FINANCIAL REPORTING

MESSAGE FROM THE CHIEF FINANCIAL OFFICER

I am pleased to submit the U.S. Small Business Administration's (SBA) Performance and Accountability Report for FY 2004. This report provides the SBA's program and financial results as required by the Reports Consolidation Act.

FY 2004 was a year of tremendous accomplishment for the SBA in the area of financial management. SBA's improved independent audit opinion reflects the progress we have made and the improved quality of our financial statements. By building on the progress made in FY 2003, the Office of the Chief Financial Officer (OCFO) was able to address virtually all of the issues identified in last year's audit and complete our financial statements within the accelerated schedule. We made substantial improvements in the internal controls surrounding our subsidy modeling re-estimate process, as well as the financial reporting process, both areas identified by the auditor in FY 2003 as material weaknesses. We are particularly proud of the progress we made given the shortened reporting cycle.

Last year, the SBA's independent auditor issued a "disclaimed" opinion on our FY 2003 financial statements. A primary factor in the disclaimed opinion was that SBA was late in completing its credit subsidy models and financial statements and did not leave sufficient time for the auditor to conduct its testing and reviews, particularly of the credit cost estimates and the related accounting transactions. During FY 2003, SBA had redeveloped or substantially modified its subsidy models for almost all of its loan programs including Disaster, the Secondary Market Guarantees, 7(a), 504 and SBIC Participating Securities. We also undertook a major analysis to resolve the impact of the asset sales program on the Agency's budget. The magnitude of these efforts left SBA unable to provide sufficiently timely and consistent information to the auditors.

Because of the work completed the previous year, during FY 2004, SBA was able to minimize the changes made to its loan subsidy models and focus on improving the internal control process around the development of the subsidy cost estimates. Completing the cost estimates within our established schedule allowed the OCFO to conduct its planned financial reporting quality assurance process and follow the established internal controls. Overall, this was the major change that resulted in the delivery of timely and consistent financial information to the auditors.

The FY 2003 audit report included 13 recommendations to address weaknesses in the Agency's credit reform controls. The recommendations ranged from improving documentation of the models, procedures and related data to establishing procedures to identify and explain unusual subsidy balances. To address these recommendations, SBA took the following actions:

- Established a Loan Team within the OCFO that includes staff working on loan programs in the budget, accounting and subsidy model development areas to enhance communication and consistency and to work as a team to resolve the audit findings and other identified problems;
- Created and followed a new, rigorous internal control process for developing the subsidy cost estimates and re-estimates that included improved documentation for all of the loan models;
- Developed several new analyses and reports to compare the net present value of the cash flows in the subsidy cost models with the assets and liabilities recorded in the Agency's accounting system;
- Adopted the "balances" approach to re-estimates to ensure consistency between the accounting system and subsidy models; and
- Completed a major effort to improve the quality of the data used in the SBIC loan subsidy models and made further improvements to the forecast assumptions for the SBIC Participating Securities subsidy model.

With regard to weaknesses in the Agency's financial management and reporting processes, the FY 2003 audit report included 16 recommendations covering a wide range of topics such as conducting a broad review of SBA's budgetary proformas and making specific accounting policy changes. Because of SBA's inability to meet many of its internal deadlines in FY 2003, a key recommendation was that SBA develop a comprehensive plan with firm milestones for meeting the accelerated financial statement schedule. SBA agreed that this was a key challenge and it became our top priority for FY 2004.

We started by adopting a conceptual change that was to see the financial statement and PAR production process not as a year-end activity, but instead, as an ongoing, year-round activity. Most of the information used in the year-end statements is not produced annually, but, at least, quarterly and frequently, monthly or even daily. This provided a tremendous opportunity for reviewing data and addressing problems and inconsistencies long before the year-end. We utilized this notion to realign responsibilities among various offices within the OCFO, to work more effectively with SBA's program offices, to enhance our reports, and to establish new procedures for reviewing existing reports to get more out of them. Highlights of the specific actions we took include:

- Expanded the quality assurance group in Denver to focus on getting the proper data in the financial system in the first place, so there would be less data quality clean-up work required during report production;
- Enlisted an independent accounting firm to work with an internal team to improve our journal voucher proformas, reconciliation reports and procedures;
- Developed and circulated new reports for the procurement office and all program offices to identify and if necessary, to liquidate outstanding obligations on an on going basis; and
- Developed a comprehensive plan with firm milestone dates to meet the FY 2004 accelerated financial reporting date of November 15th.

During FY 2004, SBA also undertook an upgrade of its administrative accounting system based on Oracle's Federal Financial software. Planning, development and testing were completed during the year and, at the start of FY 2005, SBA switched to Oracle 11i. This software upgrade provides additional administrative accounting functionality and should minimize the number of manual adjustments required in preparing our financial reports.

The SBA also continued to make important strides in budget and performance integration this year. Our ongoing efforts were reflected in an upgrade to "green" status in the President's Management Agenda, making us one of only five agencies with a green rating in budget and performance integration. We continued to use and improve upon our cost accounting model. The Agency is in the second year of using its five-year strategic plan, which was completed last year, so we are on our way to achieving consistency across our strategic plan and our budget and accounting formulation and execution reports. Our program and results cost estimates continue to improve and the SBA demonstrated its commitment to using this information in the budget allocation process again this year.

In summary, FY 2004 was a strong year in financial management at the SBA. While we recognize there are still many challenges, we believe the progress we have made will continue to bear fruit for us in the coming years. We will continue to use the principles of the President's Management Agenda as a guide for the SBA's initiatives to improve financial performance in the coming year. Thank you for your interest in our FY 2004 Performance and Accountability Report.

Thomas Dumaresq
Chief Financial Officer

CFO Reply

DATE: November 15, 2004

TO: Robert Seabrooks, Assistant IG for Auditing

FROM: Thomas Dumaresq, Chief Financial Officer

SUBJECT: FY 2004 Financial Statement Audit Report

The Small Business Administration (SBA) is in receipt of the draft Independent Public Accountant (IPA) reports from Cotton and Company, LLP, that include the auditor's opinion and separate reports on internal controls and compliance with laws and regulations. As you know, the IPA audit of the Agency's financial statements and related processes is a core component of SBA's financial management program.

Meeting the accelerated reporting date of November 15th was a major accomplishment for SBA, the IG and the IPA this year and we could not have done it without the coordinated effort made by all parties involved. SBA is proud of the work it did in establishing an aggressive but realistic set of milestones and working cooperatively with Cotton & Co. to ensure they received timely and accurate materials.

Overall we are pleased that the SBA has received an improved audit opinion from the independent auditor compared to the previous three years and believe it accurately reflects a substantial improvement in the quality of the Agency's financial statements. We see this as a particularly strong accomplishment given the shortened reporting cycle. Nevertheless, we are disappointed not to have reached a "clean" audit opinion since that was our objective. Although we were able to successfully resolve essentially all of the FY 2003 audit findings, the accelerated schedule presented new challenges that we were not able to overcome in the available time. However, given all that we have accomplished in the past several years and our experience meeting the accelerated reporting timeframe this year, we are confident that we can resolve the issues identified in the audit in the coming year.

The IPA's Report on Internal Control retains the two material weaknesses included in the FY 2003 report: the financial management and reporting controls and credit reform controls. While we are disappointed that all of the progress we feel we have made in these areas did not result in reducing these to reportable conditions, we understand that additional improvements need to be made and we are committed to maintaining the strong momentum we have established to improve the Agency's financial management processes and results. The IPA's Report on Internal Control recommends that SBA continue to refine and accelerate its reporting processes in light of the 45-day reporting schedule. We agree that we can make further progress in this area and we request that your office continue to work with the IPA to identify opportunities for further improving the audit process and resource availability to ensure SBA also receives adequate time to understand and respond to audit findings.

We appreciate all of your efforts and those of your colleagues in the Office of the Inspector General as well as those of Cotton & Co. While the audit process was again challenging this year, we believe our efforts and the assistance we received from you and Cotton & Co. resulted in substantial improvements in the quality of our financial statements. Overall, we feel our financial management capacity has improved considerably this year and we are proud of what we have accomplished. We continue to be committed to excellence in financial management and look forward to making more progress in the coming year.

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

AUDIT REPORT
Issue Date: November 15, 2004
Number: 5-05

To: Hector V. Barreto,
Administrator

Tom Dumaresq,
Chief Financial Officer

/S/original signed

From: Robert G. Seabrooks,
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2004 Financial Statements

.

Pursuant to the Chief Financial Officers Act of 1990, attached are the Independent Auditor's Report and accompanying reports on internal control and compliance with laws and regulations issued by Cotton & Company LLP. The auditor issued an unqualified opinion on the Fiscal Year (FY) 2004 combined statement of budgetary resources and the FY 2003 consolidated balance sheet (as restated); issued a qualified opinion on the FY 2004 consolidated balance sheet and statements of net costs, changes in net position, and financing. As agreed upon between the Office of the Chief Financial Officer and the Office of the Inspector General, the auditor did not apply all necessary auditing procedures in accordance with generally accepted auditing procedures to express an opinion on SBA's FY 2003 consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources, which previously received a disclaimed opinion from the auditors in FY 2003. A summary of FY 2004 audit results is outlined below.

Summary of FY 2004 Audit Results

Statement:	**FY 2004**	**FY 2003**
Balance Sheet	Qualified	Unqualified
Statement of Net Cost	Qualified	Disclaimed
Statement of Changes in Net Position	Qualified	Disclaimed
Statement of Budgetary Resources	Unqualified	Disclaimed
Statement of Financing	Qualified	Disclaimed

The auditor's qualification stemmed from their inability to satisfy themselves as to the reasonableness of (1) SBA's FY 2004 subsidy re-estimates pertaining to its Section 7(a), 504, Small Business Investment Company (SBIC) Participating Securities, and SBIC Debenture programs, (2) the value of Credit Program Receivables and Related Foreclosed Property, and (3) the value of Liabilities for Loan Guarantees for these four programs.

The Independent Auditor's Report on Internal Control discusses three matters considered reportable conditions: (1) Financial Management and Reporting Controls; (2) Credit Reform Controls; and (3) Agency-Wide Information System Controls. The auditors further considered combined matters described in the first two areas to be material weaknesses under the standards established by the American Institute of Certified Public Accountants and the Office of Management and Budget Bulletin No. 01-02. The auditor found other management and internal control issues that will be communicated in a separate management letter.

The Independent Auditor's Report on Compliance with Laws and Regulations disclosed that SBA was not in substantial compliance with the Federal Financial Management Improvement Act (FFMIA) because of the following: (1) SBA is not in substantial compliance with federal financial system requirements; (2) SBA financial system is not in substantial compliance with federal accounting standards; and (3) SBA is not in substantial compliance with the United States Standard General Ledger at the transaction level. As discussed in more detail in the Independent Auditor's Report on Internal Control, the auditor also noted instances of noncompliance with the Anti-Deficiency Act and the Federal Credit Reform Act.

SBA management generally agreed with the auditors' findings and recommendations and noted that meeting the accelerated reporting date of November 15th was a major accomplishment for SBA, the Inspector General and the Independent Public Accountant this year and could not have done it without the coordinated effort made by all parties involved. SBA is proud of the work it did in establishing an aggressive but realistic set of milestones and working cooperatively with Cotton & Company to ensure they received timely and accurate materials. SBA management is also pleased that the SBA has received an improved audit opinion from the independent auditor compared to the previous three years and believe it accurately reflects a substantial improvement in the quality of the Agency's financial statements. SBA management saw the audit results as a particularly strong accomplishment given the shortened reporting cycle.

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 follow-up and resolution. Please provide us your proposed management decisions within 30 days on the attached SBA Form 1824, Recommendation Action Sheet.

Should you or your staff have any questions, please contact Jeff Brindle, Director, Information Technology and Financial Management Group at (202) 205-7490.

Attachments

COTTON & COMPANY LLP
auditors ◆ advisors
333 NORTH FAIRFAX STREET ◆ SUITE 401 ◆ ALEXANDRIA, VIRGINIA 22314 ◆ 703/836/6701 ◆ FAX 703/836/0941 ◆ WWW.COTTONCPA.COM

INDEPENDENT AUDITOR'S REPORT

Inspector General
U.S. Small Business Administration

We audited the accompanying consolidated balance sheets of the U.S. Small Business Administration (SBA) as of September 30, 2004, and 2003 (restated); related consolidated statements of net cost, changes in net position, and financing; and combined statements of budgetary resources for the fiscal years then ended. These financial statements are the responsibility of SBA management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following four paragraphs, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in 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 audits provide a reasonable basis for our opinion.

The scope of our examination for the Fiscal Year (FY) 2003 financial statements was limited, because SBA was late in completing development and testing of certain credit program subsidy models, completing its credit program subsidy re-estimates, and preparing its financial statements. As a result, adequate time did not remain to obtain sufficient, competent evidential matter, apply auditing procedures necessary to conduct an audit in accordance with generally accepted auditing standards and generally accepted government auditing standards, and form a reasonable basis for an opinion on the financial statements by the January 30, 2004, reporting deadline specified by the Office of Management and Budget (OMB) Memorandum titled Fiscal Year (FY) 2003 Financial and Performance Reporting (August 13, 2003.)

SBA restated its FY 2003 financial statements during FY 2004. The scope of our examination of the September 30, 2003, restated balance sheet included applying auditing procedures sufficient to enable us to express an opinion thereon. The scope of our examination did not include additional auditing procedures sufficient to enable us to express an opinion on the restated consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources for the year ended September 30, 2003.

Because we did not apply all necessary auditing procedures to conduct an audit in accordance with generally accepted auditing standards or dispose of all reservations identified during our work conducted as part of the FY 2003 audit, we are not able to express, and we do not express, an opinion on SBA's FY 2003 restated consolidated statements of net cost, changes in net position, and financing and combined statement of budgetary resources.

We were not able to satisfy ourselves as to the reasonableness of SBA's FY 2004 subsidy re-estimates pertaining to its Section 7(a), 504, Small Business Investment Company (SBIC) Participating Securities, and SBIC Debenture programs or to the value of SBA's Credit Program Receivables and Related Foreclosed Property, Net and Liabilities for Loan Guarantees for these four programs. SBA forecasted its cash flow activity, including purchases for defaulted loans, recoveries on defaults, interest transactions on estimated cash balances, and other collection and disbursement activities for the second half of FY 2004. SBA consistently overestimated purchase activity, which in turn affected projections of other cash flow components. We were not able to determine the impact of this material over-estimate of purchase activities on the re-estimates of subsidy costs. In addition, the material over-estimate of purchase activities directly affects SBA's valuation of its Credit Program Receivables and Related Foreclosed Property and Liabilities for Loan Guarantees, because SBA makes adjustments between these two financial statement line items based on estimates of activity for the second half of FY 2004.

In our opinion, the consolidated balance sheet as of September 30, 2003, and the combined statement of budgetary resources for the period ended September 30, 2004, present fairly, in all material respects, the financial position of SBA as of September 30, 2003, and its budgetary resources for the period ended September 30, 2004. Except for the effects of such adjustments, if any, that might have been determined to be necessary had we been able to examine additional evidence related to the re-estimates and financial statement line items explained in the previous paragraph, the consolidated balance sheet as of September 30, 2004, and statements of net cost, changes in net position, and financing for the period ended September 30, 2004, present fairly in all material respects, the financial position of SBA as of September 30, 2004, and the results of operations, changes in net position, and reconciliation of net costs to budgetary obligations for the period ended September 30, 2004.

SBA presented its net costs of operations in FY 2004, consistent with its strategic goals. As discussed in Note 1.S and Note 15, to the financial statements, SBA restructured its strategic goals during FY 2004 and presented its FY 2003 net costs of operations in summary without costs matching current-year goals.

During the conduct of our FY 2003 audit (OIG Report No. 4-10, *Audit of SBA's Fiscal Year 2003 Financial Statements*, January 28, 2004) Cotton & Company identified certain matters causing us reservations regarding whether particular FY 2003 financial statement amounts and disclosures were presented fairly in accordance with prevailing federal accounting standards. We were not able to apply all auditing procedures that may have allowed us to resolve our reservations before the due date for audited financial statements. As noted above, during the conduct of our FY 2004 audit, we did not apply audit procedures to enable us to express an opinion on the restated FY 2003 consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources. Accordingly, we were not able to resolve the reservation related to the gain or loss on asset sales, and we identified one new matter causing us reservations regarding the consolidated statement of net cost for the period ended September 30, 2003.

Restated Gain or Loss on Asset Sales

SBA conducted an analysis to calculate revised gain/loss on loans sold during FYs 1999 through 2003. SBA computed a revised net book value using various assumptions depending on the program and available data. The revised net book value was subtracted from the loan sale proceeds to calculate a revised gain/loss. We have concerns with the data used in this analysis for the Section 7(a) and 504 guaranteed business loan programs and communicated them to management. SBA did not respond to our concerns in time for us to complete our review of the revised gain/loss calculation. SBA disclosed a $163 million and $126 million changes between previously reported losses and revised gains in its Section 7(a) and 504 credit programs, respectively. We did not apply additional auditing procedures during the FY 2004 to resolve this reservation.

Consolidated Statement of Net Cost

As described in Notes 1.S and 15, to the financial statements, SBA reported its net costs of operations consistent with the agency's strategic goals. SBA restructured its strategic goals during FY 2004 and added a new goal, the costs of which are allocable to all other strategic goals. As the result of this restructuring, SBA presented its FY 2003 net costs of operations in total, rather than by strategic goal. As a result, the consolidated statements of net costs for FYs 2003 and 2004 are not comparable. OMB Bulletin 01-09, *Form and Content of Agency Financial Statements*, states that the financial statements and related footnotes should present balances and amounts for current and prior years for comparative purposes. In addition, its states that the statement of net cost should present responsibility segments that align directly with the major goals and outputs described in an entity's strategic and performance plan, required by the Government Performance and Results Act (GPRA).

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. Information presented in SBA's Performance and Accountability Report (PAR), including management's discussion and analysis, required supplementary stewardship information, required supplementary information, and other accompanying information are not required parts of the basic financial statements, but are additional information required by the Federal Accounting Standards Advisory Board and OMB Bulletin No. 01-09. We applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it. Our limited procedures raised doubts, however, that we were unable to resolve regarding whether material modification should be made to the information for it to conform to OMB Bulletin No. 01-09.

In accordance with *Government Auditing Standards*, we have also issued reports dated November 15, 2004, on our consideration of SBA's internal control and on its compliance with laws and regulations. Those reports, which disclose material weaknesses and reportable conditions in internal control and non-compliance with certain laws and regulations and the Federal Financial Management Improvement Act, are integral parts of a report prepared in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our work.

COTTON & COMPANY LLP

Chris Hayward

Charles Hayward, CPA

November 15, 2004
Alexandria, Virginia

COTTON & COMPANY LLP
auditors ♦ advisors
333 North Fairfax Street ♦ Suite 401 ♦ Alexandria, Virginia 22314 ♦ 703/836/6701 ♦ fax 703/836/0941 ♦ www.cottoncpa.com

Independent Auditor's Report on Internal Control

Inspector General
U.S. Small Business Administration

We audited the consolidated balance sheets of the U.S. Small Business Administration (SBA) as of September 30, 2004, and 2003 (restated); related consolidated statements of net cost, changes in net position, and financing; and combined statements of budgetary resources for the fiscal years then ended and have issued our report thereon, dated November 15, 2004. In that report, we issued an unqualified opinion on the Fiscal Year (FY) 2004 combined statement of budgetary resources and the FY 2003 consolidated balance sheet (as restated); issued a qualified opinion on the FY 2004 consolidated balance sheet and statements of net costs, changes in net position, and financing; and disclaimed an opinion on the FY 2003 consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources.

Except as described in our November 15, 2004, Independent Auditor's Report referred to above, we conducted our audits in accordance with auditing standards generally accepted in the United States; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statement*.

In planning and performing our work, we considered SBA's internal controls over financial reporting by obtaining an understanding of SBA's internal controls, determining if internal controls had been placed in operation, assessing control risk, and performing tests of controls. We limited internal control testing to those controls necessary to achieve objectives described in OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our work was not to provide assurance on internal controls. Consequently, we do not provide an opinion on internal controls.

Our consideration of internal controls over financial reporting would not necessarily disclose all matters in internal controls over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants (AICPA) and OMB Bulletin No. 01-02, 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 SBA'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 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. Because of inherent limitations in internal control, misstatements, losses, or noncompliance may nevertheless occur and not be detected.

We noted matters involving internal controls and its operation in the following three areas that we consider to be reportable conditions:

1. Financial Management and Reporting Controls
2. Credit Reform Controls
3. Agency-Wide Information System Controls

We consider combined matters described in the first two areas to be material weaknesses under standards established by AICPA and OMB Bulletin No. 01-02, as discussed below.

1. FINANCIAL MANAGEMENT AND REPORTING CONTROLS

SBA's internal control and quality assurance procedures over financial management and reporting continue to need improvement in the following areas:

- Financial Statement Preparation and Quality Assurance
- Financial Accounting Transactions and Review of Account Balances
- Funds Control Management
- Anti-Deficiency Act Compliance
- Intra-Governmental Transactions

SBA made substantial improvements during FY 2004 and was able to provide its FY 2004 interim and final draft financial statements and footnotes, supporting trial balances, and key audit evidence in accordance with agreed-upon milestone dates. SBA's quality control procedures, however, continue to need improvement to ensure that financial reports and audit evidence are accurate, reliable, and provided in a timely manner. The FY 2004 audit plan contained key milestone dates that were negotiated based on what SBA could realistically accomplish during its first year operating under an accelerated audit schedule. Some of these key milestone dates should ideally be accelerated further to ensure adequate time to complete the audit in accordance with generally accepted auditing standards, resolve audit issues, and prepare the Performance and Accountability Report. To accomplish this, SBA must continue to refine its resource management controls and critical-path approach for completing reconciliations; calculating and reviewing accruals, re-estimates, and other manual adjustments; closing the general ledger; preparing complete and accurate financial statements and footnotes; and performing appropriate analytical procedures and evaluation of account balances.

We discuss SBA's control weaknesses and areas needing improvement on the following pages under their respective captions.

FINANCIAL STATEMENT PREPARATION AND QUALITY ASSURANCE

SBA maintained insufficient and sometimes ineffective quality control over its interim and final draft financial statements, related footnote disclosures, and other sections of the Performance and Accountability Report, including the Management Discussion and Analysis (MD&A) and the Performance Report sections. The reports contained numerous, pervasive, and obvious errors, including inconsistencies among the principal financial statements, footnote disclosures, and MD&A and Performance Report sections. This resulted in a significant number of auditor comments on each version of the draft financial statement packages. For example:

- Footnotes contained many factual inaccuracies and grammatical errors.

- Footnote schedules did not sum properly, digits were omitted from amounts presented in the schedules, and footnote amounts did not tie to the applicable financial statement line item or other related footnotes.

- SBA omitted essential disclosures in its footnotes, such as discussion about its use of significant estimates in the financial statements, the agreed-upon accounting treatment for additional interest on subsidy re-estimates resulting from changes in discount rates for interest income and expense transactions with Treasury, and the time period for which actual data were used for developing the FY 2004 re-estimates and its methodology for annualizing such data.

- SBA mischaracterized a reduction in new borrowing authority as a repayment of borrowings. As a result, Footnote No. 11, Debt, showed borrowings in excess of borrowing authority. This was not identified during SBA's quality review process.

- Footnote No. 6, Credit Program Receivables and Related Foreclosed Property and Liability for Loan Guarantees, showed an increase in guaranteed loans outstanding in FY 2004 that exceeded new guaranteed loans disbursed resulting from a $10 billion misstatement of FY 2003 guaranteed loans outstanding. SBA did not identify this illogical condition during its internal control review process.

- Footnote No. 4, Master Reserve Fund, contained an incorrect amount carried forward from financial statements published for FY 2003 that was related to the FY 2002 restatement of subsidy re-estimates.

- SBA's August 2004 statement of budgetary resources did not tie to the trial balance, because one line item contained a "hard coded" number from June that was not deleted when preparing the August statement.

- Expected relationships among the financial statements and between the financial statements and footnotes were incorrect.

- The draft MD&A and Performance Measures sections were missing information in some key areas. In addition, some of the data and text presented either were not supported by the underlying documentation or were inconsistent with our audit results. We noted that management did not ensure that the final MD&A was materially consistent with the final principal financial statements and audit results. For instance, management did not update the Analysis of Financial Results section of the MD&A so that it agreed with the final financial statements.

OMB Circular A-127, *Financial Management Systems,* states:

> *The agency financial management system shall be able to provide financial information in a timely and useful fashion to…comply with internal and external reporting requirements, including, as necessary, the requirements for financial statements prepared in accordance with the form and content prescribed by OMB and reporting requirements prescribed by Treasury.*

Also, Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, states:

> *Financial reporting is the means of communicating with those who use financial information. For this communication to be effective, information in financial reports must have these basic characteristics:*

understandability, reliability, relevance, timeliness, consistency, and comparability.

SBA corrected the majority of the errors and inconsistencies identified with the draft financial statements submitted throughout the audit period.

In addition, SBA did not prepare its consolidated statement of financing in accordance with the most recent guidance available to facilitate the implementation of Statement of Federal Financial Accounting Standards (SFFAS) No. 7, *Accounting for Revenue and Other Financing Sources*. Specifically, SBA included its interest transactions with the public and Treasury in the section titled Resources Used to Finance Items Not Part of the Net Cost of Operations, although interest transactions were reported on the net cost of operations. In addition, SBA did not include its amortization of the allowance for subsidy in the section titled Components Not Requiring or Generating Resources.

According to SFFAS No. 7, the purpose of the statement of financing is to explain the relationship between a reporting entity's budgetary resources and its net cost of operations. Through reconciliation, the statement provides information necessary for understanding how budgetary resources finance the net cost of operations and affect assets and liabilities of the reporting entity. The SFFAS No. 7 Implementation Guide (April 2002) explains concepts and standards to aid in understanding and implementing SFFAS No. 7.

Recommendation:

1.A We recommend that the CFO continue to develop new quality assurance review procedures and enhance existing procedures to ensure that all financial transactions are properly reflected in the financial statements, and that footnote disclosures are accurate and logical and contain comprehensive information essential to the fair presentation of SBA's financial condition. We recommend the following:

- Performing additional analytical procedures monthly or quarterly.
- Developing and completing additional checklists.
- Performing studies of best practices.
- Having an independent review conducted by individuals not associated with SBA's daily financial management and reporting responsibilities, such as an outside peer reviewer.

FINANCIAL ACCOUNTING TRANSACTIONS AND REVIEW OF ACCOUNT BALANCES

SBA's quality assurance process did not detect all instances in which its accounting practices were not United States Standard General Ledger (SGL) compliant or for which accounting transactions were not recorded, processed, summarized, and reported in compliance with OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, and federal accounting standards. We noted the following matters.

Improper Accounting Treatment for Appropriation Transfer

SBA incorrectly treated an appropriation transfer from the Department of Homeland Security for Disaster Loan Program administrative expenses, as reimbursable activity rather than appropriated funds. This transfer was received in September 2004 to provide emergency funding for disasters occurring in Florida. SBA treated the appropriation transfer as reimbursable activity to accommodate immediate obligation and disbursement needs associated with emergency funding.

Within its accounting system, SBA had already established separate account symbols for its salary and expense fund to distinguish transactions incurred under reimbursable activities from direct activities. SBA's Disaster Loan Program administrative appropriations are typically received in the loan program funds and advanced to the salary and expense fund reimbursable account where the expenditures are obligated and paid. The apportionment to advance money from the program funds and receive the spending authority from offsetting collections in the salary and expense fund is included on the Standard Form (SF) 132, Apportionment and Reapportionment Schedule, and approved by OMB. Because the Disaster Loan Program account classification information was already set up in the reimbursable account, SBA also treated the appropriation transfer received in its salary and expense fund as reimbursable activity, similar to its other Disaster Loan Program administrative appropriations.

This treatment was not appropriate, because both the salary and expense direct and reimbursable funds are apportioned as one fund. Therefore, the transfer received in the salary and expense fund was not apportioned as spending authority from offsetting collections, and it was not apportioned to be advanced to the salary and expense reimbursable account.

By adopting such treatment, SBA created the erroneous intra-fund transactions identified below:

Financial Statement	Financial Statement Line Item	General Ledger Account	Misstatement
Statement of Budgetary Resources and Statement of Financing	Obligations Incurred and Outlays-Collections	480201, Unexpended Obligations - Prepaid/Advanced	$22,579,915 Overstated
		490201, Delivered Orders - Obligations, Paid	$7,420,085 Overstated
	Spending Authority from Offsetting Collections-Unfilled Customer Orders and Outlays-Disbursements	422201, Unfilled Customer Orders With Advance	$22,579,915 Overstated
		425201, Reimbursements and other Income Earned - Collected	$7,420,085 Overstated
Balance Sheet	Advances	141001, Advances to Others	$22,579,915 Overstated
	Other Liabilities	231001, Advances from Others	$22,579,915 Overstated
Statement of Net Cost	Intragovernmental Earned Revenues	520001, Revenue from Services Provided	$7,420,085 Overstated
	Gross Costs with Public	610001, Operating Expenses	$7,420,085 Overstated

SBA made correcting entries after we brought this matter to its attention.

Statement of Federal Financial Accounting Standard No. 7 states that unexpended appropriations should be adjusted for other changes in budgetary resources, such as rescissions and transfers.

Improper Assignment of Disaster Administrative Expense to Strategic Goals

SBA allocated indirect salary and expense costs to its strategic goals for purposes of reporting net costs of operations consistent with its goals. It used a cost study to calculate percentages assigned to each goal. It assigned 100 percent of Disaster Loan Program administrative expenses received in the program fund to Goal C, Restore Home and Businesses Affected by Disaster. As noted previously, in September 2004, SBA received an appropriation transfer in its salary and expense fund from the Department of Homeland Security to cover Disaster Loan Program administrative expenses. Because the transfer appropriation was received in the salary and expense fund, it was allocated to each of SBA's strategic goals rather than being assigned 100 percent to Goal C. This resulted in understating costs assigned to Strategic Goal C by about $5.7 million and overstating other strategic goals by the same amount.

SBA was aware of this condition but did not have a process in place to correct the misstatement of net cost of operations at the strategic-goal level.

SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards for the Federal Government*, states that in principle, costs should be assigned to outputs by directly tracing costs, assigning costs on a cause and effect basis or allocating costs on a reasonable and consistent basis. Direct tracing applies to specific resources that are dedicated to particular outputs.

Subsidy Realignment Entry

SBA recorded an offline journal entry to properly align the present value of future cash flows between the Liabilities for Loan Guarantees and Credit Program Receivables and Related Foreclosed Property, Net, balance sheet line items. During FY 2004, SBA developed a revised methodology for determining the amount of the alignment entry. The methodology identifies the estimated present value of future cash flows for loans with a guarantee still in force from the subsidy re-estimate models. The balance in General Ledger Account 2180, Liability for Loan Guarantee, is then "aligned" with this estimate. We noted two exceptions with SBA's alignment entry.

SBA did not segregate the present value of future cash flows for its Small Business Investment Company (SBIC) Participating Securities Program between those related to guarantees still in force and those related to SBICs that have already defaulted. SBA aligned General Ledger Account 2180 to the unsegregated present value of future cash flows from the subsidy re-estimate model, causing it to be understated and General Ledger Account 1399 to be overstated. As a result of our audit inquiries, SBA determined that an audit adjustment was necessary and posted an adjusting entry to correct the following misstatements:

Fiscal Year 2004 Financial Statements			
Financial Statement	**Financial Statement Line Item**	**General Ledger Account**	**Misstatement**
Balance Sheet	Credit Program Receivables and Related Foreclosed Property, Net	1399, Allowance for Subsidy	$343,287,839 Overstated
	Liability for Loan Guarantees	2180, Loan Guarantee Liability	$343,287,839 Understated
Fiscal Year 2003 Financial Statements			
Balance Sheet	Credit Program Receivables and Related Foreclosed Property, Net	1399, Allowance for Subsidy	$222,136,726 Overstated
	Liability for Loan Guarantees	2180, Loan Guarantee Liability	$222,136,726 Understated

Second, SBA recorded the FY 2003 alignment entry and validated that the resulting General Ledger Account 2180 balance agreed to the estimated present value of future cash flows for guarantees in force per the subsidy re-estimate models. Subsequent to this, SBA posted another transaction that affected the General Ledger Account 2180 balance. As a result, the account balance no longer agreed to the target amount per the re-estimate models. SBA did not identify this condition during its quality assurance review process of the September 30, 2004, draft financials statements. Upon audit inquiry, SBA determined why the balance did not align and made an audit adjustment to correct the following misstatements:

Fiscal Year 2003 Financial Statements			
Financial Statement	**Financial Statement Line Item**	**General Ledger Account**	**Misstatement**
Balance Sheet	Credit Program Receivables and Related Foreclosed Property, Net	1399, Allowance for Subsidy	$33,063,756 Understated
	Liability for Loan Guarantees	2180, Loan Guarantee Liability	$33,063,756 Overstated

Secondary Market Guarantee Re-estimate Accounting Entry

SBA's Secondary Market Guarantee re-estimate was improperly recorded in the general ledger, resulting in misstatements in the following general ledger account balances:

Financial Statement	Financial Statement Line Item	General Ledger Account	Misstatement
Balance Sheet	Accounts Payable	2005U, Payable Subsidy to Financing Fund (Unfunded)	$6,736,325 Overstated
	Accounts Receivable	1101U, Receivable Subsidy from Program Fund (Unfunded)	$6,736,325 Overstated
	Liabilities for Loan Guarantees	2180, Loan Guarantee Liability	$6,736,325 Overstated
Statement of Net Cost	Gross Costs with Public	5013U, Interest Expense on Subsidy Reestimate	$2,143,411 Overstated
		5105U, Subsidy Expense (Unfunded)	$4,592,914 Overstated
		5119U, Interest Expense (Unfunded)	$2,143,411 Overstated
	Earned revenue from Public	4034, Interest Income Subsidy Reestimate	$2,143,411 Overstated

SBA's quality assurance review procedures were inadequate and did not detect these errors either before or after the re-estimate transactions were posted in the accounting system. SBA corrected the errors after we brought them to its attention.

Net Position Balances

SBA did not have a process in place to routinely validate the propriety of its net position balances. We identified several funds that had potentially invalid cumulative results of operations and unexpended appropriations balances and asked SBA to review them to determine validity.

SBA determined that the balances were misstated. The misstatements were most likely attributable to use of improperly recorded prior-year appropriations. SBA posted the following correcting entries:

Financial Statement	Financial Statement Line Item	General Ledger Account	Fund	Misstatement
Balance Sheet and Statement of Changes in Net Position	Unexpended Appropriations	3100, Unexpended Appropriations	X4156	$273,500,000 Overstated
			X0100DA	$5,355,698 Understated
			30100DA	$477,663 Understated
			X0200DA	$523,317 Overstated
			10100DA	$509,444 Understated
			20100DA	$842,581 Understated
			900100DA	$1,301,103 Overstated
	Cumulative Results of Operations	3310, Cumulative Results of Operations	X4156	$273,500,000 Understated
			X0100DA	$5,355,698 Overstated
			30100DA	$477,663 Overstated
			X0200DA	$523,317 Understated
			10100DA	$509,444 Overstated
			20100DA	$842,581 Overstated
			900100DA	$1,301,103 Understated

Disaster Loan Program Interest Transactions with Treasury

SBA developed a component of its Disaster Loan Program interest on subsidy re-estimates to correct for shortfalls in Disaster Program financing fund balances resulting from:

- Inconsistencies among various credit reform tools and schemes for calculating and applying cohort weighted average and single effective interest rates. In accordance with OMB guidance, SBA calculated interest transactions with Treasury using budget assumptions for the Disaster Loan Program 2002 cohort until it was 90-percent disbursed; SBA's adjustment corrected for differences between those assumptions and actual discount rates that became known once the cohort was 90-percent disbursed.

- Misallocation of borrowings between Disaster Loan Program and World Trade Center/Pentagon (WTCP) Program and commingling Disaster Loan Program and WTCP Program net cash balances in its calculation of interest transactions with Treasury prior to FY 2004. This resulted in the improper use of program and cohort discount rates for calculating interest transactions with Treasury.

SBA overlooked the additional interest on subsidy re-estimates when posting its FY 2004 and restated FY 2003 re-estimates for inclusion in its August 2004 draft financial statements. In addition, when the entry was posted, it was posted as a FY 2004 transaction; the portion related to SBA's failure to separately calculate interest transactions for the WTCP Program should have been recorded as a FY 2003 restatement, because the errors related to FY 2003 and prior accounting periods. SBA did not separately calculate the effects of the two conditions noted above. The correcting entry affected the following financial statement line items:

Financial Statement	Financial Statement Line Item	General Ledger Account	Misstatement
Balance Sheet	Accounts Receivable	1101U, Receivable Subsidy from Program Fund (Unfunded)	$25,626,197 Understated
	Credit Program Receivables and Related Foreclosed Property	1399, Allowance for Subsidy	$3,565,585 Understated
	Accounts Payable	2005U, Payable Subsidy to Financing Fund (Unfunded)	$25,626,197 Understated
	Other Liabilities	2012U, Payable to Special Receipt Fund (Unfunded)	$22,060,612 Understated
Statement of Net Cost	Earned Revenue from Public	4033, Interest Income (Non Federal)	$3,565,585 Overstated
		4034, Interest Income Subsidy Reestimate	$25,626,197 Understated
	Intragovenmental Gross Costs	5034U, Interest Expense-Subsidy Reestimate (Unfunded)	$22,060,612 Understated
Statement of Net Cost and Statement of Financing	Gross Costs with Public and Upward/Downward Reestimates	5013U, Interest Expense on Subsidy Reestimate (Unfunded)	$25,626,197 Understated

The Federal Credit Reform Act of 1990 requires that the rate of interest charged by the Secretary of Treasury on lending to financing accounts or paid to financing accounts on uninvested funds be the same as the discount rate used in estimating net present values.

Recommendation:

1.B. We recommend that the CFO continue to develop new quality control procedures and tools and enhance existing procedures and tools to prevent and detect errors or misstatements in amounts recorded in SBA's financial accounting systems or in the accounting treatment and presentation of economic events and to ensure that underlying transactions in the financial statements are accurate, complete, and presented in conformity with federal accounting standards and principles. We recommend that procedures be included for:

- Assigning sufficient human resources to perform financial management and quality assurance functions.
- Providing appropriate training and ensuring knowledge transfer among accountants and analysts responsible for recording, reviewing, and approving accounting transactions.
- Developing appropriate skill sets to enable efficient, complete, and accurate analysis of detailed and summarized financial data.

FUNDS CONTROL MANAGEMENT

SBA's funds control management improved significantly since FY 2003, but continues to have weaknesses, as discussed below.

Invalid Budgetary Proforma Entries

SBA used an application called Budget Proforma to record budgetary accounting entries in its Financial Reporting Information System (FRIS) consolidated general ledger based upon proprietary and memorandum transactions occurring in the Loan Accounting System (LAS), because LAS does not include budgetary accounting transactions. We noted the following misstatements on the combined statement of budgetary resources related to SBA's budgetary proformas:

- During FY 2004, SBA corrected invalid proforma posting logic for Transaction Codes 311 and 320. It did not, however, make retroactive adjustments to correct the effects from the invalid logic. As a result, Spending Authority from Offsetting Collections and Obligations Incurred were understated by $313,057.

- SBA posted a manual journal voucher to correct year-to-date effects from invalid budgetary posting logic for Transaction Code 462. This entry did not result in the correct budgetary balances. As a result, Spending Authority from Offsetting Collections and Obligations Incurred were understated by $14,546,294.

SBA did not reconcile its proprietary and related budgetary account balances to ensure that the results of its budgetary proforma posting logic were correct. In addition, SBA's quality assurance process did not detect account balance errors. SBA corrected these misstatements after we brought them to its attention.

Substantial compliance with the SGL at the transaction level, as mandated by the Federal Financial Management Improvement Act (FFMIA), requires that SBA record financial events consistent with applicable posting models/attributes reflected in the SGL. Generally accepted accounting principles require that transactions be recorded based upon events that actually occurred.

Monitoring Undelivered Orders

SBA did not adequately monitor undelivered orders, as discussed below:

Invalid Loan Program Undelivered Orders: During FY 2003, we noted that SBA maintained invalid loan program undelivered orders. In response to our recommendation, SBA developed two reports to aid disaster assistance and servicing offices in identifying invalid Disaster Program undelivered orders resulting from duplicate loan approvals or based on the age of the undelivered order. Although SBA made significant improvement in identifying and de-obligating invalid or unneeded Disaster Program undelivered orders, we noted the following during FY 2004 testing:

- 3 instances of duplicate loan approvals.

- 35 instances of invalid posting logic at Transaction Code 212, which reestablished an undelivered order when a loan disbursement check was returned after the loan was cancelled.

In addition, we noted 12 instances in which SBA failed to de-obligate unneeded undelivered orders for its Business Direct Loan Program in a timely manner.

This condition resulted in the following misstatements on the combined statement of budgetary resources:

Financial Statement	Financial Statement Line Item	General Ledger Account	Known Misstatement	Projected Misstatement
Statement of Budgetary Resources and Statement of Financing	Undelivered Orders and Obligations Incurred	7801B, Undelivered Orders-Unpaid-Loans	$3,390,202 Overstated	$31,872,616 Overstated
	Unobligated Balances Available	7610, Allotments-Realized Resources	$3,390,202 Understated	$31,872,616 Understated

During FY 2004, SBA corrected $1,259,595 of the known misstatements once we brought them to its attention.

OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, defines a valid obligation as a binding agreement that will result in outlays immediately or in the future. The undelivered orders detailed above will not result in future outlays and should have been de-obligated.

Administrative Undelivered Orders: During sample testing of administrative undelivered orders, we identified a $1.5 million undelivered order for a grant for which the performance period had expired on August 31, 2003. SBA stated that a verbal extension of the grant period had been authorized, but it had not prepared and signed a written modification to the grant agreement as of September 30, 2004. Accordingly, SBA could not provide support to substantiate the need for this undelivered order nor could we determine its propriety without discussion with the Office of Procurement and Grants Management (OPGM).

Part 31 U.S.C. Section 1501 (a) (5) requires an obligation to be supported by documentary evidence of a grant payable under an agreement authorized by law.

Recommendation:

We recommend that the CFO:

1.C. Continue to refine the review process implemented during FY 2004 to identify invalid or unneeded Disaster Program undelivered orders and develop a similar review process for the Business Direct Loan Program.

1.D. Coordinate with the Director of OPGM to ensure that a written grant amendment is issued to extend the performance period for the grant identified above.

1.E. Coordinate with OPGM to implement a control to ensure that all future administrative undelivered orders are supported by valid obligating documents.

ANTI-DEFICIENCY ACT COMPLIANCE

SBA did not have sufficient funds control to ensure that activity affecting expired salary and expense funds was valid and did not result in Anti-Deficiency Act violations. For example, it recorded $7.1 million of obligation activity in expired funds during FY 2004 that SBA management could not readily explain as appropriate upward adjustments.

OMB Circular A-11, Section 20-13, Period of Availability for Making Disbursements*,* states that budget authority is not available for new obligations during the expired phase of a fund. Agencies may, however, use expired budget authority to make certain adjustments to obligations incurred before budget authority expiration.

Because SBA did not routinely review these obligations to ensure Anti-Deficiency Act compliance, it was unable to assure us that its FY 2004 obligation activity in expired funds met OMB Circular A-11 criteria.

Recommendation:

1.F. We recommend that CFO implement procedures to require senior management review and approval of all obligation activity in expired funds and maintain sufficient documentation to substantiate its validity and compliance with OMB Circular A-11 and the Anti-Deficiency Act.

INTRA-GOVERMENTAL TRANSACTIONS

While SBA strengthened its process for reconciling intra-governmental activity and balances with trading partners, it was unable to reconcile a significant amount of intra-governmental activity through September 30, 2004. In some instances, SBA did not fully capture the requisite trading partner data, such as agency location code, in its accounting system. In addition, SBA's contacts with a significant trading partner, Office of Personnel Management, failed to resolve large differences noted by Treasury. Further, SBA's attempts to contact another significant trading partner, General Services Administration, were not reciprocated.

Treasury Financial Manual, 2-4700, Agency Reporting Requirements for the Financial Report of the United States Government (May 28, 2004), requires agencies to capture trading partner information in their accounting systems and fully reconcile differences with trading partners on a quarterly basis. Additionally, according to *Treasury's Federal Intragovernmental Transactions Accounting Policies Guide* (September 24, 2004), the responsibility for reconciliation of an agency's activity and balances is with the agency regardless of the trading partner's involvement with the transaction.

Recommendation:

1.G. We recommend that the CFO strengthen internal controls to ensure that all requisite trading partner data are fully captured in SBA's accounting system, and that all trading partners are contacted quarterly to reconcile differences. In addition, we recommend that CFO seek assistance from OMB to enhance cooperation from non-responsive trading partners.

2. CREDIT REFORM CONTROLS

SBA developed and implemented draft standard operating procedures for calculating re-estimates and established an internal review and documentation process for all of its credit re-estimate activities during FY 2004. This process covered the following elements:

- Ensuring version control and security over model input data.
- Verifying program structure and documenting technical changes to the model.
- Updating model assumptions and accounting data.
- Reviewing cash flows generated from the model for reasonableness.
- Ensuring completion of interest rate re-estimates when required.
- Ensuring use of appropriate discount rates.
- Reviewing accuracy of data used in the credit subsidy calculator or balances approach re-estimate calculator.

Standard operating procedures provided for a four-person review process. The preparer and first- and second-level reviewers ensured that each of the procedures was executed correctly and was sufficiently documented to support SBA's re-estimate calculations. The fourth individual, an SBA contractor with expertise in econometrics and statistical analyses, then performed an independent verification and validation exercise.

The existence of and adherence to a set of standard operating procedures for calculating re-estimates, along with more meaningful and standardized documentation of the process and results, and an effective internal review process were critical to SBA's success in meeting key milestone dates. They also were essential to completing the audit process within an accelerated financial reporting timeframe.

Although much substantial and noteworthy progress was made, additional improvements are warranted to ensure that reasonable estimates can be produced and audited in a timely manner in the future. We noted conditions during testing of the credit subsidy re-estimate process in the following areas:

- Program-Level Accounting Data
- Historical Accounting Data in Cash Flow Models
- Discount Rates for Re-Estimates and Interest Transactions
- Projected Cash Balances
- Actual Cash Flows for Analytical Procedures

PROGRAM-LEVEL ACCOUNTING DATA

SBA prepared re-estimates for its loan-related activities at the program level, such as the 7a guarantee program versus the SBIC Participating Securities Program or Disaster Loan Program. SBA accounted for over 25 programs within its 3 financing funds. The accounting system did not, however, have a unique data element to identify the program. Instead, SBA used a "point break" data element within the accounting system and manually assigned multiple point breaks to each program. Therefore, SBA was able to accumulate and analyze data at the program level outside of the accounting system.

The proper segregation and integrity of data at the program level is essential for computing re-estimates using the balances approach and performing other program-level analytical procedures, such as comparing actual to estimated cash flows and validating data used in the re-estimate models and cash-flow outputs produced by the models.

This process of accumulating data at the program level is labor intensive and subject to human error and interpretation. Financial data are used by many individuals, including credit analysts, accountants, program personnel, and auditors. While SBA made progress in identifying which point breaks should be assigned to which programs, we noted some inconsistencies in program classification among various analyses prepared by SBA. In addition, SBA had to manually prepare and review data each time it was used. This was often time consuming and hindered SBA's ability to efficiently complete its analyses and our ability to perform our audit.

OMB Circular A-127 states:

> *The design of the financial management systems shall reflect an agency-wide financial information classification structure that is consistent with the U. S. Government Standard General Ledger, provides for tracking of specific program expenditures, and covers financial and financially related information. This structure will minimize data redundancy, ensure that consistent information is collected for similar transactions throughout the agency, encourage consistent formats for entering data directly into the financial management systems, and ensure that consistent information is readily available and provided to internal managers at all levels within the organization.*

Recommendation:

2.A. We recommend that the CFO investigate the feasibility of enhancing the agency's accounting data structure to include a program code within the financial reporting information system and update this new program code data element for existing financial records. If this is not feasible, we recommend that the CFO maintain an authoritative crosswalk between point breaks and programs and develop procedures to ensure accurate and consistent summarization of data at the program level.

HISTORICAL ACCOUNTING DATA IN CASH FLOW MODELS

The conditions we noted related to SBA's development of its subsidy re-estimates are discussed below.

Incorrect Estimated Disbursements

SBA calculated a re-estimate for a 2004 cohort under its 7a Supplementary Terrorist Assistance Relief (STAR) program, although no new obligations were incurred or disbursements made beyond the 2003 cohort. SBA forecasted second half of FY 2004 program demand for all cohorts to project its September 30, 2004, cash balances. Because no disbursements were made in the first half of the year for the 2004 cohort, the forecast model used loans from the second half of FY 2003 to project disbursement activity for the second half of FY 2004.

SBA's quality assurance process did not detect that a re-estimate had been completed for a cohort for which no budget authority existed. This resulted in a $143 million overstatement of forecasted disbursements in the 2004 cohort, which produced an erroneous $1 million downward re-estimate.

Incorrect Unpaid Principal Balances

SBA's 7a model used unpaid principal balance (UPB) at the beginning of each quarter to forecast cash flows in subsequent periods. Actual cash flow activity records for the period ended March 31, 2004, for loans in 1996 and 1997 cohorts were missing certain data elements, including one that designated the loan status as either active or inactive. Loans with missing data were dropped from the data set, and the UPB was understated for 1996 and 1997 cohorts. SBA estimated that the FY 2004 re-estimates were understated by approximately $4.2 million as a result.

Incorrect Disaster Loan Program Borrowing

Beginning in FY 2003, SBA established new disaster loan point breaks to account for WTCP physical and economic injury disaster loans. For a direct loan program, the unsubsidized portion of the loan disbursement is funded by borrowing from Treasury. SBA did not, however, have any borrowing transactions in its WTCP point breaks, because all borrowing was erroneously attributed to the Disaster Loan Program point break codes. As a result, WTCP point breaks showed a substantial amount of negative cash, and the Disaster Loan Program showed too much cash.

In addition, SBA did not segregate its net cash balances between its Disaster Loan Program and WTCP Program when computing and recording interest expense or income transactions with Treasury during FYs 2002 and 2003. As a result, the cumulative net cash balances (uninvested funds less debt owed to Treasury) for both programs were misstated in the accounting system. SBA needed to manually reconstruct its net cash balances in order to use the balances approach for re-estimating these programs.

SFFAS No. 2, Accounting for Direct Loans and Loan Guarantees, states:

> *The efforts to make accurate projections should begin with establishing and using reliable records of historical credit performance data….*

SBA made accounting adjustments during FY 2004 totaling about $500 million to realign its borrowing activity between WTCP and regular disaster point breaks and calculated an additional component to its re-estimate to cover the effects of failing to separately calculate and record interest transactions with Treasury in its WTCP Program in prior years.

Incomplete Historical Data

SBA used incomplete disbursement and default data when developing its historical average default and principal repayment assumption curves for its SBIC Participating Securities Program cash flow model. These errors resulted in overstating subsidy re-estimates by approximately $2 million.

The Federal Accounting Standards Advisory Board's (FASAB) Credit Reform Task Force (Accounting and Auditing Policy Committee), Technical Release No. 6, Preparing Estimates for Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act, requires agencies to compare budgeted to actual cash flows to ensure that cash flow models reflect actual cash flows from the accounting records. Additionally, Technical Release No. 6 requires budget and accounting offices to ensure that cash flow models are updated to reflect actual cash flows and terms of the loan program recorded in the accounting records.

Recommendation:

2.B. We recommend that CFO continue to improve its quality assurance and review process to ensure that historical accounting data used in cash flow models are complete and accurate based on underlying accounting records.

DISCOUNT RATES FOR RE-ESTIMATES AND INTEREST TRANSACTIONS

To compute interest transactions with Treasury, SBA used discount rates that were inconsistent with discount rates used to estimate the present value of future cash flows, which should be the cohort weighted average or single effective discount rates set once a cohort becomes 90-percent disbursed. This inconsistency likely stemmed from two circumstances.

First, the OMB Consolidated Credit Tool (c-credit tool) and Interest Calculator for Credit Financing Accounts each compute the cohort weighted average discount rate based on yearly disbursement amounts entered by the preparer. If different disbursement amounts are entered into each tool, different discount rates will result and be used by the respective tool. Second, the single effective discount rates (used for 2001 cohort and later) must be manually entered in the tools. SBA did not have a procedure in place to make sure that single effective discount rates used for interest transactions were the actual cohort discount rate when the cohort became 90-percent disbursed.

We noted that SBA did not maintain an official list or database of the cohort weighted average or single effective discount rates that were set when the interest rate re-estimates were performed. SBA was required to retrieve subsidy re-estimate files from previous years, which were not always available, to ensure that the appropriate discount rate was used in the current re-estimate. A similar exercise was not performed when the interest transactions were calculated, and different individuals were responsible for preparing the re-estimates and calculating the interest transactions with Treasury.

The use of discount rates other than those set when the cohort became 90 percent disbursed resulted in a net error of approximately $5 million.

The Federal Credit Reform Act of 1990 requires that the rate of interest charged by the Secretary of Treasury on lending to financing accounts or paid to financing accounts on uninvested funds be the same as the discount rate used in estimating net present values.

Recommendation:

2.C. We recommend that the CFO develop and implement procedures for ensuring consistency and a clear audit trail between the discount rate resulting from the interest rate re-estimate and discount rates used for both subsequent technical re-estimates and calculations of interest income and expense transactions with Treasury.

PROJECTED CASH BALANCES

SBA used the "balances approach" for calculating its FYs 2004 and 2003 restated re-estimates. This approach compares actual cash balances less debt owed to Treasury in the accounting system with forecasted cash flows projected by the subsidy re-estimate models. Any excess or deficiency in net cash balances results in a re-estimate under this approach. SBA began preparing its re-estimates in the spring of 2004 and was able to use September 30, 2003, actual cash balances to calculate the FY 2003 restated re-estimate. Starting with the March 2004 actual net cash balance, SBA projected the second half of FY 2004 cash activity, such as purchases, collections, and FY 2004 interest income and expense transactions with Treasury.

SBA's original projections for its non-disaster programs assumed that, as part of interest transactions with Treasury, it would earn or pay interest for one-half of a year on the change between the FY 2003 funded and FY 2003 restated re-estimates. Because the change will not be funded until FY 2005, SBA should have calculated an additional amount of "interest on re-estimate" for its FY 2003 restatements. SBA's quality assurance procedures did not detect this condition. SBA revised its FY 2004 re-estimates after we brought this to its attention.

The effect of this error did not change the total combined FY 2003 and FY 2004 re-estimates and would not have occurred had SBA not needed to restate its FY 2003 re-estimates. Because of the error, however, amounts recorded as subsidy re-estimate versus interest on re-estimates during FY 2004 were misstated, impacting the consolidated statements of net cost and financing. The effects ranged from $0.8 million to $6 million depending on the program and totaled approximately $19 million.

In addition, SBA used an incorrect recovery curve to estimate recovery activity for the second half of FY 2004 under the SBIC Debentures program. As a result, estimated balances on deposit with Treasury as of September 30, 2004, were overstated, and the re-estimate was understated by $442,574.

Recommendation:

2.D. We recommend that CFO continue to refine its quality review procedures to ensure that it correctly applies procedures necessitated by the use of the balances approach, if restatements are required in the future.

ACTUAL CASH FLOWS FOR ANALYTICAL PROCEDURES

SBA prepared a cash flow component analysis of actual plus forecasted cash flows over the cohort life for its SBIC Participating Securities Program. It included this analysis in supporting documentation provided with the model as part of its quality assurance process. This analysis was intended to be used to evaluate the reasonableness of the cash flow forecasts. It did not contain explanations describing procedures performed or conclusions reached. In addition, we noted instances in which the actual cash flows for FYs 1994 through 2003 did not agree with LAS, and forecasted cash flows did not agree with the model output. To be reliable and effective, the analysis should be accurate and demonstrate the test performed, test results, and conclusions reached.

We noted that SBA did not perform a similar analysis of cohort-specific actual plus forecasted cash flows for its other guaranteed loan programs. Unlike the traditional approach for re-estimating, the balances approach does not require actual cash flow amounts to be included in the cash flow spreadsheets. Although not required, an analysis of actual plus forecasted cash flow streams over the life of the cohort, to determine if proper and intuitive relationships among cash flow components exist, would be useful in explaining trends and substantiating the reasonableness of cash flow projections.

In addition, SBA used March 31, 2004, cash balances annualized to September 30, 2004, to establish its net cash balances with Treasury for its balances approach re-estimates. SBA forecasted cash flow activity for the second half of the year, including purchases for defaulted loans, recoveries on defaults, interest transactions on estimated cash balances, and other collection and disbursement activities. At year-end, SBA compared its projections with actual activity for the second half of FY 2004, and noted that it had consistently overestimated purchase activity, which in turn affected projections of other cash flow components. The accelerated audit schedule did not allow sufficient time to effectively analyze the cause of some differences or develop an auditable approach to measuring the effects of such differences on projected re-estimates and resulting account balances. While SBA had some features in place to study and measure the impacts caused by such differences, it recognized that additional analytical procedures and tools may be useful.

As noted in our Independent Auditor's Report, we were not able to satisfy ourselves as to the reasonableness of SBA's FY 2004 subsidy re-estimates for the Section 7(a), 504, SBIC Participating Securities, and SBIC Debenture Programs or its Credit Program Receivables and Related Foreclosed Property and Liabilities for Loan Guarantees account balances for these four programs.

Recommendation:

2.E. We recommend that the CFO continue to develop and refine existing analytical tools and analyses to substantiate the reasonableness of forecasted cash flows and subsidy re-estimates produced by its models, including analytical analyses of actual plus projected cash flows over the cohort life, statistical methods for establishing the degree of uncertainty inherent in the subsidy models, and procedures to determine model quality.

2.F. We recommend that the CFO develop and test an approach for quantifying the impact on re-estimates and account balances caused by differences between actual and projected cash flows if SBA continues to use interim data for computing its re-estimates.

3. AGENCY-WIDE INFORMATION SYSTEMS CONTROLS

SBA continued to improve internal control over its information system environment in certain areas during FY 2004. Specifically, SBA:

- Conducted certification and accreditation (C&A) reviews for additional major applications.
- Continued to implement the Windows 2000 operating system at various field locations.
- Conducted a disaster recovery exercise.

While these accomplishments are important and noteworthy, SBA continues to have serious weaknesses in its information systems control environment, as discussed below:

- OCIO did not have an adequate information technology training program in place for personnel who administer or oversee SBA's IT resources.
- Management had not corrected known deficiencies. Specifically, 14 of 26 recommendations for 13 findings noted in FY 2003 were not adequately addressed.
- Duties within financial applications were not adequately segregated. SBA's Joint Accounting and Administrative Management System (JAAMS) security administration and user account administration privileges have been granted to several individuals. In addition, we identified one user with both financial- and IT incompatible duties within JAAMS.
- Policies and procedures for the administration of the SBA's network operating system have not been developed.
- No minimally-acceptable baseline configuration existed for SBA's network operating system, general support computer operating systems, and database management system. In addition, we found several weaknesses within the security configurations of these platforms when compared to federal guidance and industry best practices promulgated by the Center for Internet Security, National Institute for Standards and Technology, and National Security Agency.
- Access authorization and restriction controls to the SBA network, JAAMS, LAS, and the Sybase general support systems were not adequate. Access authorization forms documenting approval of access and privileges granted were not required for the network, Sybase, and LAS. Although JAAMS did require access authorization forms, not all forms could be located for review.
- Emergency access authorizations to SBA's Network, JAAMS, LAS, and the Sybase general support system were not adequately documented.
- Network, JAAMS, and LAS password controls were weak.

- SBA did not review inactive accounts on the network, LAS, or the Sybase general support system.

- Logging and monitoring of security events within SBA general support systems and JAAMS were inadequate.

- Business resumption plans have not been completed and fully incorporated into SBA's Continuity of Operations Plan (COOP)

- Several vulnerabilities continued to exist on the SBA network.

SBA's OIG will issue a separate report titled *Audit of SBA's Information System Controls, FY 2004,* that will provide additional detail of our scope of work, findings, and recommendations in the following categories:

General Control Categories

- Entity-wide security program control
- Access control
- Application software development and program change control
- System software control
- Segregation-of-duty control
- Service continuity control

Application Control Categories (Oracle administrative accounting system)

- Authorization control
- Completeness control
- Integrity of processing and data file control
- Accuracy control

STATUS OF PRIOR-YEAR FINDINGS

As required by *Government Auditing Standards*, we provide the status of reportable conditions for the prior-year audit in the appendix.

OTHER MATTERS

We considered SBA's internal control over required supplementary stewardship information by obtaining an understanding of SBA's internal control, determining if internal control had been placed in operation, assessing control risk, and performing tests of control as required by OMB Bulletin No. 01-02. Our objectives were not to provide assurance on internal control; accordingly, we do not provide an opinion on such control.

Finally, with respect to internal control related to SBA performance measures, we obtained an understanding of the design of significant internal control relating to existence and completeness assertions, as required by OMB Bulletin No. 01-02. We concluded that SBA's control over performance measures did not ensure accuracy and reliability as required by OMB Bulletin 01-09 and prevailing FASAB standards. Our procedures were not designed to provide assurance on internal control over reported performance measures; accordingly, we do not provide an opinion on such control.

We also noted certain other matters involving internal control that we will report to SBA management in a separate letter.

This report is intended solely for the information and use of SBA management, OMB, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

COTTON & COMPANY LLP

Charles Hayward, CPA
Partner

November 15, 2004
Alexandria, Virginia

APPENDIX

STATUS OF FY 2003 AUDIT FINDINGS

Description	Recommendation	Status
Credit Reform Controls	Develop a comprehensive SOP detailing the subsidy re-estimate process, including related internal controls, that reflects SBA's current re-estimate preparation processes and any proposed improvements. Update the SOP at least annually to capture significant changes such that it reflects the current operating process. (1A)	Implemented
	Complete the Section 7(a) model documentation in accordance with Tech Release No. 3 and assure that the identified shortcomings are addressed by the documentation. Perform and document the likelihood ratio test and comparison of predicted versus actual default and prepayment probabilities for subgroups of the population. (1B)	Implemented
	Direct a coordinated effort among OCFO and Investment Division to fully document the SBIC program models in accordance with Tech Release No. 3. (1C)	Implemented
	Clearly define which programs (program codes) should be included in the Section 7(a) re-estimate actuals. (1D)	Implemented
	Develop a quality assurance system to ensure that data extracted from LAS for inclusion in the Disaster and 7(a) subsidy re-estimate models are complete and accurate. (1E)	Implemented
	Develop, as an interim measure, an internal control procedure to reconcile the Investment Division SBIC Participating Securities and Debenture transaction data to LAS at the cohort and activity-year level; research and fully explain all variances; and determine if Investment Division data are appropriate for use in subsidy re-estimates. (1F)	Implemented
	Begin recording all SBIC transactions in the proper fiscal year and cohort and add SBIC-specific transaction codes to LAS, as necessary, to better identify SBIC activity, so that SBIC subsidy re-estimate actuals can be derived from LAS in the future. (1G)	Implemented
	Develop, document, and implement data quality assurance procedures to establish the completeness and accuracy of data provided by SBA's fiscal and transfer agent for Secondary Market Guarantee estimation purposes. (1H)	Partially Implemented
	Determine if selection and development of the SBIC Participating Securities model's forecast assumptions are consistent with program guidelines and are reasonable in light of historical experience and current economic conditions and document the basis for such assumptions. (1I)	Implemented

Description	Recommendation	Status
	Develop a quality assurance review process to minimize errors in calculating re-estimates and/or ensure that errors that do occur are detected and corrected in a timely manner. (1J)	Implemented
	Direct a coordinated effort among applicable OCFO branches to identify potential disconnects between the agency's subsidy models and accounting records and make refinements to subsidy models and post correcting entries to the general ledger as appropriate. (1K)	Implemented
	Implement a system of internal control in which the Office of Financial Analysis and the Office of Financial Administration monitor the direct loan subsidy allowance account balance and the liability for loan guarantees account balance as compared to the outstanding balances of loans and/or guarantees, at the program and cohort levels monthly. Maintain documentation that explains unusual fluctuations determined to be appropriate, supports any adjusting entries to the general ledger and details revisions made to subsidy models and/or assumptions. (1L)	Implemented
	Ensure that the FRIS general ledger and subsidiary feeder systems are properly accounting for credit reform activities at the program and cohort levels in accordance with SFFAS No. 2. (1M)	Implemented
Financial Management and Reporting Controls	Assess whether SBA has devoted sufficient and qualified resources to adequately address its current financial reporting shortcomings and determine if the current process is in need of re-engineering to meet accelerated financial reporting deadlines in future years. (2A)	Implemented
	Develop a comprehensive plan with firm milestone dates to meet the FY 2004 accelerated financial reporting date of November 15th. (2B)	Implemented
	Design specific procedures to identify accounts requiring estimation or other adjustment in a timely manner to achieve proper valuation in the financial statements. (2C)	Implemented
	Lead a collaborative effort between the Office of Financial Administration accountants and the Office of Financial Analysis analysts, such that sufficient knowledge transfer is achieved to enable SBA to design and implement comprehensive and effective analyses and review processes regarding estimates and other accounting adjustments. (2D)	Implemented
	Complete the document titled *Checklist for Reports Prepared Under the CFO Act--Revised 2003*, as issued jointly by the General Accounting Office and the President's Council on Integrity and Efficiency, before submitting financial statements to help ensure the adequacy of financial statement presentation and disclosure. (2E)	Implemented

Description	Recommendation	Status
	Correct known budgetary proforma errors and perform a complete analysis of posting logic to ensure compliance with the SGL at the transaction level. (2F)	Implemented
	Coordinate with the Office of Disaster Assistance to develop and implement procedures to review and determine the validity of outstanding disaster Loan UDOs quarterly. Invalid UDOs should be de-obligated to ensure efficient use of funds. (2G)	Implemented
	Coordinate with the Director of the Office of Procurement and Grants Management to develop additional or strengthen existing internal controls to identify administrative obligations with no activity and process de-obligations in a timely manner. (2H)	Implemented
	Develop procedures to ensure proper cut-off to ensure completeness of administrative transactions for financial reporting. (2I)	Implemented
	Ensure that adequate supporting documentation is maintained to substantiate recorded administrative obligations. (2J)	Not Implemented
	Continue to review obligation activity posted against expired funds in FY 2003 and make a determination if the Antideficiency Act was violated. Maintain sufficient documentation to ensure a clear audit trail during FY 2004. (2K)	Not Implemented
	Develop control techniques to ensure that only valid obligation activity is posted against expired funds and review transactional detail monthly to ensure no invalid activity was posted. (2L)	Partially Implemented
	Investigate the possibility of implementing automated funds controls within the Loan Accounting System that allot the lesser of apportioned authority or realized resources at the fund level. (2M)	Implemented
	Enhance the cash management tracking system by implementing a control technique to ensure that obligations incurred transactions entered via journal voucher do not exceed the lesser of apportioned authority or realized resources. (2N)	Implemented
	Calculate and pay all interest due to immediate pay vendors for late payments in prior fiscal years and begin paying Prompt Payment Act interest to these vendors on future late payments. (2O)	Implemented
	Perform a thorough account analysis at the fund level to identify account and posting anomalies, such as accounts with unnatural balances. Any anomalies detected should be researched and subsequently corrected to ensure compliance with SGL posting logic and federal accounting standards. (2P)	Implemented

Description	Recommendation	Status
Agency-wide Information Systems Control	Please refer to SBA's OIG report titled *Audit of SBA's Information System Controls, FY 2003*.	Unresolved. Updated in SBA's OIG report titled *Audit of SBA's Information System Controls, FY 2004*.

COTTON & COMPANY LLP
auditors • advisors

333 North Fairfax Street • Suite 401 • Alexandria, Virginia 22314 • 703/836/6701 • fax 703/836/0941 • www.cottoncpa.com

Independent Auditor's Report on Compliance with Laws and Regulations

Inspector General
U.S. Small Business Administration

We audited the consolidated balance sheets of the U.S. Small Business Administration (SBA) as of September 30, 2004, and 2003 (restated); the related consolidated statements of net cost, changes in net position, and financing; and the combined statements of budgetary resources for the fiscal years then ended and have issued our report thereon, dated November 15, 2004. In that report, we issued an unqualified opinion on the Fiscal Year (FY) 2004 combined statement of budgetary resources and the FY 2003 consolidated balance sheet (as restated); issued a qualified opinion on the FY 2004 consolidated balance sheet and statements of net costs, changes in net position and financing; and disclaimed an opinion on the FY 2003 consolidated statements of net cost, changes in net position, and financing and the combined statement of budgetary resources.

Except as described in our November 15, 2004, Independent Auditor's Report referred to above, we conducted our audits in accordance with auditing standards generally accepted in the United States; standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 01-02, *Audit Requirements for Federal Financial Statements*.

SBA management is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether SBA's financial statements are free of material misstatement, we performed tests of agency 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 01-02, including requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to SBA.

Our Independent Auditor's Report on Internal Control states that SBA had $8.7 million of obligation activity in expired funds during FY 2004 (see the section in that report titled Anti-Deficiency Act Compliance), which could not be readily explained as appropriate upward adjustments by SBA management. Accordingly, we were not able to conclude whether or not SBA violated the Anti-Deficiency Act.

The results of our tests of compliance with the laws and regulations described in the third paragraph above, exclusive of FFMIA, disclosed the following instance of noncompliance, which is required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02.

Anti-Deficiency Act

During FY 2004, SBA's Office of General Counsel (OGC) ruled that SBA improperly augmented its appropriations by allowing its fiscal and transfer agent to retain the float interest earned on fees collected on SBA's behalf as compensation. Additionally, OGC determined that this practice constituted a violation of the Anti-Deficiency Act. SBA has notified OMB about this violation and is in the process of preparing an anti-deficiency letter required by the Act.

Also, SBA calculated the amount of float interest for each fiscal year during which this interest was earned and identified the appropriate fiscal year funding source for these amounts. OMB approved a $1.1 million reapportionment for SBA's business loan guarantee financing account to reflect spending authority from offsetting collections from federal sources. SBA recorded an adjusting entry to move this amount from various salary and expense accounts to the financing account.

Under FFMIA, we are required to report whether SBA's financial management systems substantially comply with federal financial management system requirements, federal accounting standards, and the United States Government Standard General Ledger (SGL) at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. Results of our tests disclosed instances, described below, indicating that SBA's financial management systems did not substantially comply with federal financial management system requirements, federal accounting standards, and the United States SGL at the transaction level.

Please see our Independent Auditor's Report on Internal Control (applicable section cited) for details regarding each of the matters discussed below.

SBA is not in substantial compliance with federal financial management system requirements, because:

- Access control, segregation-of-duty, and other general-control weaknesses existed, which are described in the Office of Inspector General report titled *Audit of SBA's Information System Controls, FY 2004*. (3. Agency-Wide Information System Controls)

- Security weaknesses and non-conformances with OMB Circular A-130, *Management of Federal Information Resources*, continued to exist in certain major applications and general support systems. (3. Agency-Wide Information System Controls)

- SBA maintained insufficient funds control over obligation activity in expired salary and expense funds. (1. Financial Management and Reporting Controls, Anti-Deficiency Act Compliance)

- SBA's accounting system did not accumulate data at the program level to ensure that consistent financial information was collected and readily available for management at all levels of the organization, as required by OMB Circular No. A-127, *Financial Management Systems*. (2. Credit Reform Controls, Program-Level Accounting Data)

SBA was not in substantial compliance with federal accounting standards, because it:

- Incorrectly recorded borrowing transactions attributable to its World Trade Center/Pentagon (WTCP) Program to its Disaster Loan Program and commingled the net cash balances in its calculation of interest transactions with Treasury for FYs 2002 and 2003. (2. Credit Reform Controls, Incorrect Disaster Loan Program Borrowing)

- Used incorrect discount rates to calculate its interest income and expense transactions with Treasury. (2. Credit Reform Controls, Discount Rates for Interest Transactions)

- Submitted draft financial statements, related footnote disclosures, and other sections of the Performance and Accountability report, such as the Management Discussions and Analysis (MD&A) and Performance Report sections, that contained numerous, pervasive, and obvious errors including inconsistencies among the principal financial statements, footnotes, and MD&A and Performance Report sections. (1. Financial Management and Reporting Controls, Financial Statement Preparation and Quality Assurance)

- Did not assign disaster loan administrative expenses covered by an appropriation transfer to the proper strategic goal. (1. Financial Management and Reporting Controls, Improper Assignment of Disaster Administrative Expense to Strategic Goals)

- Did not segregate the present value of future cash flows for its Small Business Investment Company (SBIC) Participating Securities Program between the Liability for Loan Guarantees and Credit Program Receivables and Related Foreclosed Property. (1. Financial Management and Reporting Controls, Subsidy Realignment Entry)

- Recorded additional interest on re-estimates to the wrong accounting period. (1. Financial Management and Reporting Controls, Disaster Loan Program Interest Transactions with Treasury)

- Overstated loan undelivered orders because it failed to deobligate unneeded obligations. (1. Financial Management and Reporting Controls, Invalid Loan Program Undelivered Orders)

- Incorrectly treated an appropriation transfer from another agency as reimbursable activity rather than appropriated funds. (1. Financial Management and Reporting Controls, Improper Accounting Treatment for Appropriation Transfer)

- Presented its FY 2003 net costs of operations in total, rather than by strategic goal. (Independent Auditor's Report)

SBA was not in substantial compliance with the United States Government SGL at the transaction level, because:

- SBA misstated unexpended appropriations and cumulative results of operations account balances in several funds. (1. Financial Management and Reporting Controls, Net Position Balances)

- SBA recorded invalid spending authority from offsetting collections and obligations incurred due to improper budget pro-forma posting logic. (1. Financial Management and Reporting Controls, Invalid Budgetary Proforma Entries)

SBA's Office of the Chief Financial Officer is responsible for financial management systems within SBA. We recommend that SBA assign priority to corrective actions for these FFMIA-related matters consistent with requirements of OMB Circular A-50, *Audit Followup*.

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

This report is intended solely for the information and use of SBA management, OMB, and Congress and is not intended to be and should not be used by anyone other than these specified parties.

COTTON & COMPANY LLP

Charles Hayward, CPA

November 15, 2004
Alexandria, Virginia

CFO Reply

DATE: November 15, 2004

TO: Robert Seabrooks, Assistant IG for Auditing

FROM: Thomas Dumaresq, Chief Financial Officer

SUBJECT: FY 2004 Financial Statement Audit Report

The Small Business Administration (SBA) is in receipt of the draft Independent Public Accountant (IPA) reports from Cotton and Company, LLP, that include the auditor's opinion and separate reports on internal controls and compliance with laws and regulations. As you know, the IPA audit of the Agency's financial statements and related processes is a core component of SBA's financial management program.

Meeting the accelerated reporting date of November 15th was a major accomplishment for SBA, the IG and the IPA this year and we could not have done it without the coordinated effort made by all parties involved. SBA is proud of the work it did in establishing an aggressive but realistic set of milestones and working cooperatively with Cotton & Co. to ensure they received timely and accurate materials.

Overall we are pleased that the SBA has received an improved audit opinion from the independent auditor compared to the previous three years and believe it accurately reflects a substantial improvement in the quality of the Agency's financial statements. We see this as a particularly strong accomplishment given the shortened reporting cycle. Nevertheless, we are disappointed not to have reached a "clean" audit opinion since that was our objective. Although we were able to successfully resolve essentially all of the FY 2003 audit findings, the accelerated schedule presented new challenges that we were not able to overcome in the available time. However, given all that we have accomplished in the past several years and our experience meeting the accelerated reporting timeframe this year, we are confident that we can resolve the issues identified in the audit in the coming year.

The IPA's Report on Internal Control retains the two material weaknesses included in the FY 2003 report: the financial management and reporting controls and credit reform controls. While we are disappointed that all of the progress we feel we have made in these areas did not result in reducing these to reportable conditions, we understand that additional improvements need to be made and we are committed to maintaining the strong momentum we have established to improve the Agency's financial management processes and results. The IPA's Report on Internal Control recommends that SBA continue to refine and accelerate its reporting processes in light of the 45-day reporting schedule. We agree that we can make further progress in this area, including the production of the PAR document itself. We note that we were able to correct the inconsistencies you reported between the PAR draft document and the final financial statements before the final publication of the PAR, but we recognize additional work is needed to ensure this complex process is completed accurately in the shortened timeframe. In addition, we request that your office continue to work with the IPA to identify opportunities for further improving the audit process and resource availability to ensure SBA also receives adequate time to understand and respond to audit findings.

We appreciate all of your efforts and those of your colleagues in the Office of the Inspector General as well as those of Cotton & Co. While the audit process was again challenging this year, we believe our efforts and the assistance we received from you and Cotton & Co. resulted in substantial improvements in the quality of our financial statements. Overall we feel our financial management capacity has improved considerably this year and we are proud of what we have accomplished. We continue to be committed to excellence in financial management and look forward to making more progress in the coming year.