U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
AUDITING DIVISION

AUDIT REPORT
Issue Date: November 13, 2009
Number: 10-04

To: Jonathan I. Carver
Chief Financial Officer

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of SBA's FY 2009 Financial Statements

Pursuant to the Chief Financial Officer's Act of 1990, attached is a copy of the *Independent Auditors' Report* issued by KPMG LLP on the Small Business Administration's financial statements for the fiscal year ended September 30, 2009. The audit was performed under a contract with the Office of Inspector General (OIG) and in accordance with *Generally Accepted Government Auditing Standards;* Office of Management and Budget's (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements,* as amended; the Government Accountability Office (GAO)/President's Council on Integrity and Efficiency (PCIE) *Financial Audit Manual;* and GAO's *Federal Information System Controls Audit Manual.*

The KPMG report concluded that SBA's consolidated financial statements presented fairly, in all material respects, the financial position of SBA as of and for the years ended September 30, 2009 and 2008. It also presented fairly, in all material respects, SBA's net costs, changes in net position, and combined statements of budgetary resources for the years then ended.

With respect to internal controls, KPMG reported a material weakness over financial reporting, and continued to report a significant deficiency related to Information Technology security controls. Details regarding the matters that led to the auditor's conclusion on internal controls are further discussed in Exhibits I and II of the *Independent Auditors' Report.* KPMG's test for compliance with certain laws, regulations, contracts and grant agreements determined that the Agency did not fully comply with the Debt Collection Improvement Act of 1996 because SBA did not consistently follow Treasury guidelines for referring delinquent debts for collection. Details regarding the auditor's conclusion are included in the "Compliance and Other Matters" section of the *Independent Auditors' Report.* The auditors did not report any other instances or matters regarding noncompliance.

We provided a draft of KPMG's report to SBA's Chief Financial Officer (CFO), who concurred with its findings and recommendations and agreed to implement the recommendations. The CFO is delighted that SBA has again received an unqualified

audit opinion and believes these results accurately reflect the quality of the Agency's financial statements and its improved accounting, budgeting and reporting processes.

We reviewed a copy of KPMG's report and related documentation and made necessary inquiries of their respective representatives. Our review was not intended to enable us to express, and we do not express, an opinion on the SBA's financial statements, KPMG's conclusions about the effectiveness of internal control, or its conclusions about SBA's compliance with laws and regulations. However, our review disclosed no instances where KPMG did not comply, in all material respects, with *Generally Accepted Government Auditing Standards*.

We appreciate the cooperation and assistance of SBA and KPMG. Should you or your staff have any questions, please contact me at (202) 205-[Ex.2] or Jeffrey R. Brindle, Director, Information Technology and Financial Management Group at (202) 205-[Ex.2]

Attachment

KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Office of Inspector General,
U.S. Small Business Administration:

We have audited the accompanying consolidated balance sheets of the U.S. Small Business Administration (SBA) as of September 30, 2009 and 2008, and the related consolidated statements of net cost and changes in net position, and combined statements of budgetary resources (hereinafter referred to as "consolidated financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our fiscal year 2009 audit, we also considered SBA's internal control over financial reporting and tested SBA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these consolidated financial statements.

Summary

As stated in our opinion on the consolidated financial statements, we concluded that SBA's consolidated financial statements as of and for the years ended September 30, 2009 and 2008, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

Our opinion emphasized SBA's implementation of Statement of Federal Financial Accounting Standards (SFFAS) No. 31, *Accounting for Fiduciary Activities*.

Our consideration of internal control over financial reporting resulted in identifying a certain deficiency that we consider to be a material weakness, item number 1, and other deficiencies that we consider to be a significant deficiency, item number 2, as follows:

1 Improvement Needed in Internal Controls over Financial Reporting
2 Improvement Needed in Information Technology (IT) Security Controls

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed one instance of noncompliance that is required to be reported herein under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

3 Noncompliance with the Debt Collection Improvement Act

The following sections discuss our opinion on the SBA's consolidated financial statements; our consideration of the SBA's internal control over financial reporting; our tests of SBA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of SBA as of September 30, 2009 and 2008 and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of SBA as of September 30, 2009 and 2008 and its net costs, changes in net position, and budgetary resources for the years then ended, in conformity with U.S. generally accepted accounting principles.

As stated in Note 4 to the financial statements, SBA implemented the requirements of SFFAS No. 31 in fiscal year 2009.

The information in the Management's Discussion and Analysis, Required Supplementary Information, and Required Supplementary Stewardship Information sections is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Internal Control Over Financial Reporting

Our consideration of the internal control over financial reporting was for the limited purpose described in the Responsibilities section of this report and was not designed to identify all deficiencies in the internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

In our fiscal year 2009 audit, we identified a deficiency in internal control over financial reporting that we consider a material weakness, as described in Exhibit I, and other deficiencies that we consider to be a significant deficiency, as described in Exhibit II. Exhibit III presents the status of the prior year significant deficiency.

We noted certain additional matters that we have reported to management of SBA in a separate letter dated November 13, 2009.

Compliance and Other Matters

The results of our tests of compliance described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed one instance of noncompliance that is required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

As stated in its Federal Managers' Financial Integrity Act (FMFIA) Assurance Statement, SBA management reported the agency was noncompliant with the Debt Collection Improvement Act in fiscal year 2009 due to instances where it did not refer a substantial number of charged off loans to Treasury for offset and cross servicing.

The results of our tests of FFMIA disclosed no instances in which SBA's financial management systems did not substantially comply with the: (1) Federal financial management systems requirements; (2) applicable Federal accounting standards; and (3) the U.S. Standard General Ledger at the transaction level.

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Responsibilities

Management's Responsibilities. Management is responsible for the consolidated financial statements; establishing and maintaining effective internal control; and complying with laws, regulations, contracts, and grant agreements applicable to SBA.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2009 and 2008 consolidated financial statements of SBA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04, require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of SBA's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2009 audit, we considered SBA's internal control over financial reporting by obtaining an understanding of SBA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We did not test all controls relevant to operating objectives, as broadly defined by the FMFIA. The objective of our audit was not to express an opinion on the effectiveness of SBA's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of SBA's internal control over financial reporting.

As part of obtaining reasonable assurance about whether SBA's fiscal year 2009 consolidated financial statements are free of material misstatement, we performed tests of SBA's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including the provisions referred to in Section 803(a) of FFMIA. We limited our tests of compliance to the provisions described in

the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to SBA. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

SBA's response to the findings identified in our audit is presented in Exhibit IV. We did not audit SBA's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of SBA's management, SBA's Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 13, 2009

Exhibit I

U.S. Small Business Administration

Material Weakness

Introduction

Exhibit I herein describes the material weakness and Exhibit II describes the control deficiencies, which collectively resulted in a significant deficiency, for the year ended September 30, 2009, and our recommendations. The status of the prior year significant deficiency is reported in Exhibit III, and SBA management's response is presented in Exhibit IV.

Material Weakness

The material weakness we identified for the year ended September 30, 2009, is summarized below.

(1) Improvement Needed Surrounding Controls Over the Financial Reporting Process

SBA has various reconciliation and data quality improvement procedures between and within its various systems and departments to ensure that the agency's financial statements are reasonable and fairly presented. The purpose of these procedures is to improve the overall quality of the data SBA uses internally to monitor operations and loan portfolio performance as well as to periodically report to its various stakeholders, such as the U.S. Department of Treasury and the Office of Management and Budget (OMB). However, these procedures need to be strengthened to improve the quality and accuracy of the quarterly and year-end financial reporting process.

SBA did not timely identify a $346.6 million overstatement in its financial statements concerning its liability for loan guaranties and defaulted loan guaranty receivable balances. The error was due to a lack of effective process controls over SBA's Return on Assets (ROA) calculation. The ROA calculation is used to record an alignment entry which adjusts the net defaulted loan guaranty receivable and the liability for loan guaranty balances to net present value (NPV) in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 2, *Accounting for Direct Loans and Loan Guarantees*. One of the main inputs of this calculation is the NPVs generated by the Credit Subsidy Calculator 2 (CSC2). For cohorts reestimated using projected disbursements SBA did not properly reduce the NPV amounts on a prorata basis to reflect the NPV based on actual disbursements to date.

Additionally, we noted that the ROA adjusting entry was improperly posted before all loan guaranty transactions were posted to the general ledger. As a result, the defaulted loan guaranty and liability for loan guaranty balances were overstated by $32.7 million.

The lack of process controls resulted in cumulative misstatements totaling $379.3 million related to the defaulted loan guaranties and liability for loan guaranty balances at September 30, 2009. SBA subsequently recalculated the alignment entry and reposted the transactions to correct the balances in error.

OMB Circular A-123, *Management's Responsibility for Internal Controls*, states: "management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. Management shall consistently apply the internal control standards to meet each of the internal control objectives and to assess internal control effectiveness."

Recommendations

We recommend that the Chief Financial Officer:

1. Implement a reconciliation procedure in which a staff member traces and agrees the NPV in the ROA calculation to the outputs generated by the CSC2 prior to posting the alignment entry in the general ledger.

2. Develop policies and procedures to ensure the ROA alignment entry is made after all credit reform loan guaranty activity has been posted to the general ledger.

3. Enhance SBA's procedures related to its in-depth analysis of the valuation of the liability for loan guaranties and defaulted loan guaranty receivable balances to ensure the balances are properly presented at the NPV in accordance with SFFAS No. 2.

Exhibit II

U.S. Small Business Administration

Significant Deficiency

The significant deficiency identified for the year ended September 30, 2009, is summarized below:

(2) Improvement Needed in Information Technology (IT) Security Controls

During fiscal year 2009, we noted that SBA made progress in several areas in its efforts to address prior year IT internal control deficiencies. Despite these improvements, we also noted that deficiencies continued to exist in the areas of security access controls, software program changes, patch management, and end-user computing.

Security Access Controls

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

A summary of the security access control deficiencies we identified during the fiscal year 2009 SBA financial statement audit follows:

- We noted several [redacted] vulnerabilities, with [redacted] hosted by SBA's [redacted] service provider. Details are not provided in this report due to their sensitivity, but have been provided to SBA management. Many of these issues were tracked by the internal [redacted] support team; however, the issues were not appropriately tracked and prioritized by the Plan of Action and Milestones (POA&M) in which the Office of Chief Information Officer (OCIO) provides oversight and management.

- We noted security vulnerabilities with [redacted] hosted in the [redacted] Details are not provided in this report due to their sensitivity, but have been provided to SBA management. Although we noted improvement in this area since fiscal year 2008, consistent and periodic completion of vulnerability scans would have helped SBA reduce the number of vulnerabilities.

- We identified access control weaknesses through our technical vulnerability testwork [redacted].

- Validation of physical access to the data center at [redacted] is not performed in accordance with SBA Standard Operating Procedure (SOP) 90-47.2, *Automated Information Systems Security Program*, which requires that a listing of authorized personnel for SBA computer facilities (e.g., server rooms) be maintained, and access be revalidated at least quarterly. In addition, we noted that visitor logs at [redacted] were not fully completed.

- OCIO management was unable to provide reasonable assurance that electronic media is sufficiently sanitized prior to disposal, in accordance with SOP 90-47.2. The SOP requires that (1) media must be sanitized prior to disposal by using one of the three approved methods: overwriting, degaussing, or destruction, and (2) a log of who completed the sanitation action must be maintained.

- OCIO management was unable to provide reasonable assurance that user access to the [redacted] system was appropriately authorized and approved, in accordance with National Institute of Standards and

Technology (NIST) Special Publication 800-53, *Recommended Security Controls for Federal Information Systems*, Section AC-2.

- OCIO management does not enforce a process for monitoring, reviewing, and signing-off on the audit logs [ex. 2]].

The majority of the above issues are consistent with findings identified by the Office of Inspector General (OIG) in past years. In fact, the OIG has identified IT security as a significant SBA management challenge since at least fiscal year 2000.

Recommendations – Security Access Controls:

We recommend that the Chief Information Officer (CIO) coordinate with SBA program offices to:

4. Improve the vulnerability tracking and monitoring process to include unresolved vulnerabilities in the [ex. 2] POA&M.

5. [ex 2]].

6. Develop a more thorough approach to track and mitigate patch management and configuration management vulnerabilities identified during [ex. 2] scans.

7. Prevent users from [ex. 2]] to the [ex. 2]] by developing and implementing procedures for ensuring mandatory [ex. 2]].

8. Implement controls to comply with SOP 90-47.2 regarding the validation of [ex. 2]] to the data center.

9. Implement procedures to control the process for requesting and granting access to the [ex. 2] system, and implement procedures to retain the appropriate approval evidence for tracking and validation.

10. Implement a process to monitor the audit logs of all [ex. 2]] on a regular basis.

Software Program Changes

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

Exhibit II

U.S. Small Business Administration

Significant Deficiency

A summary of the software program change control deficiencies we identified during the fiscal year 2009 SBA financial statement audit follow:

- An agency-wide change control process has not been implemented, and the Enterprise Change Control Board (ECCB) charter is in draft form. In fiscal year 2008, the Office of the Chief Information Officer (OCIO) stated that the ECCB charter would be implemented and that it would adhere to the IT Infrastructure Library.

- The OCIO was unable to provide evidence that (1) testing and approvals were performed for six of eight selected LAN\WAN operating system changes, (2) testing and approvals were performed for eight of eight selected Financial Reporting Information System (FRIS) operating system changes, and (3) the listing of JAAMS operating system changes was complete and accurate.

- The OCIO was unable to provide evidence that changes to the LAN/WAN were appropriately tracked, approved, and implemented for the selected sample of seven application changes.

- Change controls to management LAN/WAN emergency changes were not sufficient. The OCIO was unable to provide testing results and approvals for two of the three selected emergency changes.

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

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

Recommendations – Software Program Changes:

We recommend the CIO:

11. Oversee the development of a finalized ECCB charter that is supported by a promulgated SOP.

12. Implement procedures for documenting operating system, software, and emergency change testing results, testing approvals, and final approvals. Specifically, such procedures and controls need to be applied for the LAN\WAN.

We recommend the CFO:

13. Implement a process to capture all change requests for JAAMS.

14. Ensure consistent application of procedures for documenting operating system change testing results, testing approvals, and final approvals. Specifically, such procedures and controls need to be applied for the FRIS.

U.S. Small Business Administration

Significant Deficiency

End-user Computing

End-user computing tools/programs (e.g., spreadsheets and other user-developed programs) present the need for a unique set of general control procedures within an organization. By its nature, end-user computing brings the development and processing of information systems closer to the user. End-user computing capabilities typically include access to any end-user developed programs or objects, such as spreadsheets that contain critical data/information. Critical data/information could include personally identifiable information (PII) and financial data. While this environment may not typically be subjected to the same level of rigor and structure as an IT general controls environment, policies and procedures in this area are important to the overall IT environment. During our follow-up on this prior year deficiency, we noted that the policy and procedure has been drafted, but, had yet to be finalized, approved, and implemented in the SBA environment.

Recommendations – End-user Computing:

15. We recommend the Senior Policy Analyst in the Office of the Administrator coordinate with program offices using end-user programs containing sensitive data, such as PII and financial data, to implement end-user computing procedures in accordance with the guidance provided by the OCIO.

Exhibit III

U.S. Small Business Administration

Status of Prior Year Significant Deficiency

Fiscal Year 2008 Finding	Fiscal Year 2009 Status of Finding
1. Improvement needed in management information technology security controls	During our review of SBA's information technology (IT) general and application controls, we noted improvements in remote access authorizations, Cer. 2] sanitization over sensitive media, and user account recertification for the Loan Accounting System and the LAN/WAN. However, we continued to identify opportunities for SBA to improve its internal controls. The control deficiencies that continue to exist are in the following areas: security access controls, software program changes, and end-user computing. This year, we also noted weaknesses in port security and the monitoring of system audit logs. Therefore, in fiscal year 2009, the presentation of the issue was modified to reflect current year operations, and we continue to report a significant deficiency in internal controls as it relates to IT systems and their impact on the consolidated financial statements. See Exhibit I for additional information.

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

DATE: November 13, 2009

TO: Debra Ritt, Assistant IG for Auditing

Ex. 6]

FROM: Jonathan Carver, Chief Financial Officer

SUBJECT: Draft Audit Report on FY 2009 Financial Statements

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

We are delighted that the SBA has again received an unqualified audit opinion from the independent auditor. We believe these results accurately reflect the quality of the Agency's financial statements and our improved accounting, budgeting and reporting processes. As you know, the SBA has worked hard over the past several years to address the findings from our independent auditors. Our core financial reporting data and processes have improved substantially and we are proud that the results of our efforts have been confirmed by the independent auditor. The draft audit report contains a material weakness concerning controls around the Liability for Loan Guaranties (LLG) and the Return On Assets (ROA). This calculation is performed once a year under severe time constraints. The SBA has procedures in place for this calculation; however due to time constraints the procedure was not completely followed. SBA will improve the process controls around Loan Liability Guaranties (LLG) and Return On Assets (ROA) in order to mitigate the significant time constraints during the audit. It is notable that this error was corrected within hours upon notification by the auditors.

The audit report includes a continuing significant deficiency in the SBA's information technology controls. As the auditors noted in their report on the 2009 financial statements, the SBA made substantial progress in resolving IT deficiencies. The SBA will continue to improve the Agency's IT security during the upcoming fiscal year. The SBA is developing plans to track, monitor, and aggressively mitigate vulnerabilities in all agency systems. Furthermore, the SBA will clarify and strengthen detailed procedures

required to ensure security access controls are in place to protect SBA data from unauthorized modification, disclosure, and loss.

The audit report contains one instance of non-compliance with applicable laws and regulations as of September 30, 2009 that the SBA identified. During FY 2009, the SBA did not refer a substantial number of loans to the Treasury Department for cross-servicing or for the Treasury offset. The SBA management team established a Debt Collection Improvement Act (DCIA) team to tackle the problem comprised of members from the Offices of Capital Access, Chief Financial Officer and Chief Information Officer. The root of this error was identified as a system coding error. The error has since been corrected and additional resources have been allocated to refer these loans to the Treasury within the next six months. A mitigation plan is in place to ensure that this error does not occur in the future.

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