and guarantied loans, we noted four circumstances where interim updates to SOPs needed improvement:

1 During our testwork over direct and guaranty loan charge-offs at the Fresno Commercial Loan Servicing Center and Herndon National Purchase Liquidation Center, we noted that Procedural Notice 5000-619, *Treasury Debt Collection* (effective 8-26-99 expiring on 8-1-2000), was not properly re-issued or incorporated into SBA's SOPs.

2 During our testwork over direct loan modifications at the Fort Worth Loan Processing and Disbursement Center, we noted that SOP 50-30, *Disaster Assistance Program Chapter 10- Section 109-Cancellations*, was not properly updated to reflect the removal of the requirement to document all cancellations using SBA form 1913. Based on our knowledge assessment of the loan officers, we noted they were not aware that SBA form 1913 was no longer used to document loan cancellations.

3 During our testwork over direct loan charge-offs at the Santa Ana National Disaster Resolution Center (NDRC), we noted that the site-specific charge-off policies and procedures for loans under $15,000 were stated in a 2006 e-mail correspondence from the Office of Portfolio Management rather than in a formal procedural document. Additionally, we noted that this e-mail/policy was not formally distributed and available to all employees performing these charge-off procedures.

4 During our testwork over direct loan disbursements and charge-offs at the Fort Worth Loan Processing and Disbursement Center, we noted that SOP 20-03, *Accounting Structure*, issued in 1994, was not properly updated to reflect SBA's debit and credit accounts posted for transaction codes 398 – Treasury Borrowings on Cash Insufficiency and 416 – Asset Charged Off.

Criteria:

OMB Circular A-123, *Management Responsibility for Internal Control*, states "management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations."

Cause:

There is not an adequate process in place for reviewing, monitoring, tracking, applying, and centralizing the interim updates to SBA's policies and procedures that have not yet been incorporated into SBA's SOPs. Further, there are not adequate procedures to ensure that SOPs are updated as needed due to expiration of procedural notices or other circumstances, as deemed appropriate.

Effect:

The lack of an adequate interim policy update process increases the risk that SBA will not be in compliance with either their internal policies or external accounting and compliance standards.

Recommendation:

KPMG recommends that the Office of Capital Access and Office of Financial Assistance:

6. Implement the SBA-developed corrected action plan for timely updating, reviewing, and approving their SOPs. For non-disaster SOPs, SBA should make revisions to the SOP online, and for the disaster SOPs, SBA plans on maintaining a work in progress management-approved version of each SOP online.
7. Include the Web site links/references to all revised memorandums embedded within the applicable section(s) of the SOP document for further guidance on the proper implementation of the SOP changes.
8. Develop policies and procedures for maintaining, centralizing, reviewing, approving, and communicating the revisions made to the SOP online in a timely manner.
9. Develop required user training for employees to properly apply the revisions made to the SOP online.
10. Enhance polices and procedures for monitoring expired procedural notices or interim updates to existing policies and procedures to ensure they are reissued or included in the revised SOP as deemed appropriate.

Agency Response:

We concur with the finding and recommendations.

Improvement is needed in the review of the disaster program credit model calculations.

Condition:

The Disaster Loan Program subsidy reestimate calculation uses actual cash flow information as of June 30, 2007, and projected information for the last quarter of the fiscal year. During our testwork over the reestimate calculation, we noted that certain data elements (e.g., Deviations Principal, charge-off total, charge-off principal) calculated by the SBA cash flow model for the 2006 and 2007 cohorts were not properly mapped to the Credit Subsidy Calculator (CSC) Tool. SBA uses an Excel tool to format cash flows to run through OMB's CSC2 to generate reestimates.

SBA management subsequently performed a review of the fourth quarter projections for the 2005 cohort and noted a similar situation. We noted that this issue is limited to the 2005, 2006, and 2007 cohorts for the Disaster Loan Program as these three cohorts are the only ones with projected fourth quarter disbursements.

Criteria:

The Government Accountability Office's *Standards for Internal Control in the Federal Government* states "application system development and maintenance control provides the structure for safely developing new systems and modifying existing systems. Included are documentation requirements; authorizations for undertaking projects; and reviews, testing, and approvals of development and modification activities before placing systems into operation."

Cause:

SBA has a comprehensive process to review its cash flow models and other tools used to perform the reestimate calculations. Also, SBA engages a contractor to perform an Independent Validation and Verification (IV&V) of all cash flow models. Comments as a result of the contractor's review are discussed and considered by management for implementation. It should be noted that management's approach to reviewing the models is not intended to cover all aspects. Rather, management's review is focused on those areas that represent a potential risk of significant misstatement to the financial statements and the President's budget. The issue noted above refers to a lack of effective management review in a focused area of the cash flow model and an area where management believes the risk of a significant misstatement is low.

Effect:

Management determined that the errors in the reestimate calculations resulted in an $11.8 million difference from the original reestimate. Management considered this difference immaterial as it relates to the overall disaster loan portfolio and, therefore, did not correct the reestimates or the financial statements.

Recommendation:

We recommend that the SBA Office of the Chief Financial Officer:

11. Consider automating the manual data interface processes inherent in the overall model structure to ensure that information flows completely and accurately from the models to the OMB CSC2.
12. Continue to perform annual risk assessments of potential misstatement, especially in cases where manual procedures must be used, and, where appropriate, increase the intensity of its manual reviews.

Agency Response:

We concur with the finding and recommendations.

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Improvement is needed over undelivered orders.

Condition:

Out of 47 obligations tested as of August 31, 2007, we noted that 2 obligations totaling $115,000 were recorded in Oracle prior to approval. The difference between the posting dates and the dates noted on the authorizing documents ranged from one to three days. In addition, one authorizing travel document for $700 was signed after the travel was completed.

We also tested a sample of 58 Undelivered Orders (UDOs) as of June 30, 2007, and noted that 3 sample items totaling $1.4 million should have been de-obligated.

Criteria:

OMB Circular A-123, *Management Accountability and Control*, Section I, defines management controls as "the organization, policies and procedures used by agencies to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making."

OMB Circular A-123, Section II, states "monitoring the effectiveness of internal control should occur in the normal course of business. In addition, periodic reviews, reconciliations or comparisons of data should be included as part of the regular assigned duties of personnel. Periodic assessments should be integrated as part of management's continuous monitoring of internal control, which should be ingrained in the agency's operations."

Cause:

The errors appear to be attributed to human error and oversight related to the obligation process. The issues noted above are indicative of a lack of management/supervisory review of controls to ensure the existence and accuracy of the financial information recorded.

Effect:

Untimely approval and posting of obligations in Oracle indicate inconsistencies in obligating procedures and could result in an invalid obligation being made. UDOs are overstated by $1.4 million.

Recommendation:

KPMG recommends that the SBA Office of the Chief Financial Officer:

13. Continue to strengthen monitoring procedures over controls surrounding approval of obligations.
14. Ensure obligations are properly approved prior to entering into Oracle.
15. Review undelivered orders periodically to ensure that amounts are properly de-obligated as necessary.

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Agency Response:

We concur with the finding and recommendations.

Improvement is needed over payroll processing and controls over official personnel files.

Condition:

During our testwork at the Denver Finance Center, Herndon, and Headquarters, we performed dual-purpose tests on 61 statistically selected official personnel files (OPF). Based on the procedures performed, we noted the following instances where SBA did not properly perform and/or maintain OPF files in accordance with the Government Accountability Office (GAO) and Office Personnel Management (OPM) standards, and SBA payroll deductions and calculations were improperly computed.

Missing Documentation:

- The OPF for one Office of the Inspector General (OIG) employee was requested on August 13, 2007; however, the file could not be located by the OIG or the Office of Human Capital Management (OHCM) until October 16, 2007.
- Six sample items did not contain the applicable SF-50, Notification of Personnel Action, in the OPF, and SBA management was not able to locate the forms for our review.
- Four sample items did not contain the OPM Form 71, Request for Leave or Unapproved Absence, on file to support annual leave taken. In addition, two requested timesheets could not be provided.
- Four sample items did not have the Thrift Savings Plan (TSP) form or other supporting documentation in the employee's OPF file if the employee made an online change in Employee Express.
- Nine sample items did not have a current SF 2809, Employee Health Benefits Registration form, in the file.
- Three sample items did not include the SF 2817, Federal Employees' Group Life Insurance Program form, in the OPF.

Improper Deductions/Calculations:

- Five employees' hours in the sample population did not agree to the PQ-32, AD-334, or the timesheet.

Criteria:

The OPM G*uide to Personnel Record Keeping* states "records are filed in the Official Personnel Folder to document events in an individual's Federal employment history that have long-term consequences for the employee and the Government. Care should be exercised in filing documents correctly to ensure all documents pertaining to an employee's rights and benefits are available in the personnel folder when needed."

The Joint Financial Management Improvement Program's *Human Resources & Payroll Systems Requirements,* JFMIP-SR-99-5 states "all human resources and payroll systems must provide, at a minimum, the following qualities:

- Complete, accurate, and prompt payment of pay and deductions.
- Complete, accurate, and prompt generation and maintenance of human resources and payroll records and transactions.
- Timely access to complete and accurate information, without extraneous material, to those internal and external to the agency that requires the information.
- Timely and proper interaction of human resources and payroll systems with Core financial systems.
- Adequate internal controls to ensure that human resources and payroll systems are operating as intended."

The GAO *Standards for Internal Control in the Federal Government* states "control activities…include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the *creation and maintenance of related records which provide evidence of execution of these activities as well as appropriate documentation.*" In addition, "access to resources and records should be limited to authorized individuals, and accountability for their custody and use should be assigned and maintained."

The GAO *Maintaining Effective Control over Employee Time and Attendance Reporting* states "information in T&A records should be promptly and properly recorded to meet control objectives. It should be complete, accurate, valid, and comply with legal requirements. Agency policy should establish accountability for recording T&A information and for the maintenance of and access to T&A records and supplementary records. Agency policy should establish how T&A information for employees temporarily assigned to another agency will be recorded and maintained. Management may require employees and timekeepers, if any, to attest or verify T&A information. T&A information that supports financial reporting or cost reporting should be auditable."

<u>Cause:</u>

The findings above resulted from management oversight, a lack of formal written policies and procedures, and a lack of management monitoring the services provided by the National Finance Center (NFC) and OPM.

<u>Effect:</u>

The missing or inaccurate documentation increases the risk that an employee will not receive the appropriate pay and/or benefits. The differences and inconsistencies in payroll deductions and calculations increases the risk that the expenses recorded in the general ledger will be inaccurate. In addition, documents that are not filed increase the chance of noncompliance with government accounting standards and OPM regulations.

<u>Recommendation:</u>

We recommend that the Office of Human Capital Management ensure that:

16. Proper documentation is maintained in the OPF files to support the personnel actions in accordance with GAO and OPM guidelines.

17. Proper training is provided to timekeepers over authorization and preparation of time and attendance documentation and file maintenance.
18. Services provided by NFC and OPM are monitored.
19. Formal policies and procedures are developed that address the need for and provide guidance to employees for personnel management.

Agency Response:

We concur with the finding and recommendations.

Exhibit II

U.S. SMALL BUSINESS ADMINISTRATION

Status of Prior Year Comments
FY 2007

The status of prior year management letter comments is presented below.

Internal Control Over Financial Reporting	Fiscal Year 2007 Status
Improvements are needed over the monthly fund balance with Treasury reconciliations	Resolved
Improvement is needed in the field cashiering process	Resolved
Improvement is needed in the review of data used in the credit reestimate models	Revised and repeated in Exhibit I under the heading *Improvement is needed in the review of the Disaster program credit model calculations*
Improvement is needed in controls over cash and negotiable instruments at the Little Rock Commercial Loan Servicing Center (CLSC)	Resolved
Improvement is needed in controls over the checks on hand at the Disaster loan processing center	Resolved
Improvement is needed in the guarantied loan charge-off process	Revised and repeated in Exhibit I
Improvement is needed in the guarantied loan purchase process	Revised and repeated in Exhibit I
Improvement is needed in the Disaster loan charge-off process	Resolved
Improvement is needed in the Disaster loan modification process	Resolved
Improvement is needed in the Disaster loan disbursement process	Resolved
Improvement is needed in the management and tracking of loan files	Resolved
Improvement is needed in controls over Official Personnel Files	Revised and repeated in Exhibit I under the heading *Improvement is needed over payroll processing and controls over Official Personnel Files*