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

AUDIT REPORT
Issue Date: April 11, 1997
Number: 7-6-H-006-012

TO: J. Larry Wilson
Chief Financial Officer

Peter L. McClintock

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

SUBJECT: Audit of SBA's FY 1996 Financial Statements - Management Letter

The attached Management Letter presents conditions noted in the Cotton & Company, CPAs' audit of SBA's Fiscal Year 1996 financial statements. This audit was performed pursuant to the Chief Financial Officers Act of 1990.

The Management Letter includes conditions related to the internal control structure and other issues that were identified during the audit but were not required to be included in the Auditor's Report. SBA officials generally 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 (2)

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February 14, 1997

MANAGEMENT LETTER COMMENTS
INDEPENDENT AUDIT OF FISCAL YEARS 1996 AND 1995
PRINCIPAL FINANCIAL STATEMENTS

Inspector General
Small Business Administration

We have audited the Small Business Administration's (SBA) principal financial statements as of September 30, 1996, and 1995, and for the years then ended, and have issued our report, dated February 14, 1997, to SBA under separate cover. That report also included our reports on SBA's internal control structure and compliance with laws and regulations.

The purpose of this management letter is to communicate nine nonreportable findings to SBA management. Of these nine, we reported:

- One in the Fiscal Year (FY) 1995 audit report as a reportable condition.
- Four as nonreportable conditions in the management letter accompanying our FY 1995 audit report.

We included a total of six nonreportable findings in our FY 1995 management letter. In response, SBA has taken the necessary actions to resolve one of the six findings (No. 1). We address finding No. 2 from the FY 1995 management letter in a separate management letter to the Office of Information Resources Management (OIRM) for FY 1996.

This letter is intended solely for the information and use of SBA management.

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

Very truly yours,

COTTON & COMPANY, LLP

By: Matthew H. Johnson, CPA, CGFM

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INDEPENDENT AUDIT OF FISCAL YEARS 1996 AND 1995
PRINCIPAL FINANCIAL STATEMENTS
NONREPORTABLE FINDINGS

Certain nonreportable findings came to our attention during the audit of the Small Business Administration's (SBA) Fiscal Year (FY) 1996 principal financial statements. We discuss these matters and present our recommendations in the following categories:

- Internal Controls
- Compliance Matters

We reported finding No. 1 in our FY 1995 audit report and No. 6 through No. 9 in the management letter accompanying our FY 1995 audit report. Where SBA partially addressed our recommendations, we modified our findings and recommendations.

INTERNAL CONTROLS

1. Financial Transaction Processing Controls

SBA field offices do not have procedures for verifying that certain transactions initiated in field offices and submitted to the Office of Financial Operations (OFO) for processing have been entered into the Loan Accounting System (LAS). These transactions are:

1. Adjustments to loan accounts.
2. Purchase or sale of collateral.
3. Notes receivable accepted in loan modifications.

We reported this finding in our FY 1995 audit report and recommended that OFO develop a mechanism for reporting to field offices when a transaction is processed and that the field offices verify transaction processing. We have modified this finding from a reportable condition in FY 1995 to a nonreportable condition in FY 1996, because OFO implemented a process for notifying field offices when transactions were processed.

Field offices do not, however, have standard procedures to ensure that all transactions are processed. For example, during our review of field offices, we found three loans with a recorded balance of $27.6 million that had been written-off to zero by the field office, but not processed by OFO. Because the field offices had no procedures for ensuring all transactions are processed, the financial statement misstatements went undetected.

General Accounting Office (GAO) Title 2, *Policy and Procedures Manual for Guidance of Federal Agencies*, Appendix III, Accounting System Standards, requires agency systems to include controls that prevent or detect:

1. Failure to record a transaction.
2. Duplicate transaction recording.
3. Loss of a transaction document in handling
4. Processing of unauthorized or incorrect data.

We recommend that field offices develop appropriate controls, such as maintaining logs to document all transaction processing required and accomplished. These logs should contain a copy of the action form (SBA Form 327, Modification or Administrative Action, or SBA Form 297, Collateral Purchase Report), and logs should be placed in the loan file after matching with the OFO notification.

2. Documentation of Cash Reporting and Reconciliation Processes

SBA does not have documented procedures for its cash reporting and reconciliation processes. SBA recently transferred the cash reconciliation function to OFO and automated both the reconciliation and reporting functions. SBA devoted its resources to performing these functions but still needs to document these procedures.

Internal control standards require agencies to maintain written materials of system documentation, including policies and procedures, operating procedures, and administrative practices. Also, the GAO's Title 2, Appendix II, Internal Control Standards, states that internal control systems and all transactions and other significant events are to be clearly documented and that the documentation is to be readily available for examination. Without such documentation, managers cannot effectively control their operations, and SBA's operations cannot be analyzed efficiently.

We recommend that the Office of Chief Financial Officer (OCFO) document cash reporting and reconciliation processes. The documentation should include standards and guidelines for completing the reporting and reconciliation processes to ensure that SBA's control objectives are accomplished in a timely manner.

3. Reconciliation of SBIC Loans to SBA Loan Accounting System

SBA's Loan Accounting System does not accurately reflect transactions and account balances related to the Small Business Investment Company (SBIC) program. Inaccuracies occur, because OCFO does not obtain enough information to properly record the transactions and balances.

For example, in our loan confirmation sample of 244 loans, four pertained to SBIC loans. Of those four, two were related to the First Connecticut SBIC, which consisted of a total of 32 loans valued at $22.9 million. The SBIC, however, is bankrupt and has settled with SBA for $5 million; as such, the balance for loans receivable associated with this SBIC should be zero.

Additionally, SBA pursued legal action against the independent public accountant (IPA) that audited the SBIC for negligence in conjunction with the audit. SBA's Office of SBIC Litigation and Field Operations has entered into an agreement with the IPA requiring the IPA to pay SBA between $5 million and $16 million, depending upon the outcome of arbitration hearings. Thus, SBA must establish a receivable for $5 million. The Office of SBIC Liquidation has not directed OCFO to charge off the 32 loans, because it intends to apply the settlement amount from the IPA to the loan receivable balances.

OCFO was unaware that this SBIC was no longer in business, and that an agreement had been reached between SBA and the IPA responsible for the SBIC audit. Therefore, SBA did not correct the accounting for this SBIC.

The Chief Financial Officers Act of 1990 (Public Law 101-576) requires agency CFO's to be responsible for directing, managing, and providing policy guidance and oversight of all agency financial management personnel, activities, and operations.

We recommend that the OCFO in coordination with the Office of SBIC Liquidation:

1. Review outstanding SBIC balances to ensure that they are recorded properly and accurately.

2. Develop policies and procedures to notify OCFO of all financial management activities, thus ensuring that transactions and events are recorded accurately and in a timely manner.

4. Payment File Controls

Controls over payment files for certain types of disbursements do not adequately ensure that unauthorized payments are not made. OFO receives payment files from SBA's LAS showing payments scheduled for disbursement. OFO then reviews and modifies certain files as necessary and transfers them first to the UNIX computer, then to the LAN file server, and finally to a desktop computer for transmission to Treasury.

OFO also initiates certain types of payment files and transfers them to the desktop computer in the same manner. The payment files reside on the LAN file server for various lengths of time, leaving them vulnerable to unauthorized and undocumented modification. This condition is partially mitigated, because the payment recipient is usually aware that a payment is being sent. Certain types of disbursements, such as "W" and "C" schedule disbursements, are generally made without the knowledge of the intended recipient.

Federal government internal control standards require transactions and other significant events be authorized and executed only by persons acting within the scope of their authority. Because unauthorized and undocumented modifications can occur, SBA cannot assure that this internal control standard is being met.

We recommend that OCFO design and implement a program to transfer payment files automatically, without operator intervention, from the UNIX computer to the desktop computer used for transmission to Treasury. We also recommend that a report be printed that provides details of changes that include payee name, address, and amount. This report should include all changes made from the time the payment file is received from LAS to the time it is transmitted to Treasury. Further, this report should be reviewed and retained for future reference for at least one year.

5. Federal Credit Reform Act Subsidy Rate Reestimates

SBA's loan programs fall under the requirements of the Federal Credit Reform Act (FCRA) of 1990. Statement of Federal Financial Accounting Standard (SFFAS) No. 2, Accounting for Direct Loans and Loan Guarantees, and OMB Circular No. A-34, Instructions on Budget Execution, provide 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 must be adjusted for any significant differences attributable to the reestimates.

SBA has not calculated subsidy-rate reestimates for its SBIC program since FCRA became effective on October 1, 1991. Thus, SBA is not reporting in its principal financial statements the effects, if any, resulting from annual reestimates of its SBIC loan program.

OCFO financial managers stated that, in FY 1996, the current SBIC program had nominal activity and no defaults, and financial managers determined that reestimates were not significant. Therefore, SBA determined that the data had not changed enough to warrant a reestimate. However, as noted in finding number 3, SBA financial managers were not always aware of certain transactions and events effecting the SBIC program.

We recommend that SBA reestimate subsidy rates annually in accord with SFFAS No. 2 and OMB Circular A-34.

COMPLIANCE MATTERS

6. Managing Credit Programs

SBA has not implemented all of the provisions of OMB Circular A-129, Managing Federal Credit Programs, which prescribes policies and procedures and sets standards for managing credit programs. As of September 30, 1996, SBA did not require lenders to use certified real estate appraisers when valuing collateral estimated at more than $100,000. We reported this finding in both our FY 1994 and FY 1995 management letters.

Because lenders are not required to use certified real estate appraisers, collateral could be valued incorrectly, resulting in financial statement misstatement and loans being under collateralized.

We recommended that SBA implement all provisions of OMB Circular A-129. SBA agreed with this recommendation and originally planned to have a new SOP published by August 1996 requiring the use of certified real estate appraisers. SOP 50-10. Policies and Procedures for Financing Function, is, however, still "in clearance," although it is expected to be published before March 31, 1997.

7. Debt Collection

SBA field offices do not consistently follow requirements of OMB Circular A-129 and SOP 50-50, Loan Servicing, Chapter 16, Uniform Collection System for SBA Serviced Business Loans. We reported this finding in our FY 1995 management letter and are repeating it for FY 1996.

OMB Circular A-129 requires agencies to adopt fair and aggressive programs to recover delinquent debt. It recommends that agencies refer all delinquent debt to an outside collection agency, but does not require referral until a loan is 6 months past due.

SOP 50-50 requires SBA to maintain weekly contact with borrowers whose loans are more than 30 days past due. It further requires the agency to transfer loans delinquent for more than 90 days to a loan officer, who becomes responsible for implementing intensive loan collection procedures. SOP 50-50 does not require referral to an outside collection agency until a loan is charged-off.

We noted that servicing centers were complying with SOP 50-50 collection procedures. They are referring loans more than 60 days past due back to the field offices for collection. We noted, however, that not all field offices were complying with SOP 50-50 collection procedures when management determines that it is not cost effective to pursue collection of all loans.

In FY 1995, we recommended that SBA develop policies and procedures to implement the OMB Circular A-129 requirement cited above. SBA agreed that debt collection procedures needed revision and that SOP 50-51, Loan Liquidation and Acquired Property, would be more appropriate (than SOP 50-50). SOP 50-51 is currently in the "in clearance" phase and is expected to be officially released in March 1997.

8. SBA Ethics Program

The Ethics in Government Act requires Presidential Appointees, Senior Executive Service, and Schedule C Employees to file annual public disclosure reports. During our FY 1995 review, we found that not all individuals had filed these reports by the required deadline. This was also reported in the findings of an Office of Government Ethics (OGE) review during FY 1995.

In June 1995, the OGE issued a report on SBA's compliance with the Ethics in Government Act of 1978. This report contained 12 recommendations for improving the SBA

Ethics Program and included our finding on the lack of public disclosure. In September 1996, OGE conducted another review, and found that SBA had made some progress in relation to the Ethics in Government Act, although it had not implemented all of its recommendations. Implementation of these recommendations, which we consider reasonable under the circumstances, can significantly improve the SBA Ethics Program and avoid a potential embarrassment to SBA.

We recommend that SBA's Office of General Counsel place high priority on implementing all remaining OGE recommendations.

9. Federal Managers' Financial Integrity Act

SBA does not have effective procedures for identifying and reporting internal control weaknesses in compliance with the Federal Managers' Financial Integrity Act (FMFIA). We reported this finding in our FY 1995 management letter and are repeating it for FY 1996. During our FY 1996 audit, we found that SBA's FY 1996 FMFIA report does not include a material condition included in our FY 1995 audit report on reconciling fund balances with Treasury.

Additionally, SBA's FY 1995 annual report states that its Computerized Internal Control Review (CICR) was a "vital part of the agency's management control system providing effective review and documentation of procedural and process deficiencies." In February 1996, SBA suspended its CICR process, canceled the applicable SOP, and formed a task force to establish a "more meaningful review process."

FMFIA requires Federal agencies to perform a self-assessment of internal controls and report identified weaknesses and planned corrective actions in an annual report. OMB Circular A-123 requires agencies to continuously monitor and improve the effectiveness of management controls. This continuous monitoring, and other periodic evaluations, should provide the basis for the agency head's annual assessment of and report on management controls.

SBA canceled its prior program and has not replaced it or provided SBA managers with written procedures. Furthermore, SBA has not established sufficient controls to ensure that material weaknesses identified in audit reports are incorporated into the annual FMFIA report.

The FMFIA review process also provides management with a tool for effectively monitoring the progress of planned corrective actions. Used effectively, the FMFIA process can provide management with the timely information needed to identify a material weakness that may go otherwise undetected.

We recommend that SBA's OCFO establish an effective self-assessment program and provide written procedures to be followed by headquarters and field offices to conduct the assessment and report results.

ATTACHMENT 2

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