



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

AUDIT REPORT

Issue Date:
February 28, 1997

Number: 7-6-H-006-010

TO: J. Larry Wilson
Chief Financial Officer

FROM: *Peter L. McClintock*
Peter L. McClintock
Assistant Inspector General for Auditing

SUBJECT: Audit of SBA's FY 1996 Financial Statements

The attached Independent Auditor's Report (Attachment 1) presents the results of audit of SBA's fiscal year 1996 financial statements pursuant to the Chief Financial Officers Act of 1990. The Auditor's Report, by Cotton & Company, CPAs, gives an unqualified opinion. The section on SBA's internal control structure discusses problems related to (1) fund balances with U.S. Department of Treasury reconciliation, (2) foreclosed property inventory records, (3) foreclosed property valuation, (4) Federal Credit Reform Act subsidy rate re-estimates, (5), computer user security codes, and (6) year-end cut-off procedures. The section on compliance with laws and regulations indicates that SBA complied in all material respects with applicable laws and regulations which could have a direct and material effect on the financial statements. 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 agreed with the findings and recommendations and, in some instances, have initiated corrective action. **The findings and recommendations are subject to review, management decision, and action by your office in accordance with Standard Operating Procedure 90 15 1, Resolution and Follow-Up Procedures on Audit Findings and Recommendations.** 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, Headquarters Operations, on (202) 205-7204.

Attachments (3)

COTTON & COMPANY

CERTIFIED PUBLIC ACCOUNTANTS, LLP

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February 14, 1997

INDEPENDENT AUDITORS' REPORT

Inspector General
Small Business Administration

We audited the Small Business Administration's (SBA) consolidated statements of financial position as of September 30, 1996, and 1995, and the related consolidated statements of operations and changes in net position (the principal statements) for the years then ended.

- For Fiscal Year (FY) 1996, the principal statements are presented fairly, in all material respects. For FY 1995, the principal statements are presented fairly, in all material respects, except for the effects of such adjustments, if any, as might have been determined necessary if: (1) we had been able to examine evidence supporting SBA's foreclosed property inventory and its valuation and (2) SBA had reconciled certain Fund Balances with Treasury between SBA and Treasury balances.
- For FY 1996, we found six reportable internal control findings as described below under SBA's Internal Control Structure; one is a material weaknesses.
- For FY 1996, we found no material noncompliance with the selected provisions of applicable laws and regulations tested.

These matters and the scope of our work are discussed in more detail below under the following captions:

- Auditors' Opinions on Principal Statements
- SBA's Internal Control Structure
- SBA's Compliance With Laws and Regulations
- Significant Matter
- SBA's Responsibilities
- Auditors' Responsibilities
- Auditors' Methodology
- Disclaimer on Other Information
- Management Comments on Audit Results
- Report Usage and Distribution

AUDITORS' OPINIONS ON PRINCIPAL STATEMENTS

SBA prepared the principal statements in accordance with:

- Office of Management and Budget (OMB) Bulletin No. 94-01, Form and Content of Agency Financial Statements.
- The accounting policies described in Notes 1.A through 1.Q of SBA's *Annual Report, 1996*.

These criteria are a comprehensive basis of accounting other than generally accepted accounting principles.

We have audited the statements of financial position of SBA as of September 30, 1996, and 1995, and the related statements of operations and changes in net position for the years then ended. These financial statements are the responsibility of SBA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except for two conditions that limited the scope of our FY 1995 audit, which we discuss below, we audited SBA's principal statements in accordance with generally accepted auditing standards; *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Bulletin No. 93-06, Audit Requirements for Federal Financial Statements. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the principal statements are free of material misstatement. We believe our audits provide a reasonable basis for our opinions.

In our opinion, the FY 1996 financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 1996, and the results of operations and changes in net position for the year then ended in conformity with the basis of accounting described above.

SBA did not maintain inventory records of foreclosed property valued (gross) at \$140 million as of September 30, 1995, in the accompanying statement of financial position. Further, SBA did not consistently value the foreclosed property inventory as required by Statement of Federal Financial Accounting Standard (SFFAS) No. 3, Accounting for Inventory and Related Property. For the FY 1995 audit, we could not satisfy ourselves by other auditing procedures regarding these inventory recordkeeping and valuation conditions.

As of September 30, 1995, SBA did not reconcile certain Fund Balances with Treasury between SBA and Treasury balances. Treasury's records showed a Fund Balance with Treasury of \$32 million (net) less than shown in SBA's general ledger. For the FY 1995 audit, we could not satisfy ourselves by other auditing procedures regarding this condition.

In our opinion, except for the effects of such adjustments, if any, on the FY 1995 financial statements as might have been determined necessary had we been able to examine evidence supporting the (1) September 30, 1995, balances for foreclosed property inventory and its valuation and (2) reconciliation of certain September 30, 1995, Fund Balances with Treasury, the financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 1995, and the results of operations and changes in net position for the year then ended in conformity with the basis of accounting described above.

We conducted our audits to form our opinions on the principal statements taken as a whole. SBA's *Annual Report* also includes supplementary schedules that show the activity comprising SBA's reporting entity. These supplementary schedules are not a required part of the principal statements.

These supplementary schedules are presented for purposes of additional analysis rather than to present the financial position and results of operations and changes in net position of the individual accounts and funds. These schedules have been subjected to the auditing procedures applied in our audits of the principal statements and, in our opinion, are fairly stated in all material respects in relation to the principal statements taken as a whole.

SBA'S INTERNAL CONTROL STRUCTURE

In planning and performing our audits of the principal statements as of and for the years ended September 30, 1996, and 1995, we considered SBA's internal control structure to determine our auditing procedures for purposes of expressing our opinions on the principal statements and not to provide assurance on the internal control structure.

The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

1. Transactions are properly recorded and accounted for to permit the preparation of reliable principal statements and to maintain accountability over assets.
2. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.
3. Transactions are executed in compliance with applicable laws and regulations.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate as the result of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect SBA's ability to record, process, summarize, and report financial data consistent with the assertions of management in the statements.

The reportable conditions and our recommendations appear below. Reportable condition Nos. 1 through 5 were also cited in the independent auditors' report on the internal control structure dated April 25, 1996, which is the report of Cotton & Company's audit of SBA's FY 1995 and 1994 principal statements.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the principal statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure 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 reportable condition No.1 to be material weakness.

We also noted other matters involving the internal control structure and its operations that we consider nonreportable conditions. We will communicate these matters to management in a separate letter.

1. Fund Balances with Treasury Reconciliation

SBA does not reconcile its Fund Balances with Treasury reported in the general ledger and those maintained by Treasury for its loan accounting funds in a timely manner and has not completed its reconciliations for FYs 1995 and 1996. Federal agencies are required to perform fund balance reconciliations both to permit the recording of appropriate adjustments and to ensure proper accountability over assets and proper matching of revenues and expenses.

During FY 1996, SBA automated its cash reconciliation function by maintaining a database of all unreconciled general ledger and Treasury transactions. The database was updated with current-month transactions and validated monthly for completeness. The volume of monthly unreconciled transactions is significant, because SBA's general ledger system uses different document identification numbers than those used for reporting transactions to Treasury. Thus, SBA's cash reconciliation process is inherently complex and labor intensive.

Also, SBA does not have an integrated system for recording cash activity in its loan accounting general ledger and for reporting cash activity to Treasury on its SF 224, Statement of Transactions, which further complicates this process. Rather than using its general ledger, SBA uses source documents entered separately into its automated Treasury reporting system. The general ledger has controls to ensure the accurate recording of transactions. The SF 224 and the general ledger are not, however, integrated. Thus, no control exists to ensure that transactions are entered correctly on the SF 224. We noted several discrepancies between the general ledger and the SF 224. These discrepancies increase the complexity of the reconciliation process.

SBA assigned significant resources during FY 1996 to researching and resolving unreconciled transactions dating back to FY 1992. As a result, it created crosswalk programs to automatically match general ledger transactions with Treasury transactions that were related, but did not have identical document identification numbers. In addition, SBA determined several instances in which its general ledger reporting was incomplete. SBA has taken preliminary action to correct this problem.

While SBA made significant progress, its cash reconciliation is not current and is not completed in a timely manner. Unreconciled differences remain for FYs 1995 and 1996. As of September 30, 1996, Treasury's records showed an aggregate Fund Balance with Treasury of \$4.5 million more than shown in SBA's general ledger for its loan accounting funds.

The Treasury Financial Manual (TFM), Volume I, Part 2, Chapter 3900, requires SBA to reconcile Fund Balances with Treasury on a monthly basis. Without current and complete reconciliations, SBA cannot fully support its Fund Balances with Treasury or ensure proper asset accountability and control and proper matching of revenues and expenses.

We recommend that OCFO assign sufficient resources to ensure that the Fund Balance with Treasury reconciliation is brought up to date and accomplished monthly thereafter. In addition, we recommend that OCFO establish an integrated system using its general ledger as the basis for reporting cash activity to Treasury.

2. Foreclosed Property Inventory Records

Property that SBA acquires through enforcing payment under secured loans is referred to as "collateral purchased" (COLPUR), or foreclosed property inventory. SBA does not maintain comprehensive inventory records of the foreclosed property units, which are valued (gross) at \$90 million and \$140 million as of September 30, 1996, and 1995, respectively, in the statements of financial position. Therefore, SBA cannot reconcile these records to its general ledger. OMB Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables, Appendix A, Chapter III, Section A.3.d, requires SBA to establish and maintain comprehensive inventory records of all foreclosed property.

SBA is in the process of developing a module within its current Loan Liquidation Tracking System (LLTS) that will contain detailed records of foreclosed property (such as, type of property, location, and value). Additionally, this module will produce a report comparing detailed records to general ledger balances, and thus will facilitate the reconciliation of general ledger balances to the detail listings of foreclosed property. To date, however, LLTS has not been modified with this module, and the lack of foreclosed property inventory records continues to be a problem. Without accurate and complete foreclosed property inventory records, SBA cannot support its corresponding principal statement balances, and it cannot achieve proper asset accountability and control as required by OMB Circular A-129.

We recommend that SBA establish the development and implementation of the LLTS module to maintain foreclosed property inventory records as a priority to ensure that the inventory system is in place during FY 1997.

3. Foreclosed Property Valuation

SFFAS No. 3, paragraph 81, requires that property acquired with loans approved before 1992 be recorded at cost and adjusted for the lower of cost or net realizable value. Any difference is carried in a valuation allowance. Additionally, property acquired with loans approved from 1992 forward is valued at the net present value of the projected future cash flows associated with the property. SBA does not, however, consistently value the property. We found that the valuation of the foreclosed property was sometimes more dependent upon the loan receivable than the value of the property acquired. For example, at one location, we found that property with an appraised value of \$90,000 was recorded at \$244,000, overstating foreclosed property by \$154,000. The field office had valued the property at \$244,000 to make the loan receivable zero. By doing so, however, SBA no longer recognizes a claim against the borrower for any future recoveries of Government funds.

Current SBA procedures require property to be recorded on Form 297, Collateral Purchase Report, at the acquisition price less prior liens or book value of the loan, depending on the circumstances under which SBA takes possession of the property. In response to our FY 1995 audit report, SBA is in the process of revising its procedures to require that foreclosed property be valued at its net realizable value.

We recommend that the Office of Financial Assistance (OFA) provide training and guidance to field offices on the revised requirements for the valuation of foreclosed property. We further recommend that OFA periodically review field office foreclosed property records to ensure that property is properly valued.

4. Federal Credit Reform Act Subsidy Rate Reestimates

SBA's loan programs are subject to the requirements of the Federal Credit Reform Act (FCRA) of 1990. SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees, and OMB Circular A-34, Instructions on Budget Execution, describe criteria for FCRA accounting. These criteria require that the estimated cost of loans be recorded, based on estimated subsidy rates, in the year loans are obligated. Each year thereafter, subsidy rates must be reestimated and the cost of the loans adjusted for any significant differences attributable to the reestimates.

SBA has not calculated subsidy rate reestimates for the Disaster Loan Program since FCRA became effective on October 1, 1991. Thus, SBA is not reporting the potential effects resulting from annual reestimates of this program in its principal financial statements.

SBA attempted to reestimate subsidy rates for the Disaster Loan Program in FY 1996, but it could not fully validate the data used to recalculate these rates. Specifically, the computed default rates were inconsistent with other available information for two of the loan years. The default rates were computed from a disaster loan database not entirely reliable for some data collection, such as the number of defaults. Despite data inconsistencies, SBA entered these default rates and other required information into OMB's cash flow model for reestimation. Because the data were unreliable, SBA could not accurately determine subsidy rates for the Disaster Loan Program. SBA has dedicated more resources to pursue the problem with data inconsistency and to enhance the integrity of data used to reestimate disaster loan subsidy rates.

We recommend that SBA continue in its efforts to establish this as a priority to enable it to reestimate subsidy rates annually in accordance with SFFAS No. 2 and OMB Circular A-34.

5. Computer User Security Codes

User security codes are an individual's electronic signature and are used in SBA's loan accounting system to authorize transactions. SBA's district and regional security officers and their backups have access to all user security codes for their respective offices. Federal Information Processing Standard (FIPS) 112, Password Usage, factors 5 and 6, state that passwords are to be known only to the owner and require that the intended owner be the only one to see the password when distributed. The password system should keep a record of password issue and not a record of passwords.

SBA's security code distribution and storage procedures require security officers to assign user security codes and provide security officers with access to user security codes. Failure to provide adequate protection of user security codes negates the control of separation of duties and provides an opportunity for unauthorized transactions.

SBA's Office of Information Resource Management acknowledges the existence of this weakness. Because no losses have been identified, however, it has decided not to modify the current system while the agency is in the process of implementing a new computer system using client server

technology, which will be in compliance with all FIPS requirements. Migration to the new system is scheduled to be completed by September 1998.

6. Yearend Cut-Off Procedures

SBA does not have procedures in place to adequately assure that transactions will be recorded and reported in the fiscal year in which they occur.

Generally accepted accounting principles require that economic events be recorded in the period in which they occur. Additionally, GAO's Title 2, *Policy and Procedures Manual for Guidance of Federal Agencies*, requires that transactions be identified and recorded in the proper period.

During our testing of various transactions, we found several instances of transactions recorded in the wrong fiscal year. For example, we statistically sampled for confirmation 31 Judgment Receivables and Receivable Obtained in Foreclosure as of September 30, 1996. We found that 6 of the 31 (19 percent) had unrecorded transactions during the fiscal year. This error resulted in an overstatement of \$12 million, which, when projected to the population of these accounts, results in an overstatement of \$53 million. Additionally, we found that certain cash disbursements (wire transfers) occurring in FY 1996 were not recorded until FY 1997. To further illustrate this problem, SBA processed 281 journal entries from October 1 to December 31, 1996, to record the purchase or sale of foreclosed property. We randomly selected 30 of these transactions and found that 8 of the journals (27 percent) recorded transactions from the prior fiscal year.

SBA does not have procedures in place to identify and record transactions entered during the current fiscal year that represent events occurring in the prior fiscal year.

We recommend that the OCFO establish procedures to ensure that transactions be recorded and reported in the year in which they occur.

SBA'S COMPLIANCE WITH LAWS AND REGULATIONS

The objective of our audits of the principal statements was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

As part of obtaining reasonable assurance about whether the principal statements are free of material misstatement, however, we performed tests of compliance with certain provisions of laws and regulations. We found that SBA complied in all material respects with provisions of applicable laws and regulations tested.

Certain immaterial instances of noncompliance will be communicated to management in a separate letter.

SIGNIFICANT MATTER

SBA's procedures for identifying and reporting internal control weaknesses in compliance with the Federal Managers' Financial Integrity Act (FMFIA) are not adequate. One of three material weaknesses included in the Independent Auditors' Report of SBA's FY 1995 and FY 1994 principal statements was not included in either SBA's FY 1995 or FY 1996 FMFIA Report to The President and the Congress.

Management letter comments from our audit of the FY 1995 and FY 1994 principal financial statements reported low involvement of District offices in the FMFIA process and recommended establishment of written procedures. These procedures have not been established. In addition, during FY 1996, SBA canceled its Computerized Internal Control Review (CICR), which was reported in its *Annual Report, 1995*, as a "vital part of the Agency's Management Control system providing effective review and documentation of procedural and process deficiencies...."

SBA'S RESPONSIBILITIES

SBA management is responsible for:

- Preparing the principal statements in conformity with OMB Bulletin No. 94-01 and the comprehensive basis of accounting described in Note 1 to the principal statements.
- Establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures.
- Complying with applicable laws and regulations.
- Compiling and reporting performance measures in accord with applicable OMB criteria.

AUDITORS' RESPONSIBILITIES

Our responsibility is to express opinions on the principal statements based on our consideration of SBA's internal control structure and our audit procedures. We are also responsible for testing compliance with selected provisions of laws and regulations and for performing limited procedures with respect to other information appearing in SBA's *Annual Report*.

AUDITORS' METHODOLOGY

To fulfill these responsibilities, we:

- Obtained an understanding of the design of significant internal control structure policies and procedures; determined if they have been placed in operation; assessed control risk for significant cycles, transaction classes, and account balances; and performed tests in the following significant internal control structure categories:
 - Cash receipts
 - Cash disbursements

- Direct loans and loan guarantees
- Budget
- Salaries and expenses

- Examined on a test basis the evidence supporting amounts and disclosures in the principal statements.

- Assessed the accounting principles used and significant estimates made by management.

- Evaluated the overall presentation of the principal statements.

- Tested compliance with selected provisions of the following laws and regulations that, if not complied with, could directly and materially affect the principal statements:
 - Antideficiency Act
 - Debt Collection Act of 1982
 - Small Business Act of 1953
 - Small Business Investment Act of 1958
 - Budget and Accounting Procedures Act of 1950
 - Federal Credit Reform Act of 1990
 - Chief Financial Officers Act of 1990
 - Government Management Reform Act of 1995

We also tested management processes for evaluating and reporting on internal control and accounting systems as required by FMFIA by comparing [in accord with OMB Bulletin No. 93-06, paragraph 6.a(4)] SBA's most recent FMFIA report with the results of our evaluation of SBA's internal control structure. We noted that reportable condition Nos. 1, 4, 5, and 6 were not included in SBA's FY 1996 FMFIA report dated January 27, 1997.

In addition, we assessed whether the other information in SBA's *Annual Report* and the manner of its presentation are materially consistent with the information in the principal statements taken as a whole.

DISCLAIMER ON OTHER INFORMATION

Our audits were made for the purpose of forming opinions on the principal statements taken as a whole. The principal statements are contained in SBA's *Annual Report*, which also contains sections titled Executive Summary, Agency Description, Description and Analysis, and SBA's Management Integrity Program. These sections contain a wide range of information presented for purposes of additional analysis. Some of this information is also required by OMB Bulletin No. 94-01.

The information in these sections is not a part of the principal statements and has not been subjected to the auditing procedures applied in the audits of the principal statements. Accordingly, we express no opinion on the information or these sections.

MANAGEMENT COMMENTS ON AUDIT RESULTS

We discussed our audit results with SBA management on February 14, 1997.

Management followed up with its written reply dated February 25, 1997. This reply, reproduced as an attachment, is responsive to our findings and indicates that management will provide a detailed corrective action plan addressing each item.

REPORT USAGE AND DISTRIBUTION

This report is intended solely for the information and use of SBA's Inspector General and management and should not be used for any other purpose. This restriction is not intended to limit the distribution of this report which, upon acceptance by SBA, is a matter of public record.

COTTON & COMPANY

By: 

Matthew H. Johnson, CPA



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

February 25, 1996

TO: Peter L. McClintock
Assistant Inspector General
for Auditing

FROM: J. Larry Wilson
Chief Financial Officer

A handwritten signature in cursive script, appearing to read "J. Wilson", written over the printed name "J. Larry Wilson".

SUBJECT: Audit of SBA's FY 1996 Financial Statements

We reviewed the draft audit report submitted by Cotton & Company (Cotton) for SBA's fiscal year 1996 financial statements, internal control status, and compliance with applicable laws and regulations. We are pleased to note the unqualified opinion in the audit report.

We agree in principle with the findings and recommendations of Cotton & Company in its independent auditors report. A detailed corrective action plan addressing each item will be forwarded to you within 30 days of issuance of the final audit report.

We would like to comment on the audit report itself. In some cases, it seems that the auditor did not sufficiently recognize Agency efforts to address audit concerns. In other cases, the auditor did adequately recognize Agency efforts. As a result, the report seems to have a negative tone in some sections. For example, the sixth internal control weakness in the report does not mention the Agency's yearend notification or reporting procedures to address unreported transactions. On the other hand, the description in the audit report for the first internal control weakness on cash reconciliation adequately describes Agency efforts on this issue. We would request that the report be reviewed to assure the full recognition of Agency efforts in all sections. In addition, the distinction in the report between FY1996 and FY1995 conditions could be improved. The unqualified opinion for FY 1996 is followed immediately by the qualified opinion for FY1995. Perhaps an introductory statement would clarify the transition to FY1995 conditions.

We appreciate the opportunity to comment on the draft audit report. Any questions may be addressed to John Kushman or Maria Moy on my staff.

ATTACHMENT 3

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