

**AUDIT OF SBA's FY 2008 FINANCIAL
STATEMENTS – MANAGEMENT LETTER**

Report No.: 9-05
Issued: December 17, 2008

**Prepared by the
Office of Inspector General
U. S. Small Business Administration**



U.S. Small Business Administration
Office Inspector General

Memorandum

To: Jenny Main
Chief Financial Officer
[FOIA Ex. 6]

Date: December 17, 2008

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2008 Financial Statements – Management Letter
Report No. 9-05

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 2008 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*, as amended; the Government 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 the Associate Administrators for Capital Access, Disaster, and Management and Administration; the Chief Information Officer; and you. We provided a draft of KPMG's report to each of these officials or their designees, who concurred with the findings relative to their respective areas. The officials or designees agreed to implement the recommendations or already have taken action to address the underlying conditions.

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

Attachment



KPMG LLP
2001 M Street, NW
Washington, DC 20036

MANAGEMENT LETTER

November 14, 2008

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, 2008, and have issued our report thereon dated November 14, 2008. 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

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IMPROVEMENT NEEDED ON SBA'S PROCESSES TO PROVIDE GUIDANCE AND IMPROVE THE TIMELY CHARGE-OFF OF DELINQUENT LOANS

Conditions:

We performed walk-throughs over the charge-off process for direct loans at the El Paso, Texas; Birmingham, Alabama; and Santa Ana, California Servicing Centers. During our walk-throughs, we noted the following conditions related to the charge-off process:

- El Paso Disaster Loan Servicing Center (DLSC); loan no. [FCIA Ex. 2]— This loan was delinquent for 2,095 days prior to being charged off. During the delinquency period, we noted that this loan was transferred from Albuquerque, New Mexico to Fresno, California to Santa Ana, California and then to El Paso, Texas before being charged off. No approval was required for the aforementioned transfers. While there is guidance within SOP 50 50, *Loan Servicing*, and SOP 50 51, *Loan Liquidation and Acquired Property and Lines of Successions*, in regards to loan file transfers, neither SOP stipulates that an approval is required prior to transfer between centers.
- In Santa Ana, California, we noted that a substantial number of loans were awaiting charge-off, a condition which was subsequently supported by information provided by the Office of Capital Access (OCA). Specifically, the report provided by OCA showed that as of May 30, 2008, 606 of 636 loans in Santa Ana were delinquent more that 360 days before being charged off. Additionally, a similar report as of the same date for Birmingham and El Paso showed that 261 of 2,329 and 1,422 of 3,298 loans, respectively, were delinquent for more that 180 days before being charged off.
- We also noted in the reports described in the bullet above, that the loan status code on many of the loans was left blank and therefore did not provide a clear indication of loan status.

Criteria:

The Office of Management and Budget's (OMB) Circular A-123, *Management's Responsibility for Internal Control*, 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 a letter dated January 3, 2000, the U.S. Department of Treasury waived the 180 days requirement to submit loans to the Treasury, as required by the Debt Collection Improvement Act (DCIA). Specifically, the letter states the following:

"As permitted under the DCIA, [the Treasury] approve[s] your request for exemption from mandatory transfer of disaster and regular business loans over 180 days delinquent that are in active workout."

"Once SBA determines that a workout is not feasible and, in the case of collateralized loans, completes its liquidation/foreclosure, any remaining delinquent debts remain subject to the DCIA's mandatory transfer provisions."

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Cause:

During Fiscal Year 2008, SBA has experienced an increased number of defaults in the direct loan program, thus increasing the number of charge-offs to be processed at the sites. According to SBA management at the sites visited, the loan centers do not have the required staff to meet the resource needs caused by the increase in loan charge-off activity, thus creating a buildup in the number of delinquent loans waiting to enter the charge-off process.

Furthermore, although the Treasury has provided a waiver to SBA eliminating the 180-day requirement to refer loans to Treasury, we were informed by OCA management that there is no time limit on how long collateralized and workout loans may be pursued before charge-off should occur; therefore, no loan disposition time line has been established.

Effect:

The lack of a file transfer approval requirement provides offices the opportunity to transfer responsibility for loans to other offices, potentially without justification. Consequently, as loan responsibilities are transferred between offices, requested charge-off actions may go unprocessed for extended periods.

In addition, a lack of timely charge-off and loan monitoring procedures reduces the likelihood that collections will be maximized. Finally, the gross loan receivable and respective allowance accounts are overstated by the amount of the backlogged loans.

Recommendations:

We recommend that the directors of the Office of Financial Assistance and OCA work together to:

1. Continue to assess staffing resources at SBA sites to properly manage SBA's core processes, including charge-off.
2. Implement policies and procedures that require the periodic review of delinquency reports for all loans in excess of 180 days. The policy should require an action plan be established and monitored for each loan that reaches a delinquency threshold (i.e., 270 days), as defined by the policy. This policy should also provide guidance that clearly defines what management considers being a loan in "active workout," after which time the policy should require that the loan be referred to Treasury Offset in accordance with DCIA.
3. Generate reports weekly, or as needed, at Headquarters to monitor delinquency rates at each servicing center and monitor centers as needed to improve loan recovery efforts.
4. Establish an "active workout" loan status comment code in the system.
5. Develop and implement procedures to ensure that all loans are properly coded in the system.

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6. Implement a monthly procedure requiring each office review all loan files that were transferred to their office electronically. This review should ensure that the transfer was appropriate and that the physical loan file was received.

Management's Response:

SBA management concurs with the audit findings and recommendations.

IMPROVEMENT NEEDED IN ADHERENCE TO IT GENERAL CONTROL PROCEDURES AND IN REVIEW OF PAYMENTS PRIOR TO PROCESSING BY TREASURY

Condition:

On May 16, 2008, the OIG notified KPMG about an issue concerning duplicate payments in which an OIG invoice was paid multiple times by SBA. As a result of further investigation of the issue, we were notified by SBA that on March 11, 2008, SBA processed a batch payment through the Oracle System multiple times resulting in duplicate payments to various vendors totaling \$11,205,608.

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:

In February 2008, SBA applied a vendor patch to its Oracle System. Prior to the upgrade, if an Oracle payment schedule had an error or was canceled, the schedule creation process would not be completed and would omit a trailer record at the end of the payment file, thus creating a control preventing the schedule from being processed and paid. As a result of the upgrade, the system was changed such that the trailer record was no longer omitted, thus allowing for the erroneous batches to be processed and paid. Through our review of SBA's testing procedures, we noted that this particular element of the upgrade was not tested by SBA prior to using the new version of the Oracle software.

Furthermore, manual certification and approval payment control procedures were not operating effectively to identify erroneous or canceled schedules submitted for processing, resulting in the duplicate payments.

Effect:

Duplicate payments totaling \$11,205,608 were processed and disbursed, all of which were subsequently collected. Subsequent to the identification of the control deficiency, SBA has corrected the Oracle System

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controls to prevent additional duplicate payments. Additionally, SBA management represented that they have also reassessed and improved the manual certification and approval control procedures.

Recommendations:

We recommend that the chief financial officer and the chief information officer:

7. Monitor all system changes to critical financial systems, such as payment systems, and develop comprehensive procedures to test software updates to ensure that the systems are operating properly and that the financial transactions are recorded timely, properly, and accurately. A critical component of these tests should be the creation of specific scenarios to observe how the systems address errors or abnormal transactions.
8. Ensure its manual controls related to batch certification are designed and implemented effectively to take into account unexpected failure of IT controls.

Management's Response:

SBA management concurs with the audit findings and recommendations.

NO PURSUIT OF COLLATERAL PRIOR TO DIRECT LOAN CHARGE-OFF IN COMPLIANCE WITH SOP 50 52 (1) CONSUMER LOAN SERVICING AND COLLECTIONS FOR DISASTER HOME LOANS

Condition:

During testwork over direct loan charge-offs at the Santa Ana Liquidation Center, we noted that prior to charge-off, the documentation to support loan no. [FISA Ex 2] did not include a collateral analysis or any documentation stating the reasons for not pursuing the underlying collateral. The borrower had not filed for Chapter 7 Bankruptcy and SBA's rights to collect on the debt owed had not expired at the time of charge-off.

Criteria:

According to SOP 50 52 (1), *Consumer Loan Servicing and Collections for Disaster Home Loans*, "Charge-off Procedures" Chapter, Paragraph 3, in regards to required procedures prior to charge-off:

"Your SBA may justify a charge-off based on one or more of the following:

- a. All efforts have been exhausted to collect from:
 - The borrower
 - Liquidation of Collateral
 - Compromise with the borrower
 - Legal remedies available.
- b. Estimated costs of future collection exceed anticipated recovery.

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- c. Borrower cannot be located or is judgment proof.
- d. SBA's rights for debt collection have expired (e.g., statute of limitations, restrictions of state law, and Agency policy).
- e. Chapter 7 (No Asset) Bankruptcy has been adjudicated.
- f. Inability of SBA or private sector collection efforts to effect further worthwhile recovery.”

Cause:

The collateral analysis was not performed due to an oversight by the loan officer that was not detected upon supervisory review of the loan file prior to charge-off.

Effect:

Lack of adherence to the aforementioned SOP increases the risks of noncompliance with laws and regulations concerning charge-off procedures. Furthermore, if a collateral analysis is not performed, it potentially reduces the chances to recover losses.

Recommendations:

We recommend the director of OFA:

- 9. Reinforce the importance of the collateral analysis as the Standard Operating Procedures (SOP) related to the liquidation process are rewritten/consolidated into an updated version of the Disaster Loan SOP.
- 10. Ensure the revised SOP clearly identifies procedures related to the disposition of collateral prior to a loan charge-off action.

Management's Response:

SBA management concurs with the audit findings and recommendations.

***SOP FINDINGS ASSOCIATED WITH DIRECT LOAN SERVICING AT THE FORT WORTH
LOAN PROCESSING AND DISBURSEMENT CENTER***

Conditions:

We noted the following deviations from SOP 50 30 (6), *Disaster Assistance Program*, while performing control testwork at the Ft. Worth Loan Processing and Disbursement Center (related criteria, case, and effect for each item are provided using the same number associated with the condition):

- During testwork over direct loan modifications, we noted loan no. (FOIA Ex 2) was reinstated 12 months after cancellation and there was no evidence of a written request from the borrower.

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- During testwork over direct loan modifications, we noted that for loan nos. [FOIA Ex 2] there was no evidence of a 14-day letter sent to the borrower explaining the issues leading to the potential cancellation.
- During testwork over direct loan disbursements, we noted that three loans did not have a credit check performed within 12 months prior to the loan disbursement. SBA relied on outdated credit reports in determining the financial status of the borrower prior to disbursement.
- During testwork over direct loan disbursements, we noted that loan no. [FOIA Ex 2] did not have a duplication of benefits search performed in conjunction with the disbursement.
- During testwork over direct loan charge-offs performed at Santa Ana Liquidation Center, we noted that uncollateralized loan no. [FOIA Ex 2] was approved for \$27,100. This loan exceeded the \$10,000 maximum for uncollateralized loans. The loan was for the purchase of personal property.

Criteria:

According to SOP 50 30 (6), Chapter 10, *Loan Servicing, Cancellation, Reinstatement, and Loan Modification*, Paragraph 110:

“Method and Deadline for Requesting Reinstatement. All requests for reinstatement must:

- (1) Be in writing and be made within six months of the date of the cancellation
- (2) Show that our cancellation action was in error
- (3) Provide justification that we should reinstate the funds.”

SOP 50 30 (6), Chapter 10, *Loan Servicing, Cancellation, Reinstatement, and Loan Modification*, Paragraph 109, states the following in regards to the 14-day letter:

“Before we initiate an action to cancel all or any funds, we must mail a letter giving 14 calendar days notice of the pending cancellation. The letter must specify the action the borrower can take to prevent the cancellation.”

According to SOP 50 30 (6), Chapter 8, *Disaster Loan Closing and Disbursement*, Paragraph 96:

“Credit review will be required of all loans that have not been fully disbursed within 12 months from the date of the LAA and annual reviews thereafter until the loan has been fully disbursed.”

According to SOP 50 30 (6), Chapter 8, *Disaster Loan Closing and Disbursement*, Paragraph 95:

“95. EVIDENCE REQUIRED BEFORE DISBURSEMENT

- (4) You must update the DOB check to determine if all grants and/or other

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recoveries have been addressed.”

According to SOP 50 30 (6), Chapter 5, *Amounts, Terms, and Conditions or Physical Disaster Loans*, Paragraph 41:

“For personal property (PP) damage, the limit is \$40,000. Personal Property includes all household contents of the primary residence and eligible vehicles.”

According to SOP 50 30 (6), Chapter 5, *Amounts, Terms, and Conditions or Physical Disaster Loans*, Paragraph 48:

Unsecured Loan Limit.

“The Limit for Unsecured Physical Disaster Loans (Home and Business) is \$10,000.”

Secured Loan Limit.

“All loans exceeding the unsecured loan limit require collateral.”

Cause:

We noted that the above conditions resulted from a lack of management oversight during the review and approval process.

Effect:

Lack of compliance with the aforementioned SOP increases the risk of misstatements as well as noncompliance with laws and regulations related to direct loan transactions.

Recommendations:

We recommend that the associate administrators for Capital Access and Office of Disaster Assistance (ODA) work together to:

11. Reinforce the importance of written support from borrowers documenting late reinstatement requests in the disaster loan program. Also, ensure loan officers are aware of the allowable exceptions to the general policy. Inform loan officers at the Processing and Disbursement Center (PDC) that in lieu of a written request from the borrower, the loan officer is required to document within the Disaster Credit Management System (DCMS) the reasoning behind a late reinstatement.
12. Reinforce the importance of the 14-day letter. Inform loan officers that this is a key supporting document for loan cancellations and copies should be maintained within DCMS.
13. Ensure loan officers and approving officials are aware of the importance of the credit check review in the form of training or issuance of center-wide memos.

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14. Reinforce the importance of the duplication of benefits search to the PDC staff.
15. Provide a procedural memo discussing appropriate personal property procedures to Center directors.

Management's Response:

SBA management concurs with the audit findings and recommendations.

***INADEQUATE REVIEW OF THE LOAN LOSS RESERVE FUND DOCUMENTATION
SUBMITTED BY INTERMEDIARIES IN THE MICROLOAN PROGRAM***

Conditions:

During our testwork over approvals and disbursements within the Microloan program, we noted the review by SBA personnel of the intermediaries' loan loss reserve fund balance was not adequate in the following instances:

- We noted the Quarterly Report used by SBA to verify that the intermediary maintained 15 percent of its outstanding portfolio in its Loan Loss Reserve Fund (LLRF) was dated December 31, 2007; however, the related bank statement was dated September 30, 2007. The bank statement date should match the date of the Quarterly Report submitted.
- We noted that an intermediary provided evidence of a 15 percent reserve in the LLRF through a "Proposed Allocation Table" rather than a bank deposit slip, bank statement, or note from the bank. The table indicated the intermediary would move funds from one LLRF bank account to another in order to meet the 15 percent match in the underfunded LLRF. However, prior to the disbursement approval by the financial analyst, there was no evidence submitted indicating the proposed allocation actually took place.

Criteria:

We have learned from SBA that management is in the process of finalizing a draft version of its Microloan program SOPs. During this process, management is relying on guidance from the Code of Federal Regulations and the "Nuts and Bolts" Guide that was drafted by Microloan program personnel for use by the intermediaries. As a result, there are no official agency policies, procedures, or guidance related to the Microloan program. However, the general provisions of the Microloan program are provided in the following paragraphs from the "Nuts and Bolts" Guide:

"The Microloan Program provides very small loans to start-up, newly established, or growing small business concerns. Under this program, SBA makes funds available to nonprofit community-based lenders (intermediaries) which, in turn, make loans to eligible borrowers in amounts up to a maximum of \$35,000. The average loan size is about \$13,000. Applications are submitted to the local intermediary, and all credit decisions are made on the local level."

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“Prior to receiving any additional approvals or funding, the intermediary must establish and maintain two different bank accounts. The first account is for the Microloan Revolving Fund (MRF). This account will be used for the loan monies disbursed by SBA. The second account is the LLRF. The LLRF is a reserve fund which holds 15 percent of all the loans disbursed. According to SBA personnel, the 15 percent LLRF should be evidenced by bank statements and/or deposit slips. The LLRF is a loan covenant established to pay any shortage in the MRF caused by delinquencies or losses on Microloans.”

Cause:

In both instances, there was inadequate review by SBA personnel of the documentation submitted by the intermediary evidencing the balance of the LLRF. Also, without the existence of a formal SOP or other authoritative procedures, there is no guidance to ensure consistency in the procedures performed.

Effect:

Inadequate evidence of funds in the LLRF increases the risk of misstatements in the LLRF account balances and a potential lack of recoveries on future loan losses, should they occur.

Recommendation:

16. We recommend that the director of OFA distribute this notice of finding and recommendation to Microloan staff to reinforce the importance of a thorough review of all intermediary submitted documents.

Management's Response:

SBA management concurs with the audit findings and recommendations.

LEGAL REVIEW IS NOT BEING PERFORMED IN ACCORDANCE WITH SOP 50 51 (2A), LOAN LIQUIDATION AND ACQUIRED PROPERTY

Condition:

During testwork over guaranty charge-offs at the Little Rock Commercial Servicing Center, we noted that there was no legal approval on the Charge-off 327 Form. While the legal department does not sign off on the Charge-off 327 Form, legal review for charge-off is evidenced on the Purchase 327 Form. However, these actions were not documented in accordance with the charge-off procedures stated in SOP 50 51 (2A).

Criteria:

SOP 50 51 (2A), *Loan Liquidation and Acquired Property*, Chapter 18, *Charge-off Procedures*, Paragraph 11, states:

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“11. What Are the Procedures for Charge Off?

You must prepare a 327 action, which must include legal concurrence in the action”

Cause:

The SOP does not accurately reflect how 327 actions are actually carried out at the field sites. For instance, according to personnel at the Little Rock site, the legal review is performed at the time of purchase, which is evidenced on the Form 327, and according to site management, is considered sufficient. As a result, management at the site determined that the legal review at the time of charge-off should not be necessary.

Effect:

There is a lack of consistency with regard to the procedures performed across the agency because site management appears to be circumventing SOP directives in favor of locally determined protocols. In addition, there is a potential risk of misstatement and lack of compliance with laws and regulations regarding charge-off procedures in cases where loans are not charged off at the time of purchase.

Recommendation:

17. We recommend that the director of OFA modify the current Administrative Form 327 for use at the Little Rock Commercial Servicing Center to clearly state that the legal review relates to both the purchase and charge-off of the loan guaranty.

Management’s Response:

SBA management concurs with the audit findings and recommendations.

LACK OF LEGAL REVIEW ON SBA FORM 327 FOR LOAN GUARANTY CHARGE-OFF

Condition:

During testwork over Loan Guaranty Charge-offs in Little Rock, we noted a lack of legal review on the Form 327 recommending charge-off for loan no. [FOIA Ex 2] in the amount of \$30,000 (the total approval amount of the loan).

Criteria:

Per SOP 50 51 (2A), Chapter 18, *Charge-off Procedures*, Paragraph 15:

“Charge-offs require the review and concurrence of SBA counsel.

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If such review cannot be completed within 30 days, or if counsel determines that additional recovery would be possible through legal action, the loan must be transferred out of 'Liquidation Status' and placed into "Litigation Status" only."

Cause:

An input error led to the legal reviewer approving the action electronically in the Guaranty Purchase Tracking System (GPTS) and signing off in the approval section of the action log, but not signing on the actual Form 327 used as support for the guaranty purchase legal review.

Effect:

Lack of OGC's review increases the risk of improper charge-offs being performed and recorded in the general ledger. Furthermore, improper charge-off procedures may limit SBA's recovery on delinquent loans from collateral or through litigation.

Recommendation:

18. We recommend that the director of OFA ensure that an adequate legal review is performed at the sites prior to charge-off. The supervisory loan specialist should perform a quality review check to confirm that all appropriate parties have reviewed the SBA Form 327 prior to the charge-off action.

Management's Response:

SBA management concurs with the audit findings and recommendations.

LACK OF LEGAL REVIEW DOCUMENTATION FOR CHARGE-OFF ACTIONS BY THE OFFICE OF GENERAL COUNSEL RELATED TO THE SMALL BUSINESS INVESTMENT COMPANY (SBIC) PROGRAM

Condition:

During our testwork over loan charge-offs for the SBIC program at Headquarters, we noted a lack of documented legal review by the Office of General Counsel (OGC) on the Form 327, *Modification or Administrative Action*, that were submitted to the Denver Finance Center (DFC) for processing related to 14 Avalon Equity Fund prioritized payments.

Criteria:

Per SOP 10 07, *SBIC Liquidation Program*:

"When a loan or note receivable is charged-off, complete an SBA Form 327 documenting the indebtedness, the amount due, and the efforts made to obtain recovery. Recommend charge-off by SBA Form 327 action and obtain approvals from your Chief and the Director, Office of Liquidation (OL), and

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concurrence by OGC. Send SBA Form 327 to OFO to record the charge-off in the Agency's loan accounting system. Retain case files for two years after charge-off and then forward them to off-site storage."

Cause:

The director of Office of Liquidation on the Charge-off 327 action failed to obtain concurrence from OGC regarding these prioritized payments.

Effect:

Lack of OGC's review increases the risk that improper charge-offs are recorded in the general ledger. Furthermore, improper charge-offs increase the risk of limiting SBA's recovery efforts.

Recommendations:

We recommend the director of the Office of Investments:

19. Implement a policy requiring that a designated employee review the SBA 327 Form prior to submission to DFC PAD. This will ensure the required signatures are present and valid in accordance with the SOP 10 07.
20. Modify the SBA Form 327 to indicate the need for required signatures prior to approval. This will help the preparer and approver of the Form 327 to ensure compliance with the signature requirements before any charge-off actions are performed.

Management's Response:

SBA management concurs with the audit findings and recommendations.

MISSING LOAN FILES

Conditions:

During testwork over direct loan charge-offs performed at Santa Ana Liquidation Center and guaranty loan charge-offs at Headquarters, we identified the following instances in which SBA was unable to obtain the loan file for our review:

- *Loan no. [FOIA Ex 2]* - The Santa Ana office was listed as the location of the file according to the data provided by SBA. However, Santa Ana was unable to confirm they received the file from the district office for charge-off.
- *Loan no. [FOIA Ex 2]* - The SBIC Guaranty program personnel at Headquarters were unable to locate the loan file and, therefore, it was not available for our review.

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Criteria:

The Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government* states that "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."

In addition, the Department of Treasury's *Management of Federal Receivables* states "Accurate and complete documentation is critical to providing proper servicing of debt, pursuing collection of delinquent debt, and in the case of guaranteed loans, processing claim payments."

Cause:

SBA does not have an effective procedure in place to track the location of loan files.

Effect:

The lack of proper and consistently applied controls over the management of loan files increases the risk that SBA will not be able to effectively service its loan and loan guaranty portfolio. In addition, missing files could lead to poor management decisions in the absence of accurate supporting documentation or unauthorized disclosure of confidential information. Furthermore, it increases the risk of misstatements in the financial statements.

Recommendation:

21. We recommend that the directors of OFA and the Office of Investments work together to enhance procedures currently in place to track the location of loan files to ensure they are readily accessible.

Management's Response:

SBA management concurs with the audit findings and recommendations.

IMPROPER REFERRAL OF DEBTOR TO TREASURY

Condition:

We performed internal control and substantive testwork on a statistically selected sample of 85 loan guaranty charge-offs. We discovered during our testwork that for loan no. [FOIA Ex 2] the borrower, who had previously filed for bankruptcy under Chapter 13, was improperly referred to Treasury for collections.

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Criteria:

Per SOP 50 51 (2A), Chapter 18, *Charge-off Procedures*, Paragraph 21:

“When do You NOT Refer an Obligor to a Collection Agency, IRS, or for a Federal Salary or Retirement Offset?”

A referral is NOT made when the obligor has filed in bankruptcy or has been discharged in bankruptcy or otherwise legally relieved of the debt”

Cause:

SBA management represented that the debtor on the loan in question did file for bankruptcy under Chapter 13 in November 2006, but the lender did not disclose this fact in the Purchase request.

Effect:

Improperly referring a borrower to Treasury could result in noncompliance with SBA policy and with the DCIA. Also, SBA was in violation of the “automatic stay” granted to the debtor upon filing for bankruptcy, which prohibits any collection efforts by creditors.

Recommendation:

22. We recommend that the director of Office of Financial Assistance reinforce the importance of reviewing a recent credit report provided by a third party prior to charge-off. In addition, management should develop a process that requires the use of a public records query tool to identify whether obligors/guarantors have filed bankruptcy prior to charge-off when information is lacking in the charge-off documentation.

Management’s Response:

SBA management concurs with the audit findings and recommendations.

IMPROVEMENT NEEDED IN LOAN GUARANTY APPROVAL PROCESS CONTROLS IN ORDER TO PREVENT APPROVAL OF DUPLICATE LOANS

Condition:

During our testwork over guaranty loan approvals at the Sacramento Loan Processing Center, we noted that loan no. [FOIA Ex 2] was a duplicate approval of loan no. [FOIA Ex 2] in the amount of \$1,456,000. The duplicate loan approval was discovered upon SBA’s review of the sample of loan approvals provided to the sites by KPMG for our testwork on June 26, 2008. Both loans were approved on October 24, 2007 and loan no. [FOIA Ex 2] was canceled on June 30, 2008. Therefore, two loan guaranties for the same borrower were approved for a total of \$2,912,000 on the same day which exceeded the limit allowable to

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one business given the 90-day rule stipulated in SOP 50 10 (5), *Lender and Development Company Loan Programs*.

During a search to identify additional duplicate loan approvals, we identified 52 potential duplicate approvals with a total dollar value of \$17,826,000. SBA personnel performed additional procedures to identify which loans represented actual duplicate approvals. Through that analysis, SBA identified 16 loans totaling \$7,464,000 that it concluded represented actual duplicate approvals.

Criteria:

OMB Circular A-123 states that “Management is responsible for developing and maintaining effective internal control. Effective internal control provides assurance that significant weaknesses in the design or operation of internal control, that could adversely affect the agency’s ability to meet its objectives, would be prevented or detected in a timely manner.”

Per SOP 50 10 (5) Chapter 3, *Loan Terms and Conditions*, Paragraph 1:

“a. Maximum Loan Amount – 90-Day Rule

If two SBA guaranteed loans are approved within 90 days of each other, the maximum gross loan amount of all the loans made in that time frame to any one business (including affiliates) cannot exceed \$2,000,000. Please note that the maximum SBA guaranty amount outstanding of all loans to any one business (including affiliates) regardless of when the loans were approved cannot exceed \$1,500,000.”

Cause:

The duplicate approval was not detected by SBA due to a lack of system preventative controls.

Effect:

The lack of an adequate system of controls or compensating controls over loan guaranty approvals increases the risk that obligations may be misstated. Based on the analysis performed, SBA concluded its undelivered orders were overstated by \$7,464,000 as of September 30, 2008.

Recommendation:

23. We recommend that the director of OFA work with the chief information officer to implement a system edit check to monitor/prevent duplicate approvals in the 504 guaranty program. In addition, we recommend that management monitor the system controls currently in place for the 7(a) program to ensure they remain effective.

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Management's Response:

SBA management concurs with the audit findings and recommendations.

***IMPROVEMENT NEEDED IN THE OFFICE OF CREDIT RISK MANAGEMENT (OCRM)
DOCUMENTATION OF DEPARTURES FROM THE GENERAL STANDARDS STATED IN SOP
51 00, ON-SITE LENDER REVIEWS/EXAMINATIONS***

Condition:

As part of our audit work over lender oversight, we selected all SBA 7(a) lenders as of June 30, 2008, with a risk rating of 4 (high risk) or 5 (highest risk) and an SBA share of loan balance greater than \$10 million to determine if an on-site, risk-based review was performed during FY 2007 and FY 2008 in accordance with SBA's SOP 51 00, *On-site Lender Reviews/Examinations*. Based on our testwork, we noted that for the following 28 of 91 high-risk 7(a) lenders with an SBA share of loan balances greater than \$10 million, an on-site risk based review (RBR) was not performed within the 12- to 24-month cycle general guidelines, as stated in the SOP. Specifically, we noted that for 28 lenders, documentation did not exist to support OCRM's departure from the general guidelines of the SOP.

While OCRM management indicated its rationale to KPMG for deviating from the guidelines during our discussions, they were not able to provide documentation to support management's decision for the deviation from SOP guidelines.

Per our inquiry of OCRM management, they represented to us that a plan to review 7(a) lenders between \$10 and \$20 million, which is intended to minimize the costs incurred by small lenders, is currently in draft form. OCRM management also represented that the goal is to finalize these review procedures for small 7(a) lenders by January 2009.

Criteria:

SBA SOP 51 00 states:

“On-site reviews are generally conducted on: (1) all 7(a) Lenders with outstanding balances on the SBA-guaranteed portions of its loan portfolio amounting to \$10 million or more and (2) all CDCs with outstanding balances on its SBA-guaranteed debentures totaling \$30 million or more. Though less frequent, SBA may conduct on-site reviews of any SBA Lenders, as it considers necessary. SBA's calculation of the outstanding balances of 7(a) Lender loan portfolios and CDC debenture portfolios will be based on a 12 to 24 month cycle, determined depending upon the risk characteristics of the lender.”

OMB A-123 states:

“Generally, identifying and implementing the specific procedures necessary to ensure effective internal control, and determining how to assess the effectiveness of those controls, is left to the

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discretion of the agency head. While the procedures may vary from agency to agency, management should have a clear, organized strategy with well-defined documentation processes that contain an audit trail, verifiable results, and specify document retention periods so that someone not connected with the procedures can understand the assessment process.”

Cause:

OCRM did not formally document its rationale for extending the on-site lender reviews/examinations for 7(a) lenders over \$10 million beyond the general 12- to 24-month cycle as stated in SOP 51 00.

Effect:

Lack of documentation to support departures from the guidelines of SOPs potentially undermines the integrity of OCRM’s operations and its risk management strategies.

Recommendations:

24. We recommend that the director of OCRM incorporate a documentation process to address those instances when departures from the 12- to 24-month general review cycle guidelines in the SOP occur.
25. We recommend that the director of OCRM finalize its draft planned procedures to review 7(a) lenders between \$10 and \$20 million.

Management’s Response:

SBA management concurs with the audit findings and recommendations.

IMPROVEMENT NEEDED IN THE NEW HIRE, PERSONNEL ACTION, AND EMPLOYEE SEPARATION PROCESS

Conditions:

During our control testwork over the new hire, personnel action, and employee separation processes, we noted the following:

New Hires

Of the five new-hire sample items tested, we noted the following:

- For one item (sample item no. 5), blocks 20 and 21 of the OF-8, Position Description Form, were not signed and dated by both an immediate supervisor of the position being filled and a position classifier.

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Personnel Action

Of the 60 personnel action sample items tested, we noted the following:

- For one item (sample item no. 10), an SF-52, Request for Personnel Action, was processed although block 6 (Action Authorized By) was not signed by the initiating office.
- For one item (sample item no. 1), an SF-52 could not be located by SBA.

Separation

Of the 15 sample items selected for employee separation, we noted the following:

- For two items (sample item nos. 1 and 11), Form 78, Separation Checklist, could not be located by SBA.
- For two items (sample item nos. 3 and 4), SBA could not locate Section III – Clearance by the Office of Inspector General (OIG), Section IV – Other Clearances, and Section VI – Servicing Personnel Office Clearance of Form 78.
- For one item (sample item no. 2), Sections IV and VI of the Form 78 were not signed by either the Clearance Official or the Servicing Personnel Specialist.
- For seven items (sample item nos. 5, 6, 8, 9, 12, 13, and 14), Section VI of the Form 78 was not signed by the Servicing Personnel Specialist.
- For one item (sample item no. 7), Section I and Section VI of the Form 78 were not signed by either the Supervisor/Admin Officer or the Servicing Personnel Specialist.
- For one item (sample item no. 10), Section II – Administrative Clearance and Section VI of the Form 78 were not signed by the Clearance Official or the Servicing Personnel Specialist.

Criteria:*New Hires*

- SBA SOP 3500 (2A), *Position Classification Program*, Appendix 6, *How to Complete Optional Form 8, "Position Description"* states: "Block 20 Supervisory Certification – The immediate supervisor of the position must sign and date in this block. The signature of a higher-level manager or supervisor is optional. Block 21 Classification/Job Grading Certification – Classifier must sign and date this block."

Personnel Action

- SBA's Guide to Preparing SF-52, *Request for Personnel Action*, Part A, *Requesting Office*, states: "6. ACTION AUTHORIZED BY Enter name, title, date, and signature of person authorized to approve the personnel or position action requested. If you are submitting an electronic version attached to an EMAIL you may add the term 'signed.'"

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Separation

- Chapter 2 of SBA's SOP 0013 5, *Property Management Program*, states: "Ensure that all SBA property is returned when an employee leaves SBA. Field Office Heads should indicate compliance by signing and dating SBA Form 78, "Separation Checklist." Headquarters Division Chiefs should initial SBA Form 78 and forward it to the FMB (Facilities Management Branch) for concurrence on the following items: Identification/Fascard, Property/Equipment, and Office/Furniture-Keys. Once you have obtained all required clearances, forward to the Office of the Chief Human Capital Officer."

Record Retention

- OMB Circular A-123 requires that documentation for internal control, all transactions, and other significant events be readily available for examination.

Cause:

New Hires and Personnel Action

- Personnel service staff did not ensure that the OF 8 and SF-52 were complete and in the file.

Separation

- Personnel service staff did not receive adequate training for the processing and documentation of the Form 78, and quality reviews were not performed to ensure that the Form 78s were complete and signed by the personnel service staff.

Effect:

New Hires

- The OF-8 is used to classify positions to ensure that SBA is paying employees appropriately for the work they perform. As such, there is a risk that SBA will not pay employees appropriately based on their responsibilities.

Personnel Action

- There is an increased risk that unauthorized personnel actions will be processed by SBA.

Separation

- There is an increased risk that former SBA employees will have unauthorized access to agency property and sensitive information.

Recommendations:

We recommend that the chief human capital officer:

26. Provide personnel service staff adequate training for the processing and documentation of the Form 78 and perform periodic quality reviews to ensure that the Form 78s are complete and are signed by the appropriate personnel service staff.

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27. Reinforce its policies and procedures in the new hire, personnel action, and separation processes to ensure that forms OF-8, SF-52, and 78 are properly completed and retained.

Management's Response:

SBA management concurs with the audit findings and recommendations.

ENHANCEMENT NEEDED TO ENSURE THE SOP RELATED TO SBA'S ORGANIZATIONAL STRUCTURE IS CURRENT

Condition:

Based on our review and evaluation of SBA's SOPs as part of our testing of SBA's control environment, we noted that SOP 00 08 (2), *National 4/93 Organizational Structure*, was not up-to-date to reflect the current functions, responsibilities, and authorities of the various SBA offices.

While SBA has made several minor revisions to this SOP in 2005 and 2006 to chapters 1, 2, and Appendix 2, the majority of this SOP, which includes organization charts, mission statements, responsibilities, service areas, and jurisdictions etc., has not been updated since 1993. Additionally, we noted that in fiscal year 2008, SBA created a Policy Team that is responsible to address this issue.

Criteria:

OMB Circular A-123 Appendix A, *Internal Control over Financial Reporting*, states that:

"A factor affecting the control environment is the agency's organizational structure. It provides management's framework for planning, directing, and controlling operations to achieve agency objectives. A good internal control environment requires that the agency's organizational structure clearly defines key areas of authority and responsibility and establish appropriate lines of reporting."

Cause:

SBA's Policy team has not completed its update of the information in the Organizational Structure SOP.

Effect:

SBA's key areas of authority, responsibility, and lines of reporting are not clearly defined, which can negatively impact the overall control environment.

Recommendation:

28. We recommend that the chief operating officer develop a formal plan to update SOP 00 08 (2), *National 4/93 Organizational Structure*. In addition, we recommend the Policy Team consider and

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evaluate the current status of other SOPs that may be outdated in preparation for the change in Federal Government Administration that will take place on January 20, 2009.

Management's Response:

SBA management concurs with the audit findings and recommendations.

UNTIMELY DE-OBLIGATION OF UNDELIVERED ORDERS AND A NEED TO IMPROVE DOCUMENTATION RECORDS

Conditions:

We tested a sample of 84 Undelivered Orders (UDOs) as of September 30, 2008, and noted the following exceptions:

- The quarterly review of open obligations reports was incomplete. During our testwork of SBA's June 2008 review, the agency personnel were unable to provide us with a complete set of reviewed reports for their June review. Further, the Regional and District Offices Report and the Office of Policy and Planning Report displayed no evidence that a review of the report was performed (e.g., handwritten comments/notations or reviewer's initials).
- Eight sampled items totaling approximately \$999,000 should have been de-obligated.
- Documentation supporting the obligating could not be provided for three items totaling approximately \$843,000.

Criteria:

OMB Circular A-123, 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 A-123, Section II goes on to indicate: "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."

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Cause:

The errors are attributed to human error and oversight related to the obligation process. The issues noted above are indicative of a lack of supervisory monitoring procedures over the budget execution process controls that are meant 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 unsupported recorded obligations. Undelivered orders are overstated by approximately \$999,000. In addition, based on our statistical sample of the items selected, the projected results of the testwork indicate that a most likely error of \$24,856,372 may exist in the undelivered orders recorded balance.

Recommendations:

We recommend that the chief financial officer:

29. Continue to strengthen monitoring procedures over internal controls related to the review and approval of obligations.
30. Ensure obligations are properly approved prior to being entered into Oracle.
31. Review undelivered orders periodically to ensure that amounts are properly de-obligated.

Management's Response:

SBA management concurs with the audit findings and recommendations.

INTERNAL CONTROLS SURROUNDING CONGRESSIONAL GRANT MONITORING

Condition:

We tested a sample of 45 grants obligated as of April 30 and September 30, 2008, and noted the following exception during our review of Congressional Grants:

The required quarterly SF-269s (Financial Status Report) were not collected and retained by SBA for a particular grantee to evidence the monitoring of grantee activity during FY 2008. We noted during our testwork related to the grantee that SBA did not retain evidence documenting the submission of an SF-269 subsequent to 2006.

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Criteria:

OMB Circular A-123, 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 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 failure to collect and retain the Form SF-269s is indicative of a lack of supervisory review and monitoring procedures to ensure the existence and accuracy of the financial information recorded. Specifically, a lack of effective monitoring prevented detection of overdue grantee monitoring procedures and related documentation.

Effect:

Lack of approving and monitoring grant activity increases the risk of errors in the financial statements and the potential for misuse of funds.

Recommendations:

We recommend the associate administrator for Management and Administration as well as the director of Business Operations work together to:

32. Strengthen internal controls relating to the approval of obligations and monitoring of grant activity.
33. Develop a tracking mechanism to ensure that all grantees submit Form SF-269s as required (biannually or quarterly, depending on the grant agreement).
34. Issue detailed guidance to provide SBA personnel with uniform procedures to carry out the grant approval and monitoring activities.

Management’s Response:

SBA management concurs with the audit findings and recommendations.

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Status of Prior Year Comments

FY 2008

Internal Control Over Financial Reporting	Fiscal Year 2008 Status
Improvement is needed in the guaranteed loan purchase process.	Resolved.
Improvement is needed in the guaranty loan charge-off and lender follow-up process.	<p>Revised and repeated in Exhibit I under the following headings:</p> <ul style="list-style-type: none"> • <i>Legal Review is not being performed in accordance with SOP 50 51 (2A) "Loan Liquidation and Acquired Property."</i> • <i>Lack of legal review documentation for charge-off actions by the Office of General Counsel related to the Small Business Investment Company (SBIC) program.</i> • <i>Improper referral of debtor to Treasury.</i> • <i>Lack of legal review on SBA Form 327 for Loan Guaranty Charge-off.</i>

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Status of Prior Year Comments

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<p>Improvements are needed over development and communication of SOPs.</p>	<p>Revised and repeated in Exhibit I under the following headings:</p> <ul style="list-style-type: none"> • <i>No pursuit of collateral prior to direct loan charge-off in compliance with SOP 50 52 (1) “Consumer Loan Servicing and Collections for Disaster Home Loans.</i> • <i>SOP findings associated with Direct Loan Servicing at the Ft. Worth Loan Processing and Disbursement Center.</i> • <i>Inadequate review of the Loan Loss Reserve Fund documentation submitted by Intermediaries in the Microloan Program.</i> • <i>Legal Review is not being performed in accordance with SOP 50 51 (2A) “Loan Liquidation and Acquired Property.”</i> • <i>Enhancement needed to ensure the SOP related to SBA’s Organizational Structure is current.</i>
<p>Improvement is needed in the review of the disaster program credit model calculations.</p>	<p>Resolved.</p>
<p>Improvement is needed over undelivered orders.</p>	<p>Revised and repeated in Exhibit I under the following heading:</p> <ul style="list-style-type: none"> • <i>Untimely de-obligation of undelivered orders and a need to improve documentation records.</i>
<p>Improvement is needed over payroll processing and controls over official personnel files.</p>	<p>Revised and repeated in Exhibit I under the following heading:</p> <ul style="list-style-type: none"> • <i>Improvement needed in the New Hire, Personnel Action, and Employee Separation process.</i>