Testimony of
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Financial Management
Committee on Government Reform
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Congressman Platts, Congressman Towns, and members of the subcommittee: I appreciate the opportunity to appear before you today to discuss the Small Business Administration's financial statements, and answer your questions. My following statement will briefly cover two topics: Our audits for FYs 2000 to 2002; and, prospectively, enhancing SBA's financial management.

Cotton & Company's audits of SBA's 2000 to 2002 financial statements

SBA's financial statements rely heavily on accounting estimates to approximate both the value of the agency's loan portfolio and the subsidy costs of its several loan programs, by cohort year. These estimates are made by modeling the agency's historical cash flows and other loan data since the inception of the Credit Reform Act of 1990. SBA uses models for estimating its original subsidy costs, and reestimating such costs in each succeeding year. While the models generally are complex, a key premise in SBA's disaster loan models has been that one illustrative loan can serve as an effective proxy for all loans made to individuals, and another illustrative loan can do the same for businesses. When the single-proxy premise was adopted, loan sales were not anticipated.

SBA first began selling its loans during 1999, and commenced large-scale loan sales the following year. The preponderance of loans sold to date has come from SBA's disaster loan portfolio. It is important to mention that SBA appears to be the sole federal agency tasked to date with selling material portions of loan portfolio cohorts, rather than selling entire cohorts. Selling material portions of cohorts leads to substantially greater accountability challenges, because of the need to track subsidy costs by cohort for loans sold and loans kept.

Recognizing the inherent uncertainty in accounting estimates, we performed substantial evaluations during each year's audit of SBA's estimating methods and tested their results. In the audit of SBA's FY 2000 financial statements, we found that book value losses on disaster loan sales were not included in the required disaster loan subsidy cost reestimates. To account for this cost, we recommended that the financial statements include an imputed subsidy reestimate of $468 million, which was the estimated amount needed to cover these losses as SBA had computed them. SBA accepted this recommendation and recorded an adjustment to its financial statements.

In the audit of SBA's FY 2001 financial statements, we found that cash flow models included (for the first time) the effects of loan sales, but the reestimated subsidy costs derived from the disaster models were substantially smaller than expected based on previous work. To resolve this apparent inconsistency, both SBA and we performed additional analysis of the subsidy estimates. That additional analysis generally confirmed that the estimated subsidy costs were consistent with what was being reported in the financing account.

You asked us to specifically address why SBA received clean opinions on its 2000 and 2001 financial statements when the accounting for loan asset sales was flawed. As others on this panel have already explained more eloquently than I can, credit reform is an extremely complex area. Partial cohort asset sales exacerbated those complexities significantly beginning in 2000. We recognized these compounded complexities, and we did extraordinary procedures to test the methodology and underlying data. The modeling flaws that are now apparent escaped our detection. Many expert eyes have looked at the estimation model and methodologies over the years. Indeed, part of our testing included coordination with and reliance upon those experts. The modeling flaws escaped everyone's detection. But, the responsibility for the audit opinion is ours and ours alone. When the inaccuracies in the estimates subsequently became evident in 2002, we did the right thing. We took steps, with SBA's cooperation, to prevent continued reliance on the financial statements. Withdrawing an audit opinion is not an easy thing to do or something that we take lightly. (In doing audits for more than 22 years, Cotton & Company LLP has never before had to withdraw an audit opinion.) In this case, it was the right thing to do.

During the audit of SBA's FY 2002 financial statements, our work demonstrated that SBA's disaster loan models were not reliable—the single-loan proxy premise became inadequate when substantial loan sales began. It did so because a single proxy loan cannot produce reliable projected cash flows when the:

- Portfolio is diverse.
- Cost of any loan increases with the loan term (terms vary from 1 to 30 years).
- Average term of loans sold is several years longer than that of the original portfolio.

The unreliability of the modeled data raised uncertainties affecting SBA's budgetary and proprietary accountability. These uncertainties involved certain material line items reported on each of the agency's five principal financial statements and related footnote disclosures since the inception of SBA's substantial loan sales in 2000. According to auditing standards, we withdrew our unqualified opinions on the FY 2000 and 2001 financial statements, and we disclaimed an opinion on SBA's most recent comparative financial statements, covering 2001 and 2002.

Enhancing SBA's Financial Management

We understand SBA will be implementing a number of financial management enhancements in support of its goal of improving financial statement reliability. We cannot overstate, however, the value that SBA's "lessons learned" will have for the federal credit reform community at large. Among other "lessons learned," we think SBA can and will convey the importance of testing subsidy models, such that other agencies subject to the Credit Reform Act can timely satisfy themselves that the cash flow models they use for subsidy estimates and reestimates are adequate to account for the cost of loan sales. Other agencies may thereby be able to avoid the difficulties SBA recently has experienced, and preserve their accountability.

SBA can enhance its financial management by implementing the following controls:

1. Assessing the conceptual soundness of subsidy estimation models and rebuilding any models that otherwise may produce unreliable results in the foreseeable future.

2. Ensuring that the documentation requirements of Federal Financial Accounting and Auditing Technical Release No. 3, *Preparing and Auditing Direct Loan and Loan Guarantee Subsidies under the Federal Credit Reform Act*, are met.

3. Developing an objectively verifiable estimate for pre-1992 guarantee loan default liability utilizing risk factors in accordance with SFFAS No. 2; maintaining sufficient documentation to support the assumptions in the calculation model; and performing a

thorough analysis to ensure that liquidating fund account balances and account activity are accounted for and presented in accordance with SFFAS No. 2.

4. Assessing whether SBA has devoted sufficient resources to adequately address its current financial reporting shortcomings and determine if the current process will need re-engineering and additional resources to enable SBA to meet accelerated financial reporting deadlines in future years.

5. Performing fluctuation analyses and determining reasons for all material changes in all financial statement account balances to permit inaccuracies that become obvious while performing such analyses to be corrected before submitting draft financial statements.

6. Re-engineering and enhancing its financial-reporting quality control process, to achieve minimum reliability expectations for draft financial statements.

7. Developing and implementing procedures to review obligated and unobligated balances remaining in liquidating funds at the end of the fiscal year, and de-obligating unneeded undelivered orders and returning them to the general fund at the end of each fiscal year.

8. Developing and implementing an integrated funds control system that allots the lesser of apportioned authority or realized resources at the fund and cohort level.

9. Developing and implementing a process to ensure that apportionment amounts are accurately recorded in SBA's GL, which includes documented supervisory reviews as necessary to reasonably assure reliability.

10. Developing a process for estimating SBA's ownership in earnings from the MRF that provides accurate, complete, and timely data for the financial statements.

We understand that SBA began its ambitious plans for improving its controls and systems late last summer—during last year's audit. In brief, the attached exhibit displays where SBA stands regarding implementation.

We expect to monitor SBA's progress during the FY 2003 audit, and will continue to watch for and recommend improvements, where warranted. In addition, we are taking steps to enhance and increase our audit focus in the credit reform aspects of the audit. These steps include adding a high-profile credit reform expert to complement our existing credit reform resources, increased involvement by another one of our partners with recognized credit reform experience (Catherine Nocera, CPA) and identification of an outside expert to "peer review" our credit reform testing. We also have agreed with GAO that we will coordinate more closely with their credit reform experts before the audit is completed. Finally, the SBA OIG plans to provide further support and assistance during the audit.

I will be pleased to answer your questions.