



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

TRANSMITTAL MEMORANDUM
Report No. 13-09

DATE: December 12, 2012

To: Jonathan I. Carver
Chief Financial Officer

FROM: John K. Needham /s/
Assistant Inspector General for Auditing

SUBJECT: KPMG Management Letter Communicating Matters Relative to SBA's FY 2012
Financial Statement Audit

The attached Management Letter identifies matters that were identified during the audit of the SBA's FY 2012 financial statements. The audit was performed by KPMG LLP, an independent public accountant, under a contract with the Office of Inspector General and in accordance with *Generally Accepted Government Auditing Standards*; Office of Management and Budget's (OMB) Bulletin No. 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 Management Letter addressed recommendations to the Associate Administrator for Capital Access; Chief Financial Officer; Chief Human Capital Officer; Office of Disaster, Assistance Deputy Administrative Officer; and Director for the Offices of Financial Assistance, Financial Program Operations, Information Systems Support, and Financial Analysis and Modeling. We provided a draft of KPMG LLP's report to each of these officials or their designees, who fully or substantially concurred with the findings relative to their respective areas. The officials or designees agreed to implement the recommendations or have already taken action to address the underlying conditions.

Should you have any questions, please contact Jeffrey Brindle, Director, Information Technology and Financial Management at (202) 205-7490.

Attachment



KPMG LLP
Suite 12000
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MANAGEMENT LETTER

November 14, 2012

CONFIDENTIAL

Inspector General,
U.S. Small Business Administration:

We have audited the consolidated financial statements of the U.S. Small Business Administration (SBA), as of September 30, 2012 and 2011, and for the years then ended, and have issued our report thereon dated November 14, 2012. We conducted our audit 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 Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended. In planning and performing our fiscal year 2012 audit, we considered the SBA's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the SBA's internal control. Accordingly, we do not express an opinion on the effectiveness of the SBA's internal control.

During our audit, we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management, are intended to improve internal control or result in other operating efficiencies, and are summarized in Exhibit I. The status of prior year comments is presented in Exhibit II.

In addition, we identified certain deficiencies in internal control that we consider to be a significant deficiency, and communicated them in our *Independent Auditors' Report* dated November 14, 2012.

Our audit procedures are designed primarily to enable us to form an opinion on the financial statements, and therefore may not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the SBA's organization gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

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

Very truly yours,

KPMG LLP

U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012

INADEQUATE REVIEW OF SBA'S RETURN ON ASSETS RE-ESTIMATE CASH FLOW MODELS

During our testwork over the Return on Assets cash flow models, we noted that SBA's America Recovery Capital, and 504 Program re-estimate models incorrectly calculated the net present value (NPV) of the remaining cash flows.

The America Recovery Capital Program re-estimate model incorrectly identified the first projected cash flow period as a historical cash flow, which caused the Credit Subsidy Calculator (CSC2) Tool to exclude it from the NPV remaining cash flows calculation. The 504 program re-estimate model for some cohorts was not updated with the new functionality developed for the model, which caused the first two projected cash flow periods to be excluded from the NPV calculation by the CSC2 Tool for eight cohorts across various 504 programs.

We recommend the Chief Financial Officer (CFO):

1. Enhances existing review procedures to ensure that the ROA re-estimate models are completely reviewed, and that management reviews and approves any changes/updates to the models.

Management's Response:

The SBA's management concurs with the finding and recommendation.

IMPROVEMENT IS NEEDED IN THE DOCUMENTATION OF THE OBLIGATIONS REVIEW PROCESS

The CFO does not have a current Standard Operating Procedure (SOP) that delegates specific responsibilities for creating an obligation, monitoring undelivered orders (UDO), and de-obligating funds in its accounting system (Oracle).

During our walkthrough of SBA's processes for reviewing its obligations, we noted that the CFO had issued a procedural notice that outlined the UDO review and close-out responsibilities of the Office of Planning and Budget and the Denver Finance Center staff. However, the notice is temporary and does not adequately address the responsibilities of the Denver Finance Center staff, which has been delegated the responsibility of initiating obligations and ensuring the timely de-obligation of UDOS in the accounting system.

We recommend the CFO:

2. Develops, formalizes, and implements a current SOP to include staff roles and responsibilities, specific criteria, and time frames for initiating, monitoring, and closing obligations. This SOP should include the specific titles of the personnel who are delegated these responsibilities.

U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012

Management's Response:

The SBA's management concurs with the finding and recommendation.

INADEQUATE CONTROLS OVER THE 7(a) 1502 ERROR PROCESS

As part of our audit procedures for the FY 2012 financial statement audit, we discussed the status of corrective actions the SBA had taken since FY 2011 to remediate the prior year finding. The responsible SBA management officials asserted to KPMG that Colson (the fiscal agent) had identified 16,044 errors in its *Lender Exception Report* dated April, 2012; while the SBA identified 34,812 errors for that same period.

In October 2012, SBA management officials asserted to KPMG that new edit checks/business rules had been implemented as of September 1, 2012. Due to the timing of the implementation and the completion of financial statement audit, it was not practical to perform audit procedures to determine if the new system was operating effectively for the FY 2012 audit. Given the aforementioned differences and the fact that the noted control issues covered the majority of the FY 2012, we considered this deficiency a repeat finding during FY 2012.

We recommend the Office of Financial Assistance (OFA) and Office of Information Systems Support Directors:

3. Continue to monitor the newly implemented system reports of loans with errors or non-reported loans to ensure accurate 1502 reporting.

We also recommend the Office of Financial Analysis and Modeling (OFAM) Director:

4. Performs a detailed analysis of the potential impact of the backlog of errors that were not remediated timely.

Management's Response:

The SBA's management concurs with the findings and recommendations.

INADEQUATE DOCUMENTATION OF POLICIES AND PROCEDURES FOR THE MICROLOAN PROGRAM

The Microloan Program provides loans to start-up, newly established, or growing small business concerns. Under this program, the SBA makes funds available to nonprofit community-based lenders (Intermediaries) that in turn, make loans to eligible borrowers in amounts up to a maximum of \$50,000. The average loan size is about \$13,500. Microloan applications are submitted to the local Intermediary and all credit decisions are made on the local level.

U.S. SMALL BUSINESS ADMINISTRATION
 Management Letter Comments
 FY 2012

The OFA Director has drafted and submitted an SOP that documents the operations and control activities of the Microloan Program to the Office of General Counsel. However, that SOP has not been published. Currently, staff and Intermediaries must rely on guidance provided in the Code of Federal Regulations, SOP's developed for other SBA loan programs, and "*Nuts and Bolts*" – *Loan Administration Guide for SBA Microloan Program Intermediary Lenders*. This guide provides basic information on borrowing and lending policies and procedures of the Microloan Program.

We recommend the OFA Director:

5. Finalizes and implements the Microloan Program SOP to enable consistency in the application of procedures.

Management's Response:

The SBA's management concurs with the finding and recommendation.

LOAN FILE DOCUMENTATION

During our testwork at the Sacramento Loan Processing Center, we noted that the following documentation was not retained in the loan files:

Loan Number	Missing Documentation
1. 4949385005	E-Tran funding screenprint which provides support for the funding check
2. 5132105002	Loan application and the Loan Officers Report, documenting the review and approval of the loan

We recommend the Office of Financial Program Operations (OFPO) Director:

6. Performs quality control reviews over the loan files to ensure that all relevant documentation is retained prior to approval.
7. Reinforces, through the issuance of a memorandum or training, the importance of retaining all substantive loan documents such as the loan application and loan officer's report for all loan files.

Management's Response:

The SBA's management concurs with the findings and recommendations.

**U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012**

UNTIMELY PROCESSING OF MICROLOAN TRANSACTIONS AND IMPROPER INTERMEDIARY LENDING PILOT PROGRAM DISBURSEMENTS

During our testwork over loan disbursements and adjustments for SBA’s Intermediary Lending Pilot and Microloan Programs, we noted the following:

Loan Number	Deficiency Noted
1. 4816035001	Disbursement amount (\$600,000) exceeded the established maximum dollar threshold
2. 3441995005	Loan cancellation exceeded two years
3. 4268604204	Loan cancellation exceeded four years

We recommend the OFA Director:

8. Provides training to SBA staff regarding the Intermediary Lending Pilot Program requirements to ensure that all SBA policies and program requirements are followed.
9. Continues to review the inventory of Microloans on a quarterly basis and ensure that any outstanding actions are processed timely.

Management’s Response:

The SBA’s management concurs with the findings and recommendations.

UNTIMELY SITE VISITS FOR LOAN DEFAULTS

During our testwork over guaranty loan purchases the Little Rock Loan Servicing Center, we determined that a site visit was not performed within 60 days of default for the following four loans, [Ex. 4] , [Ex. 4] , [Ex. 4] , and [Ex. 4] .

We recommend the OFPO Director:

10. Reinforces, through the issuance of memorandum, the importance of a site visit for each loan prior to purchase; and that all site visits must be completed within 60 days to be in compliance with SOP requirements.

Management’s Response:

The SBA’s management concurs with the finding and recommendation.

**U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012**

UNTIMELY PROCESSING OF CHARGED-OFF LOANS

During our testwork over direct loan charge-offs at the Little Rock Loan Servicing Center and Headquarters, we noted a significant time lag regarding the review and/or charge-off of loan numbers [Ex. 4] , [Ex. 4] , [Ex. 4] , and [Ex. 4] . These time lags ranged between one and five years.

We recommend the OFPO Director:

11. Performs a review of direct loans currently in liquidation status to identify loans that were partially processed in the Q-Term system and are still awaiting final approval.
12. Performs a review of direct loans in liquidation and not assigned to a disaster servicing center to determine if they are ready to be charged-off.
13. Performs quarterly reviews of the inventory of direct loans in liquidation status to ensure that the charge-off transactions occur timely and in the appropriate fiscal year.

Management's Response:

The SBA's management concurs with the findings and recommendations.

UNTIMELY POST-PURCHASE AND CHARGE-OFF REVIEWS

During our testwork over 7(a) guaranty loan purchases at the Herndon National Guaranty Purchase Center and Small Business Investment Company (SBIC) loan charge-offs at Headquarters, we noted the following:

Loan Type	Loan Number	Deficiency
7(a)	[Ex. 4]	Loan purchased in December 2011 – no post purchase review conducted
7(a)	[Ex. 4] [Ex. 4] [Ex. 4]	Three to seven year delay between loan purchase and charge-off
SBIC	[Ex. 4]	Six year delay regarding the charge-off approval and recording by Denver Finance Center staff

We recommend the OFPO Director:

14. Reinforces the need to review the *Post Purchase Work in Process Report* at the Herndon National Guaranty Purchase Center to ensure that post purchase reviews are completed timely.
15. Leverages the existing quarterly reviews of the inventory of purchased loans to ensure that loan charge-offs occur timely and in the appropriate fiscal year.

U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012

We recommend the CFO:

16. Collaborates with the Denver Finance Center Director to follow-up on SBIC loan charge-offs that are not timely recorded.

Management's Response:

The SBA's management concurs with the findings and recommendations.

INADEQUATE AND UNTIMELY FOLLOW-UP ON CORRECTIVE ACTIONS

During this year's review of SBA's lender oversight activities for its 7(a) and 504 Loan Programs, we found the Office of Credit Risk Management had not adequately and timely followed-up with lenders regarding their proposed corrective actions:

- West Central Partner, a Certified Development Company/lender in the 504 Program, voiced objections to the findings outlined in its *On-site Risk Based Review Report*. Their report was categorized "Less than Acceptable with Corrective Actions Required." There was no documented correspondence with the lender for over 252 days regarding SBA's assessment of the lenders' response, or if the lender was formalizing an appeal.
- Pacific Mercantile Bank, a 7(a) lender, submitted a response regarding its *On-site Risk Based Review Report* that was categorized "Acceptable with Corrective Actions Required." There was no documented correspondence with the lender for 150 days regarding the status of the corrective actions and/or SBA's assessment of the response.

We recommend the Associate Administrator for Capital Access:

17. Continue to develop and implement a feasible organization structure that would facilitate the timely follow-up and monitoring of deficient lenders, while at the same time ensuring adequate and timely review of all participating lenders in both the 7(a) and 504 programs.
18. Continue to develop and implement policies and procedures that ensure a timely and quality follow-up of lender corrective actions.

Management's Response:

The SBA's management concurs with the findings and recommendations.

U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012

IMPROVEMENTS NEEDED IN TIME AND ATTENDANCE AUTHORIZATION, REVIEW, AND CERTIFICATION PROCESSES

During our testwork over 45 System for Time and Attendance Reporting (STAR) Time & Attendance (T&A) Reports and supporting documentation for amounts certified, we noted the following deficiencies:

- Five STAR T&A Reports were signed and dated after the payroll disbursement date.
- One Office of Personnel Management Form 71, "Request for Leave or Approved Absence" was omitted from the employee's file.
- Two SBA 454, "Request to Work Overtime" forms were omitted from the employees' files.

We recommend the Chief Human Capital Officer and the Office of Disaster Assistance Deputy Administrative Officer:

19. Continue to reinforce policies and procedures regarding the certification of STAR T&A Reports with supervisors and timekeepers (i.e., issuance of a memorandum, training).
20. Continue to perform periodic quality assurance reviews to ensure supervisors and timekeepers are properly certifying and dating all STAR T&A Reports.

Management's Response:

The SBA's management concurs with the findings and recommendations.

IMPROVEMENT NEEDED IN THE EMPLOYEE SEPARATION PROCESS

During our review of internal control over SBA's employee separation process, we reviewed 30 files for evidence of a completed SBA Form 78, "Separation Checklist Form" (Checklist), SF-50, "Notification of Personnel Actions," and the related payroll population for any subsequent payroll transactions.

We found that 29 of the 30 Checklists were not properly completed in accordance with the instructions provided on the Checklist or in the governing SOP. More specifically, employees did not obtain clearances from SBA administrative offices where their supervisor had indicated a clearance was required. The Office of Human Resource Solutions was unable to provide the remaining Checklist.

We recommend the Chief Human Capital Officer:

21. Continues to provide training to all SBA managers and supervisors regarding the completion and acceptance of an employee's Checklist. The training should emphasize that managers and supervisors are responsible for returning the completed Checklist to the Servicing Human Resources Office.

U.S. SMALL BUSINESS ADMINISTRATION
Management Letter Comments
FY 2012

22. Continues to encourage SBA managers and supervisors to start an employee's separation process at least two weeks prior to their departure date. This will allow the employee adequate time to obtain all required signatures on the Checklist.
23. Continues to reinforce the policies and procedures that require staff in the Office of Human Resource Solutions to fully review employees' Checklists, ensuring that all required fields are completed prior to their acceptance and sign-off.
24. Develops and implements administrative actions for SBA officials who do not consistently adhere to the separation policy outlined in the SOP.
25. Establishes procedures to ensure the Servicing Human Resources Office timely receives all employees' Checklists and submits them to the Payroll Processing Branch for filing in accordance with the SBA's records retention schedule.

Management's Response:

The SBA's management concurs with the findings and recommendations.

U.S. Small Business Administration

Status of Prior Year Comments

FY 2012

Fiscal Year 2011 Comments	Fiscal Year 2012 Status
<i>Management Letter</i>	
Noncompliance with the Debt Collection Improvement Act of 1996	Revised and repeated in the <i>Independent Auditors' Report</i> dated November 14, 2012
Inadequate Review of Required Supplementary Stewardship Information	Resolved
Improvement is Needed in the Open Obligations Review Process	Revised and repeated in Exhibit I, page 1, under the following heading: <ul style="list-style-type: none"> • <i>Improvement is Needed in the Documentation of the Obligations Review Process</i>
Controls Needed for Vendor File Maintenance	Resolved
Untimely Follow-up on Lender Oversight Corrective Actions	Revised and repeated in Exhibit I, page 6, under the following heading: <ul style="list-style-type: none"> • <i>Inadequate and Untimely Follow-up on Corrective Actions</i>
Inadequate Controls over the 1502 Error Process	Revised and repeated in Exhibit I, page 2, under the following heading: <ul style="list-style-type: none"> • <i>Inadequate Controls over the 7(a) 1502 Error Process</i>
Inadequate Reviews of Guaranty Loan Charge-offs and Purchases	Resolved
Missing Loan Documentation	Revised and repeated in Exhibit I, page 3, under the following heading: <ul style="list-style-type: none"> • <i>Loan File Documentation</i>

U.S. Small Business Administration

Status of Prior Year Comments

FY 2012

<p>Untimely Post-Purchase Reviews</p>	<p>Revised and repeated in Exhibit I, page 5, under the following heading:</p> <ul style="list-style-type: none"> • <i>Untimely Post-Purchase and Charge-off Reviews</i>
<p>Improper Payment- Incorrect Amount Paid at Time of the Loan Guaranty Purchase</p>	<p>Resolved</p>
<p>Inadequate Review of Star Time and Attendance Reports</p>	<p>Revised and repeated in Exhibit I, page 7, under the following heading:</p> <ul style="list-style-type: none"> • <i>Improvements Needed in Time and Attendance Authorization, Review, and Certification Processes</i>
<p>Improvement Needed in the Employee Separation Process</p>	<p>Revised and repeated in Exhibit I, page 7, under the following heading:</p> <ul style="list-style-type: none"> • <i>Improvement Needed in the Employee Separation Process</i>