Exhibit I

U.S. Small Business Administration

Significant Deficiency

Introduction

The internal control deficiency discussed in this report and the U.S. Small Business Administration's (SBA) progress toward correcting it are discussed in the context of SBA's organizational structure and its ability to obtain funding to take corrective action. Exhibit I herein describes the control deficiencies, which collectively resulted in the significant deficiency reported below, for the year ended September 30, 2008, and our recommendations thereon. The status of prior year noncompliance and internal control deficiencies are reported in Exhibits II and III, respectively, and SBA management's response is presented in Exhibit IV.

(1) Improvement Needed in Information Technology (IT) Controls

During fiscal year 2008, we noted that SBA made progress in several areas in its efforts to address prior year IT internal control deficiencies. Despite these improvements, we also noted that deficiencies continued to exist in the areas of security access controls, software program changes, and end-user computing.

Security Access Controls

Integral to an organization's security program management efforts, technical security access controls for systems and applications should provide reasonable assurance that IT resources such as data files, application programs, and IT-related facilities/equipment are protected against unauthorized modification, disclosure, loss, or impairment.

A summary of the security access control deficiencies we identified during the fiscal year 2008 SBA financial statement audit follow:

- We noted several high-risk security vulnerabilities with many devices hosted by SBA's Disaster Credit Management System (DCMS) service provider. Details are not provided in this report due to their sensitivity, but have been provided to SBA management. The Office of the Chief Information Officer (OCIO), through its security certification and accreditation (C&A) evaluation for DCMS, identified similar security vulnerabilities that needed to be addressed prior to the system receiving a full security accreditation. Further, we reviewed the Service Level Agreement (SLA) between SBA and the DCMS service provider, as well as the service provider's Statement on Auditing Standards (SAS) 70, *Report on the Processing of Transactions by Service Organizations*, and neither encompassed security vulnerability scanning for key DCMS devices.

- Neither OCIO nor DCMS officials were able to ensure that security vulnerability scans were consistently performed for two DCMS devices physically located at SBA Headquarters. This issue was identified by the SBA Office of Inspector General (OIG) during the OIG's annual Federal Information Security Management Act (FISMA) evaluation.

- We noted security vulnerabilities with many devices hosted in the SBA Headquarters office. Details are not provided in this report due to their sensitivity, but have been provided to SBA management. Although we noted improvement in this area since fiscal year 2007, consistent and periodic completion of vulnerability scans could have helped SBA reduce the number of vulnerabilities.

- The OCIO does not appropriately control remote access authorizations. Specifically, remote access is not always requested and approved by the employees' supervisor, and can be requested by the employees

I-1

Exhibit I

U.S. Small Business Administration

Significant Deficiency

themselves. Further, e-mail approvals from supervisors are not retained for all remote access requests. As a result, controls over remote access authorization are more difficult to implement and validate.

- Validation of physical access to the data center at SBA's headquarters is not performed in accordance with SBA Standard Operating Procedure (SOP) 90-47.2, *Automated Information Systems Security Program*, which requires that a listing of authorized personnel for SBA computer facilities (e.g., server rooms) be maintained and access be revalidated at least quarterly.
- OCIO management is unable to provide reasonable assurance that electronic media is sufficiently sanitized prior to disposal, in accordance with SOP 90-47.2. The SOP requires that (1) media must be sanitized prior to disposal by using one of the three approved methods: overwriting, degaussing, or destruction, and (2) a log of who completed the sanitation action must be maintained.
- OCIO management was unable to provide reasonable assurance that access to the Loan Accounting System (LAS) and Local Area Network (LAN)/Wide Area Network (WAN) was periodically validated, in accordance with National Institute of Standards and Technology (NIST) guidance and SOP 90-47.2.

These issues are consistent with findings identified by the OIG in past years. In fact, the OIG has identified IT security as a serious SBA management challenge since at least fiscal year 2000.

Despite these issues, SBA has made significant improvements in recent years in the area of IT security, and there is commitment from the SBA to continue further improvements continue.

Recommendations – Security Access Controls:

We recommend that the SBA OCIO coordinate with SBA program offices to:

1. Ensure that SLAs with service providers require consistent and thorough security vulnerability scanning for devices supporting SBA.
2. Ensure that the scope of SAS 70 reports provided by service providers encompass security vulnerability scanning for devices supporting SBA.
3. Ensure the completion of more consistent vulnerability assessments to identify and resolve potential vulnerabilities, both within SBA offices and at service providers.

Exhibit I

U.S. Small Business Administration

Significant Deficiency

4. Implement procedures to control the process for requesting and granting remote access and implement procedures to retain the appropriate approval evidence for tracking and validation.

5. Implement controls to comply with SOP 90-47.2 regarding the validation of physical access to the data center.

6. Implement controls to comply with SOP 90-47.2 regarding the sanitizing of media prior to disposal.

7. Retain documentation supporting the validation of LAS and LAN/WAN system access in accordance with NIST guidance and SOP 90-47.2.

Software Program Changes

The primary focus of an organization's software change controls (which also encompasses patch management and configuration management efforts) is on controlling the software changes made to systems and applications in operation. Without such controls, there is a risk that security features could be inadvertently or deliberately omitted or turned off, or that processing irregularities or malicious code could be introduced into the IT environment.

A summary of the software program change control deficiencies we identified during the fiscal year 2008 SBA financial statement audit follow:

- The Office of Disaster Assistance (ODA) was unable to provide evidence that baseline configurations for the DCMS were updated in a timely manner. This issue was also identified in fiscal year 2007, and SBA was still in the process of implementing corrective actions during fiscal year 2008.

- The OCIO was unable to provide evidence that (1) testing was performed for four of eight selected LAS software changes, (2) approvals were made for two of eight selected LAS software changes, and (3) testing and approvals were documented for three selected Electronic Transaction System (E-TRAN) software changes.

- The OCIO was unable to provide evidence that changes to the LAN/WAN were appropriately tracked, approved, and implemented.

- Ineffective software program change controls in the Joint Administrative and Accounting Management System (JAAMS) directly led to duplicate payments in the amount of $11,205,608.

- The Office of the Chief Financial Officer (OCFO) was unable to provide evidence that the software change requests were consistently completed for JAAMS and the Financial Reporting Information System (FRIS).

- The OCIO was unable to provide evidence that baseline configurations for LAS were updated in a timely manner. Documented baseline configurations enable the process of tracking and controlling software changes, especially as system security settings are changed.

- The Office of the Chief Operating Officer (OCOO), in conjunction with SBA program offices, has not documented segregation of duty procedures for LAS. Consequently, we could not validate that incompatible software change duties were appropriately segregated. This issue was also identified in fiscal year 2007, and SBA was still in the process of implementing corrective actions during fiscal year 2008.

I-3

Exhibit I

U.S. Small Business Administration

Significant Deficiency

Recommendations – Software Program Changes:

We recommend the following:

8. ODA management ensures the consistent application of controls and procedures to document the DCMS baseline configuration.

9. OCIO management consistently apply procedures for documenting software change testing results, testing approvals, and final approvals. Specifically, such procedures and controls need to be consistently applied for LAS, E-TRAN, and LAN/WAN.

10. OCFO management consistently apply procedures for documenting software change testing results, testing approvals, and final approvals for JAAMS and FRIS.

11. OCIO management ensures the consistent application of controls and procedures to document the LAS baseline configuration.

12. OCOO, in conjunction with program offices, document and implement segregation of duty policies and procedures for LAS.

End-User Computing

End-user computing tools/programs (e.g., spreadsheets and other user-developed programs) present the need for a unique set of general control needs within an organization. By its nature, end-user computing brings the development and processing of information systems closer to the user. End-user computing capabilities typically include access to any end-user developed programs or objects, such as spreadsheets that contain critical data/information. Critical data/information could include Personally Identifiable Information (PII) and financial data. While this environment may not typically be subjected to the same level of rigor and structure as an IT general controls environment, policies and procedures in this area are important to the overall IT environment. We noted many SBA program offices, including the OCFO, Office of Capital Access, and Office of Human Capital Management, have not implemented end-user computing policies and procedures set forth and provided by the OCIO to identify, track, and protect end-user programs containing sensitive information.

Recommendations – End-User Computing:

13. We recommend that the OCIO reemphasize the importance to SBA program offices of controlling end-user programs containing sensitive data, such as PII and financial data, in accordance with OCIO policy.

Exhibit II

U.S. Small Business Administration

Status of Prior Year Noncompliance

Fiscal Year 2007 Noncompliance	Fiscal Year 2008 Status of Noncompliance
Debt Collection Improvement Act of 1996 (DCIA) During our audit for fiscal year 2007, we noted that SBA did not consistently follow Treasury guidelines when referring delinquent debts for collection in accordance with DCIA. Specifically, we noted that 47 of 140 delinquent debt referral transactions tested were not referred timely or were coded improperly in SBA's Loan Accounting System. These exceptions prompted SBA to examine if there were additional loans that were improperly referred to Treasury. As a result of this examination, management determined it did not refer approximately 24,000 delinquent debts for Treasury in accordance with DCIA. SBA management believes that the issue stems from outdated standard operating procedures and a lack of clear instructions to field offices regarding the referral of delinquent debt to Treasury. Towards the end of fiscal year 2007, SBA management established revised protocols that provide clear instructions to field offices to ensure compliance with DCIA.	The results of our tests of compliance with DCIA in fiscal year 2008 disclosed no instances in which SBA is in substantial noncompliance with DCIA.

II-1

Exhibit III

U.S. Small Business Administration

Status of Prior Year Significant Deficiency

Fiscal Year 2007 Findings	**Fiscal Year 2008 Status of Findings**
1. Improvement needed in management information technology security controls	During our review of SBA's information technology (IT) general and application controls, we noted improvements in formalizing policies and procedures over sanctioning contractors that don't complete annual computer security awareness training, increasing storage space for audit logs and retention of the logs themselves, implementing day-to-day data center employee responsibilities and end-user computing user-level access control policies, and finalizing Change Control Board Charter for enterprise-wide changes. However, we continued to identify opportunities for SBA to improve its internal controls. The control deficiencies that continue to exist are in the following areas: security access controls, software program changes, and end-user computing. Therefore, in fiscal year 2008, the presentation of the issue was modified to reflect current year operations, and we continue to report a significant deficiency in internal controls as it relates to IT systems and their impact on the consolidated financial statements. See Exhibit I for additional information.

III-1

Exhibit IV

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

CFO Response to Draft Audit Report on FY 2008 Financial Statements

DATE: November 14, 2008

TO: Debra Ritt, Assistant IG for Auditing

FROM: Jennifer Main, Chief Financial Officer

SUBJECT: Draft Audit Report on FY 2008 Financial Statements

The Small Business Administration is in receipt of the draft Independent Auditors' Report from KPMG that includes the auditor's opinion on the financial statements and review of the Agency's internal control over financial reporting and compliance with laws and regulations. The independent audit of the Agency's financial statements and related processes is a core component of SBA's financial management program.

We are delighted that the SBA has again received an unqualified audit opinion from the independent auditor with no reported material weaknesses. Additionally, the report found that SBA is in compliance with all applicable laws and regulations again this year. We believe these results accurately reflect the quality of the Agency's financial statements and our improved accounting, budgeting and reporting processes. As you know, the SBA has worked hard over the past several years to address the many findings from our independent auditors. Our core financial reporting data and processes have improved substantially and we are proud that the results of our efforts have been confirmed by the independent auditor.

The audit report, however, includes a continuing significant deficiency in the SBA's information technology controls. While we appreciate the recognition in the report of the substantial progress the SBA has made in this area, we are nonetheless disappointed that the significant improvements we have made were not sufficient for the auditor to eliminate this finding. During FY 2008, the SBA's Office of the Chief Information Officer instituted several processes to strengthen information security controls and took a multitude of corrective actions to address previous audit findings, closing 24 out of 41 previous findings. In addition, OCIO made significant progress on the SBA's Management Challenges reported by our Inspector General, scoring green on two key critical areas affecting service continuity controls and computer security training. We do, however, recognize that further improvements are needed in SBA's information

Federal Recycling Program Printed on Recycled Paper

Exhibit IV

technology controls, and the SBA is committed to taking all necessary action to eliminate this significant deficiency in future audit reports.

We appreciate all of your efforts and those of your colleagues in the Office of the Inspector General as well as those of KPMG. The independent audit process continues to provide us with new insights and valuable recommendations that will further enhance SBA's financial management practices. We continue to be committed to excellence in financial management and look forward to making more progress in the coming year.

Financial Statements and Notes

The U.S. Small Business Administration prepares its financial statements as a critical aspect of ensuring the accountability and stewardship for the public resources entrusted to the SBA. Preparation of these statements is also an important part of SBA's financial management goal of providing accurate and reliable information that may be used to assess performance and allocate resources.

SBA's management is responsible for the accuracy and propriety of the information contained in the principal financial statements and the quality of internal controls. The statements are, in addition to other financial reports, used to monitor and control budgetary resources. The SBA prepares these financial statements from its books and records in accordance with the accounting principles generally accepted in the United States for federal entities and the formats prescribed by the Office of Management and Budget.

The **Consolidated Balance Sheet** summarizes the assets, liabilities and net position by major category as of the reporting date. Intragovernmental assets and liabilities resulting from transactions between federal agencies are presented separately from assets and liabilities from transactions with the public.

The **Consolidated Statement of Net Cost** shows, by strategic goal, the net cost of operations for the reporting period. Net cost of operations consists of full program costs incurred by the SBA less the exchange revenues earned by those programs.

The **Consolidated Statement of Changes in Net Position** presents SBA's beginning and ending net position by two components - Cumulative Results of Operations and Unexpended Appropriations. It summarizes the change in net position by major transaction category. The ending balances of both components of net position are also reported on the Balance Sheet.

The **Combined Statement of Budgetary Resources** provides information about funding and availability of budgetary resources and the status of those resources at the end of the reporting period. Data on the Combined Statement of Budgetary Resources is consistent with information reflected on the Report on Budget Execution and Budgetary Resources (SF 133), with the one exception of offsetting receipts. Offsetting receipts offset budget authority and outlays at the agency level in the Budget of the United States Government, but are not reflected in the SF 133. The SBA included offsetting receipts in this statement for the purpose of reconciling outlay information presented to the Budget of the United States Government.

The **Required Supplementary Information** presents a Combining Statement of Budgetary Resources report by principal functional area.

The **Required Supplementary Stewardship Information** provides information on SBA's investment in human capital.

U. S. Small Business Administration

Consolidated Balance Sheet

as of September 30, 2008 and 2007

(Dollars in Thousands)

	2008	2007
ASSETS		
Intragovernmental Assets		
Fund Balance with Treasury (Note 2)	$ 3,880,755	$ 6,095,443
Total Intragovernmental Assets	3,880,755	6,095,443
Assets - Public and Other		
Cash (Note 3)	3,972	17,102
Accounts Receivable (Note 5)	34,528	43,478
Credit Program Receivables and Related Foreclosed Property, Net (Note 6)	8,522,941	8,337,462
General Property and Equipment, Net (Note 7)	4,417	1,504
Advances	1,602	
Total Assets - Public and Other	8,567,460	8,399,546
Total Assets	**$ 12,448,215**	**$ 14,494,989**
LIABILITIES		
Intragovernmental Liabilities		
Interest Payable	$ 3,430	$ 2,801
Debt (Note 9)	9,473,227	11,383,188
Net Assets of Liquidating Funds Due to Treasury (Note 10)	104,789	136,273
Downward Reestimate Payable to Treasury (Note 1, Note 13)	466,887	645,826
Other (Note 8, Note 11)	19,554	20,054
Total Intragovernmental Liabilities	10,067,887	12,188,142
Other Liabilities - Public		
Accounts Payable (Note 1)	69,184	30,249
Accrued Grant Liability (Note 1)	60,000	50,000
Liability for Loan Guaranties (Note 6)	1,825,551	1,737,860
Federal Employee Compensation Act Actuarial Liability (Note 1, Note 8)	27,061	26,321
Surety Bond Guarantee Program Future Claims (Note 8)	24,764	23,588
Other (Note 8, Note 11)	39,638	35,961
Total Other Liabilities - Public	2,046,198	1,903,979
Total Liabilities	**12,114,085**	**14,092,121**
NET POSITION		
Unexpended Appropriations (Note 1)	1,696,866	974,211
Cumulative Results of Operations (Note 1)	(1,362,736)	(571,343)
Total Net Position	**334,130**	**402,868**
Total Liabilities and Net Position	**$ 12,448,215**	**$ 14,494,989**

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration

Consolidated Statement of Net Cost

For the years ended September 30, 2008 and 2007

(Dollars in Thousands)

	2008	2007
STRATEGIC GOAL 1: Expand America's Ownership Society, Particularly in Underserved Markets		
Gross Cost	$ 995,731	$ 534,272
Less: Earned Revenue	149,322	192,055
Net Cost of Strategic Goal 1	**846,409**	**342,217**
STRATEGIC GOAL 2: Provide Timely Financial Assistance to Homeowners, Renters, Nonprofit Organizations and Businesses Affected by Disaster		
Gross Cost	1,053,030	1,152,592
Less: Earned Revenue	468,168	526,218
Net Cost of Strategic Goal 2	**584,862**	**626,374**
STRATEGIC GOAL 3: Improve Economic Environment for Small Business		
Gross Cost	14,114	24,694
Net Cost of Strategic Goal 3	**14,114**	**24,694**
COST NOT ASSIGNED TO STRATEGIC GOALS		
Gross Cost	119,931	67,305
Net Cost Not Assigned to Strategic Goals	**119,931**	**67,305**
Net Cost of Operations	**$ 1,565,316**	**$ 1,060,590**

Note 12, Note 14

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration

Consolidated Statement of Changes in Net Position

For the years ended September 30, 2008 and 2007

(Dollars in Thousands)

	2008	2007
Beginning Cumulative Results of Operations	**$ (571,343)**	**$ (773,787)**
Budgetary Financing Sources		
Appropriations Used	1,317,809	2,122,708
Donations of Cash and Cash Equivalents		12
Transfers-Out Without Reimbursement		(150,000)
Other Financing Sources		
Imputed Financing from Costs Absorbed by Others	24,014	21,091
Other - Adjustment Rescissions		(6,192)
Other - Current Year Liquidating Equity Activity	(4,502)	(9,543)
Other - Non-entity Activity	(563,398)	(715,042)
Total Financing Sources	**773,923**	**1,263,034**
Less: Net Cost of Operations	**1,565,316**	**1,060,590**
Ending Cumulative Results of Operations	**$ (1,362,736)**	**$ (571,343)**
Beginning Unexpended Appropriations	**$ 974,211**	**$ 1,839,288**
Budgetary Financing Sources		
Appropriations Received	2,060,201	1,314,748
Rescissions		(7,354)
Adjustment - Cancelled Authority	(8,446)	(21,236)
Other Adjustments	(11,291)	(28,527)
Appropriations Used	(1,317,809)	(2,122,708)
Total Budgetary Financing Sources	**722,655**	**(865,077)**
Ending Unexpended Appropriations	**$ 1,696,866**	**$ 974,211**
Ending Net Position	**$ 334,130**	**$ 402,868**

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration

Combined Statement of Budgetary Resources

For the years ended September 30, 2008 and 2007

(Dollars in Thousands)

	September 30, 2008		
	Budgetary	Nonbudgetary Financing	Total
BUDGETARY RESOURCES			
Unobligated Balance			
Brought Forward October 1	$ 622,764	$ 4,678,380	$ 5,301,144
Recoveries of Prior Year Obligations	101,875	476,638	578,513
Budget Authority			
Appropriations Received	2,060,201		2,060,201
Borrowing Authority		1,346,805	1,346,805
Spending Authority from Offsetting Collections			
Earned	399,344	3,558,120	3,957,464
Change in Unfilled Customer Orders	(103,640)	(98,469)	(202,109)
Total Budget Authority	2,355,905	4,806,456	7,162,361
Nonexpenditure Transfers, Net			
Budget Authority			
Permanently Not Available	(62,668)	(3,869,296)	(3,931,964)
Total Budgetary Resources	**$ 3,017,876**	**$ 6,092,178**	**$ 9,110,054**
STATUS OF BUDGETARY RESOURCES			
Obligations Incurred, Net			
Direct	$ 973,991	$ 4,545,113	$ 5,519,104
Reimbursable	614,131		614,131
Total Obligations Incurred, Net	1,588,122	4,545,113	6,133,235
Unobligated Balances, Available	210,390	1,152,426	1,362,816
Unobligated Balances, Not Available	1,219,364	394,639	1,614,003
Total Status of Budgetary Resources	**$ 3,017,876**	**$ 6,092,178**	**$ 9,110,054**
CHANGE IN OBLIGATED BALANCES			
Obligated Balance Brought Forward, Net October 1			
Unpaid Obligations Brought Forward	$ 501,180	$ 1,090,147	$ 1,591,327
Uncollected Customer Payments from Federal Sources Brought Forward		(177,332)	(177,332)
Total Obligated Balance Brought Forward, Net	501,180	912,815	1,413,995
Obligations Incurred	1,588,122	4,545,113	6,133,235
Gross Outlays	(1,565,797)	(4,597,457)	(6,163,254)
Recoveries of Prior Year Unpaid Obligations	(101,875)	(476,638)	(578,513)
Change in Uncollected Customer Payments from Federal Sources		98,469	98,469
Obligated Balance, Net, End of Period			
Unpaid Obligations	421,630	561,165	982,795
Uncollected Customer Payments from Federal Sources		(78,863)	(78,863)
Total Obligated Balance, Net, End of Period	**$ 421,630**	**$ 482,302**	**$ 903,932**
NET OUTLAYS			
Gross Outlays	$ 1,565,797	$ 4,597,457	$ 6,163,254
Offsetting Collections	(295,703)	(3,558,120)	(3,853,823)
Net Outlays Before Offsetting Receipts	1,270,094	1,039,337	2,309,431
Offsetting Receipts	(240)	(742,338)	(742,578)
Net Outlays	**$ 1,269,854**	**$ 296,999**	**$ 1,566,853**

Note 15

The accompanying notes are an integral part of these statements.

U. S. Small Business Administration

Combined Statement of Budgetary Resources

For the years ended September 30, 2008 and 2007

(Dollars in Thousands)

	September 30, 2007		
	Budgetary	Nonbudgetary Financing	Total
BUDGETARY RESOURCES			
Unobligated Balance			
Brought Forward October 1	$ 859,670	$ 6,811,358	$ 7,671,028
Recoveries of Prior Year Obligations	428,368	2,756,956	3,185,324
Budget Authority			
Appropriations Received	1,314,746		1,314,746
Borrowing Authority		2,966,102	2,966,102
Spending Authority from Offsetting Collections			
Earned	462,531	4,263,659	4,726,190
Change in Unfilled Customer Orders	123,320	(616,331)	(493,011)
Total Budget Authority	1,900,597	6,613,430	8,514,027
Nonexpenditure Transfers, Net			
Budget Authority	(150,000)		(150,000)
Permanently Not Available	(119,786)	(7,115,706)	(7,235,492)
Total Budgetary Resources	**$ 2,918,849**	**$ 9,066,038**	**$ 11,984,887**
STATUS OF BUDGETARY RESOURCES			
Obligations Incurred, Net			
Direct	$ 1,346,019	$ 4,387,658	$ 5,733,677
Reimbursable	950,066		950,066
Total Obligations Incurred, Net	2,296,085	4,387,658	6,683,743
Unobligated Balances, Available	545,328	1,585,198	2,130,526
Unobligated Balances, Not Available	77,436	3,093,182	3,170,618
Total Status of Budgetary Resources	**$ 2,918,849**	**$ 9,066,038**	**$ 11,984,887**
CHANGE IN OBLIGATED BALANCES			
Obligated Balance Brought Forward, Net October 1			
Unpaid Obligations Brought Forward	$ 1,168,079	$ 5,440,067	$ 6,608,146
Uncollected Customer Payments from Federal Sources Brought Forward		(793,663)	(793,663)
Total Obligated Balance Brought Forward, Net	1,168,079	4,646,404	5,814,483
Obligations Incurred	2,296,085	4,387,658	6,683,743
Gross Outlays	(2,534,616)	(5,980,622)	(8,515,238)
Recoveries of Prior Year Unpaid Obligations	(428,368)	(2,756,956)	(3,185,324)
Change in Uncollected Customer Payments from Federal Sources		616,331	616,331
Obligated Balance, Net, End of Period			
Unpaid Obligations	501,180	1,090,147	1,591,327
Uncollected Customer Payments from Federal Sources		(177,332)	(177,332)
Total Obligated Balance, Net, End of Period	**$ 501,180**	**$ 912,815**	**$ 1,413,995**
NET OUTLAYS			
Gross Outlays	$ 2,534,616	$ 5,980,622	$ 8,515,238
Offsetting Collections	(585,851)	(4,263,659)	(4,849,510)
Net Outlays Before Offsetting Receipts	1,948,765	1,716,963	3,665,728
Offsetting Receipts	(106)	(773,723)	(773,829)
Net Outlays	**$ 1,948,659**	**$ 943,240**	**$ 2,891,899**

Note 15

The accompanying notes are an integral part of these statements.

Note 1. Significant Accounting Policies

(Dollars in Thousands, except as noted)

Reporting Entity

The Small Business Act of 1953 created the Small Business Administration as an independent federal agency. SBA's mission is to maintain and strengthen the nation's economy by aiding, counseling, assisting and protecting the interests of small businesses and to help businesses and families recover from disasters. The SBA operates through the execution of a congressionally approved budget that funds its programs.

Basis of Accounting and Presentation

The SBA prepares financial statements to report its financial position and results of its operations as required by the Chief Financial Officers Act of 1990 and the Government Management Reform Act of 1994. The financial statements are prepared from the Agency's books and records in accordance with generally accepted accounting principles in the United States of America and the formats prescribed by the Office of Management and Budget. The statements are in addition to the other financial reports that are used to monitor and control budgetary resources. As a federal agency, the SBA cannot incur obligations without authority from the Congress and an apportionment by the OMB.

These financial statements reflect transactions recorded on both a proprietary accrual accounting basis and a budgetary obligation basis, in accordance with concepts and guidance provided by the OMB, the Federal Accounting Standards Advisory Board, and the U. S. Department of the Treasury. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting recognizes the legal obligation or restriction of funds in advance of the proprietary accruals and facilitates compliance with legal constraints and controls over the use of federal funds.

Use of Estimates

SBA's management makes assumptions and estimates to prepare the financial statements, based upon the facts that exist when the statements are prepared. Actual results may differ from those estimates and the differences may be significant. The most significant differences between actual results and SBA's estimates may occur in the valuation of credit program receivables under the Federal Credit Reform Act of 1990 guidelines. The SBA recognizes the sensitivity of credit reform modeling to slight changes in some model assumptions, including economic variables, and uses continual review of model factors, statistical modeling and annual reestimates to reflect the most accurate cost of the credit programs to the U. S. Government.

Budgets and Budgetary Accounting for Loan Programs

SBA's loan disbursements are financed by appropriations for long-term loan subsidy cost and borrowings from the U. S. Department of the Treasury for the remaining non-subsidized portion of the loans. The Congress may provide one year, multi-year or no year appropriations to cover the estimated long-term costs of the loan programs. The non-subsidized portion of each loan disbursement, financed initially under permanent indefinite authority to borrow funds from the Treasury, is repaid from collections of loan fees, repayments and default recoveries. The Congress limits the dollar amount of obligations that can be made for direct loans and loan guaranties in its annual appropriation bill.

A permanent indefinite appropriation is available to finance any reestimated increase of subsidy costs that occurs after the year in which a loan is disbursed. Reestimated reductions of subsidy costs are returned to the Treasury and are unavailable to the SBA. As required by the Federal Credit Reform Act of 1990 (FCRA), the SBA uses budgetary "program accounts" to account for appropriations in its credit programs and nonbudgetary "financing accounts" to account for credit program cash flow. Estimates and reestimates of credit program subsidy expenses are recorded in SBA's program accounts. Financing accounts are used to account for the Treasury borrowings and the collection of loan fees, repayments, default recoveries and disbursement of loans.

Accounts Payable

Accounts Payable are amounts due to public entities that will be liquidated during the next operating cycle. Included in the liability are payables to lender banks for the bank share of loan collections and to vendors for goods and services.

Accrued Grant Liability

Disbursements of grant funds are recognized as expenses at the time of disbursement. However, some grant recipients incur expenditures prior to initiating a request for disbursement based on the nature of the expenditures. The SBA accrues a liability for expenditures incurred by grantees prior to receiving grant funds for the expenditures. The amount to be accrued is determined through an analysis of historic grant expenditures. The Small Business Development Program and several other grant programs are subject to this treatment.

Contingencies

The SBA is a party in various administrative proceedings, legal actions, environmental suits and claims brought against the Agency. In the opinion of SBA's management and legal counsel, the ultimate resolution of these proceedings, actions, suits and claims will not materially affect the financial position or results of SBA's operations. The likelihood of loss to the SBA ranges from remote to a reasonably possible amount of $1.2 million. These activities will be monitored and recognized if a loss becomes probable.

Cumulative Results of Operations

Cumulative Results of Operations, presented on the Balance Sheet and on the Statement of Changes in Net Position, is the accumulated difference between expenditures and financing sources since the inception of the Agency. Unfunded expenses do not yet have a financing source and thus increase the loss the SBA reports as Cumulative Results of Operations. The largest category of unfunded expenses at the SBA is year-end reestimates which are funded in the following year. The majority of the Cumulative Results of Operations reported results from these unfunded reestimates.

Unexpended Appropriations

Unexpended Appropriations is the portion of SBA's appropriations received which are either undelivered or unobligated. Delivered orders result in expended appropriations and reduce the total reported as Unexpended Appropriations. Undelivered orders are the amount of orders of goods or services which have not been actually or constructively received.

Employee Benefits

Leave

A liability for employee annual leave is accrued as it is earned and reduced as leave is taken. Each year the balance of accrued annual leave is adjusted to reflect current pay rates as well as forfeited "use or lose" leave. Amounts are reported as unfunded to the extent current or prior year appropriations are not available to fund annual leave earned but not taken. Sick leave and other types of non-vested leave are expensed as taken.

Employee Health and Life Insurance Benefits

The SBA employees may choose to participate in the contributory Federal Employees Health Benefit and the Federal Employees Group Life Insurance Programs. The SBA matches a portion of the employee contributions to each program. Matching contributions are recognized as current operating expenses.

Employee Pension Benefits

The SBA employees participate in either the Civil Service Retirement System or the Federal Employees' Retirement System and Social Security. These systems provide benefits upon retirement and in the event of death, disability or other termination of employment and may also provide pre-retirement benefits. They may also include benefits to survivors and their dependents, and they may contain early retirement or other special features. SBA's contributions to both retirement plans, as well as to the government-wide Federal Insurance Contribution Act, administered by the Social Security Administration, are recognized on the Consolidated Statement of Net Cost as current operating expenses.

Federal employee benefits also include the Thrift Savings Plan. For FERS employees the SBA matches employee contributions to the plan, subject to limitations. The matching contributions are recognized as current operating expenses.

Imputed Financing Costs

The SBA recognizes the full cost of providing all employee and future retirement benefits, including life and health insurance, at the time employee services are rendered. Eligible retired SBA employees can continue to participate in health and life insurance plans. The cost is funded through Agency contributions, employee compensation to the extent withheld from employee and retiree pay, from matching of employee withholding for Thrift Savings Plan and FICA, and by the Office of Personnel Management which administers the retirement programs for the SBA employees.

The OPM calculates imputed costs as the actuarial present value of future benefits attributed to services rendered by covered employees and eligible retired SBA employees during the accounting period, net of the amounts contributed by employees, retirees, and the Agency. The SBA recognizes the imputed costs as current operating expense in the Statement of Net Cost and as a part of net cost funded by an imputed financing source included in determining SBA's net position.

Federal Employees Compensation Act

The Federal Employees Compensation Act provides income and medical cost protection to covered federal civilian employees injured on the job and to beneficiaries of employees whose deaths are attributable to job-related injury or disease. The FECA program is administered by the Department of Labor. Labor pays valid claims as they occur, which are billed to the SBA annually and funded and paid approximately 15 months later. Labor also calculates an estimated actuarial liability for future benefits based upon historical experience and other economic variables. Projected annual benefit payments are then discounted to present value using the forecasted interest rates for 10-year Treasury notes and bonds published by the OMB in its economic assumptions for the federal budget. The SBA recognizes a current unfunded cost for the actual claims paid and the change in the FECA actuarial liability each year.