



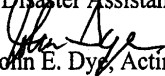
**U.S. Small Business Administration
Office of Inspector General
Washington, DC 20416**

AUDIT REPORT
Issue Date: September 20, 1999
Number: 9-24

TO: Joseph P. Loddo, Acting Chief Financial Officer

Lawrence E. Barrett, Chief Information Officer

Bernard Kulik, Associate Administrator for
Disaster Assistance

FROM:  John E. Dye, Acting Assistant Inspector General for Auditing

SUBJECT: Audit of SBA's FY 1998 Financial Statements

Pursuant to the Chief Financial Officers Act of 1990, attached is the Independent Accountant's Audit Report (Attachment 1) issued by Cotton & Co., CPAs. They concluded that the financial statements present fairly, in all material respects, the financial position of SBA as of September 30, 1998, and its net costs, changes in net positions, budgetary resources, and financing for the year then ended in accordance with Federally prescribed accounting principles.

The section on SBA's internal control structure discusses problems related to (1) financial reporting process, (2) subsidy modeling and re-estimating process, and (3) information systems controls. The section on compliance with laws and regulations indicates SBA's financial management system was not in compliance with the requirements referred to in the Federal Financial Management Improvement Act of 1996. The report includes a disclaimer on information in the CFO's annual report, which was not subject to audit procedures. The auditors also noted other management and internal control issues that will be communicated in a separate management letter.

SBA officials stated they were concerned about the internal control findings in the audit report and agreed to implement actions to address the recommendations so the findings could be removed from future audits. **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 audit follow-up and resolution.** Please provide us your proposed management decisions on SBA Form 1824, Recommendation Action Sheet, also attached, within 30 days.

Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Business Development Programs Group, on (202) 205-7204.

Attachments

COTTON & COMPANY

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ELLEN P. REED, CPA
MATTHEW H. JOHNSON, CPA

August 13, 1999

Inspector General
United States Small Business Administration

INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENTS

We have audited the Statement of Financial Position and Related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing of the U.S. Small Business Administration (SBA) as of and for the year ended September 30, 1998. These financial statements are the responsibility of SBA management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 98-08, Audit Requirements for Federal Financial Statements, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures relating to the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note 1 to the financial statements, the accounting policies used by SBA to prepare these financial statements are in accordance with OMB Bulletin No. 97-01, Form and Content of Federal Agency Financial Statements, as amended, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 1998, and its net costs, changes in net position, budgetary resources, and financing for the year then ended in conformity with the basis of accounting described in Note 1.

As discussed in Note 1 to the financial statements, SBA implemented the following Statements of Federal Financial Accounting Standards (SFFAS), all effective October 1, 1997:

- No. 4, Managerial Cost Accounting Concepts and Standards for the Federal Government.

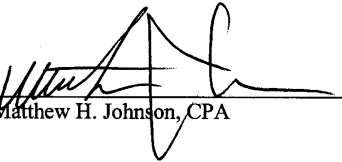
- No. 7, Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting.
- No. 8, Supplemental Stewardship Reporting.

In accordance with *Government Auditing Standards*, we have also issued reports dated August 13, 1999, on our consideration of SBA's internal control and on its compliance with certain provisions of laws and regulations.

The Required Supplementary Stewardship Information is not a required part of the basic financial statements, but is supplementary information required by OMB Bulletin No. 97-01, as amended. We applied certain limited procedures that consisted principally of inquiries of management regarding methods of measurement and presentation of supplementary information. We did not, however, audit the information and express no opinion on it.

The information in the Agency Overview and SBA Program Description and Analysis sections is not a required part of the basic financial statements, but is supplementary information required by OMB Bulletin No. 97-01, as amended. We reviewed this information to determine if it is materially inconsistent with the Statement of Financial Position. In our tests, we identified no inconsistencies. We did not, however, audit the Agency Overview and SBA Program Description and Analysis sections and, accordingly, express no opinion on them.

COTTON & COMPANY, LLP

By: 
Matthew H. Johnson, CPA

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August 13, 1999

Inspector General
United States Small Business Administration

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL

We have audited the Statement of Financial Position of the U.S. Small Business Administration (SBA) as of September 30, 1998, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources, and Financing for the year ended September 30, 1998, and have issued our report thereon dated August 13, 1999. We conducted our audit in accordance with generally accepted auditing standards; standards applicable to financial audits contained in *Government Auditing Standards* (1994 Revision), issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 98-08, Audit Requirements for Federal Financial Statements, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit, we considered SBA's internal control over financial reporting by obtaining an understanding of the agency's internal controls, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls to determine auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion on internal controls.

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal controls that, in our judgment, could adversely affect an agency's ability to record, process, summarize, and report financial data consistent with management assertions in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters discussed in the following paragraphs involving the internal control structure and its operation that we consider to be reportable conditions.

1. FINANCIAL REPORTING PROCESS

SBA faced a difficult challenge with new reporting requirements under the full implementation of OMB Bulletin 97-01. Specifically, the bulletin required preparation of three statements that SBA and other Federal agencies had not prepared. Despite its efforts, SBA was not adequately prepared for these reporting changes. During our FY 1998 audit, we found that:

- SBA's comprehensive plan for preparing financial statements lacked sufficient detail.
- SBA's quality control process was not completely effective.
- SBA management did not dedicate enough resources to ensure timely completion of its financial statements.

As a result, SBA did not meet OMB's March 1 deadline for submitting its audited financial statements and, in fact, did not provide financial statements to its auditors until June 2, 1999. Further, the statements submitted to its auditors contained several significant errors and omissions. For example, SBA failed to report on its Statements of Changes in Net Position and Financing the amount of Imputed Financing as required by OMB Bulletin 97-01; several changes were necessary to its footnotes; and over \$80 million in projected errors were identified in SBA's financial statements.

SBA's comprehensive plan for preparing financial statements lacked sufficient detail.

During the course of our audit of SBA's Fiscal Year (FY) 1997 financial statements, we reported that improvements were needed at SBA to ensure compliance with the Government Management Reform Act of 1994 (GMRA), which requires Federal agencies to submit audited department-wide financial statements to OMB by March 1. SBA did not meet the due date for FY 1998, because it had not sufficiently implemented needed improvements.

We recommended to SBA that it develop a comprehensive plan for financial reporting that identified the following, in detail:

- Procedures required for acquiring documentation and preparing financial statements according to an established timetable.
- Individual who will perform critical functions.
- Deadlines for each critical phase of the plan.
- A description of how each of the programs will consolidate into a consistent, agency-wide financial statement presentation.

SBA did prepare a plan—Comprehensive Plan for FY 1998 CFO Annual Report. This plan did not, however, provide detailed procedures for acquiring documentation and preparing financial statements or how SBA would consolidate its programs into an agency-wide financial statement presentation. Further, we noticed that SBA did not perform basic, routine analyses, such as aging of accounts receivable and comparison of prior- and current-year amounts.

SBA's quality control process was not completely effective. Although SBA's plan identified individuals responsible for quality control reviews of the financial statements, we found several errors and omissions on the statements. Errors occurred when those responsible for performing quality reviews also

had concurrent responsibility for preparing the financial statements. Also, according to SBA personnel, the amount of time between completion of the financial statements and submission to the auditors did not allow enough time for a sufficient quality control review. Thus, errors and omissions occurred.

SBA management did not dedicate enough resources to ensure timely completion of the financial statements. With new requirements under full implementation of OMB Bulletin 97-01, SBA faced a difficult challenge. OMB Bulletin 97-01 required preparation of the Statements of Budgetary Resources and Financing. These two statements required complete and accurate budgetary data, which SBA's loan accounting system could not readily provide. As a result, SBA developed a manual process for acquiring this information and preparing the statements. SBA did not, however, assign enough resources to this manual process, and deadlines were missed. For example, in its Comprehensive Plan for FY 1998, SBA established December 1, 1998, as the completion date for its general ledgers but did not submit all of its general ledgers to the auditors until June 2, 1999—6 months late.

Recommendations. We recommend that:

- The Director of the Denver Finance Center develop a detailed comprehensive plan for preparing the FY 1999 financial statement report.
- Office of the Chief Financial Officer (OCFO) identify and obtain the resources necessary to ensure accurate and timely preparation of FY 1999 financial statements including adequate resources to conduct a thorough quality control review of the financial statements prior to submission to the auditors.
- OCFO obtain training for all staff assuming financial reporting responsibilities.

2. **SUBSIDY MODELING AND RE-ESTIMATING PROCESSES**

SBA's internal control functions governing credit reform subsidy modeling and re-estimating processes continue to need improvement. During our audit of SBA's FY 1997 financial statements, we noted that substantial errors in re-estimate calculations existed, and few controls governed the budget execution and re-estimate subsidy processes. We recommended that, at a minimum, SBA document its policies and procedures governing its credit subsidy process, develop a formalized quality review program, and ensure that adequate time and resources are available to effectively implement these controls.

Responsibility for accumulating and analyzing data, designing credit subsidy models, and calculating budget estimates and re-estimates lies with the OCFO. In response to our FY 1997 audit report recommendation, OCFO:

- Prepared a comprehensive policies and procedures document for preparing subsidy estimates and re-estimates, which includes an overview of the process, programs and assumptions, data, documentation and training requirements, and deliverables and a timeline for their completion.
- Developed and implemented a quality assurance process that, for re-estimates, included a peer review by an analyst not responsible for preparing the re-estimate under review and a supervisory review.

We were not, however, able to determine the extent of these reviews, because review documentation was not always completed or available. As with other agencies subject to credit reform, SBA maintains separate subsidy rate models for each program and cohort year on spreadsheets containing numerous cell-references, formulas, and links to other spreadsheets. These models are inherently susceptible to error, alteration, and inconsistency and, thus, require detailed, labor intensive review.

Although SBA performed some peer and supervisory reviews of its 7(a), 504, and disaster re-estimates, we noted similar deficiencies in the re-estimates prepared for the FY 1998 financial statements as noted last year. For example, SBA used incorrect data and incorrect cell references in several re-estimate spreadsheets. It also did not detect the failure to calculate interest on the Cohort 1998 re-estimate as the result of an error in the OMB-provided spreadsheet. Finally, SBA did not correctly treat chargeoffs consistent with the method established for FY 1997. These errors resulted in adjustments of more than \$195 million to the re-estimates submitted for the FY 1998 financial statement audit.

An effective quality review process is essential to ensure that the work of assigned staff is adequately supervised, reviewed, and approved, as required by GAO's *Standards for Internal Controls in the Federal Government*. SBA must ensure that the peer and supervisory reviewers have the experience, training, and time commensurate with the inherently high risk associated with the re-estimate process.

We also noted that SBA's disaster models produce a reliable budget execution estimate, but, in our opinion, do not produce a reliable re-estimate or comply with the OMB Credit Subsidy User's Guide (Chapter V, I.B.1). This occurs as the result of limitations with SBA's current method of accumulating cash flows. SBA obtained proxy data, which was the best data available at the time. In our opinion, however, the methodology used in applying the proxy data did not reflect projected program behavior and produced illogical results. Consequently, SBA adjusted its disaster re-estimates by \$453 million from a \$126 million downward re-estimate to a \$327 million upward re-estimate.

SBA recognized that its existing re-estimate models have limitations, and began working on new methods for accumulating disaster data and computing subsidy estimates and re-estimates in FY 1999. While we agree with SBA's decision to develop a new model, we do not think the existing model was subjected to sufficient scrutiny to ensure that it produced a reasonable outcome for the FY 1998 re-estimates in light of its known shortcomings.

Recommendations. We recommend that OCFO:

- Continue to refine its quality assurance process to ensure that peer and supervisory reviewers have the experience, training, and time to perform reviews commensurate with the inherently high risk associated with SBA's existing re-estimate process.
- Arrange for an independent review of the new disaster models and ensure that the new models produce reliable and reasonable re-estimates prior to submitting the re-estimates for audit.

3. INFORMATION SYSTEMS

Although Office of Chief Information Officer (OCIO) and OCFO have taken steps in FY 1998 to implement corrective actions within their areas of responsibilities, further improvements are needed to address the root causes of the general control weaknesses over SBA's information systems. During our audit of SBA's FY 1998 financial statements, we found that SBA needs to:

- Fund and implement an entity-wide security program.
- Eliminate and reduce unnecessary and excessive access privileges that lessen accountability and create segregation-of-duties weaknesses.
- Consistently apply application development and change control procedures.
- Monitor programmer ability to access operating systems.
- Train security administrators and program managers.

The Office of Inspector General issued a separate report, Audit of SBA's Information Systems Controls (Report Number: 9-19), on September 2, 1999, which details our findings and recommendation.

Our consideration of internal controls over financial reporting would not necessarily disclose all matters in the internal control structure over financial reporting that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We consider the three reportable conditions described above to be material weaknesses.


In addition, we considered SBA's internal controls over Required Supplementary Stewardship Information by obtaining an understanding of SBA's internal controls, determining whether those internal controls had been placed in operation, assessing control risk, and performing tests of controls as required by OMB Bulletin No. 98-08, as amended. Our procedures were not designed to provide assurance on these internal controls. Accordingly, we do not express such an opinion.

Finally, with respect to internal controls related to performance measures reported in the sections titled Agency Overview and SBA Program Description and Analysis, we obtained an understanding of the design of significant internal controls related to existence and completeness assertions as required by OMB Bulletin No. 98-08, as amended. Our procedures were not designed to provide assurance on internal controls over reported performance measures, and, accordingly, we do not express such an opinion.

We also noted other matters involving internal controls over financial reporting and its operation that we consider nonreportable conditions. We will communicate these matters to management in a separate letter.

This report is intended solely for the information and use of the management of SBA, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties. We caution that misstatements, losses, and noncompliance may occur and not be detected by the testing performed and that such testing may not be sufficient for other purposes.

COTTON & COMPANY, LLP

By 
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MATTHEW H. JOHNSON, CPA

August 13, 1999

Inspector General
United States Small Business Administration

AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

We have audited the Statement of Financial Position of the U.S. Small Business Administration (SBA) as of September 30, 1998, and the related Statements of Net Cost, Changes in Net Position, Budgetary Resources and Financing for the year ended September 30, 1998, and have issued our report thereon dated August 13, 1999. We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards* (1994 Revision), issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 98-08, Audit Requirements for Federal Financial Statements, as amended. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

SBA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether the agency's financial statements are free of material misstatement, we performed tests of SBA's compliance with certain provisions of laws and regulations. Noncompliance with which could have a direct and material effect on the determination of financial statement amounts and certain other laws and regulations specified in OMB Bulletin No. 98-08, including requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996.

The results of our tests of compliance disclosed no instances of noncompliance with other laws and regulations discussed in the preceding paragraph exclusive of FFMIA that are required to be reported under *Government Auditing Standards* or OMB Bulletin 98-08.

Under FFMIA, we are required to report whether the agency's financial management systems substantially comply with Federal financial management systems requirements, Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA included in Appendix D of OMB Bulletin No. 98-08.

Test results disclosed instances, described below, in which the agency's financial management systems did not substantially comply with the three requirements discussed in the preceding paragraph.

- **Federal Financial Management Systems Requirements:** In conducting our audit, we found that security over financial information was not provided in accordance with OMB Circular A-130 *Management of Federal Information Resources*, Appendix 3 *Security of Federal Automatic Information Systems*.
- **Federal Accounting Standards:** Test results disclosed that SBA's financial management systems did not substantially comply with the Federal accounting standards criterion, because the audit disclosed material weaknesses in internal controls relating to SBA's ability to prepare auditable statements and related disclosures.
- **United States Government Standard General Ledger (SGL) at the Transaction Level:** SBA's financial systems did not capture information using the same descriptions and posting rules contained in the SGL. Specifically, SBA's loan accounting system does not adequately capture budgetary data in a manner that facilitates the preparation of its financial statements and reports. As a result, SBA developed a manual process whereby it develops balances for budgetary accounts based on summaries of various transactions. This manual process while effective for the preparation of required reports, does not comply with the SGL requirements at the transaction level.

For information required by OMB Bulletin No. 98-08 with respect to these noncompliance matters, please refer to the accompanying Independent Auditor's Report on Internal Control.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

This report is intended solely for the information and use of the management of SBA, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties. We caution that noncompliance may occur and not be detected by the tests performed and that such testing may not be sufficient for other purposes.

COTTON & COMPANY, LLP

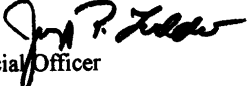
By: 
Matthew H. Johnson, CPA



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

DATE: September 16, 1999

TO: Victor Ruiz
Assistant Inspector General
for Auditing

FROM: Joseph P. Loddo 
Acting Chief Financial Officer

SUBJECT: Audit of SBA's FY 1998 Financial Statements

We have reviewed the draft audit report submitted by Cotton & Company including the opinion on SBA's fiscal year 1998 financial statements, internal control status, and compliance with applicable laws and regulations. We are pleased to note the unqualified opinion in the audit report for our third year in a row. The SBA is the only credit agency to receive an unqualified opinion for three successive years. We believe this speaks to the fiscal health of the SBA and we are proud of this accomplishment.

We are concerned, however, about the internal control findings in the audit report including (1) the financial reporting process, (2) the subsidy modeling and re-estimating process and (3) information systems controls. SBA feels it has made significant progress in addressing these previously reported findings. However we will implement actions to address the auditor's specific recommendations so that these findings will be removed from future audits. We ask that the OIG and Cotton & Company work closely with us to help make this happen.

We appreciate the opportunity to comment on this draft report, and look forward to your response to this request. Any questions may be addressed to John Kushman or Louise Wilson of my staff.

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