Testimony of
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before the
Subcommittee on Government Efficiency and
Financial Management
Committee on Government Reform
U.S. House of Representatives
April 29, 2003

Good morning. I join with others in thanking you for the opportunity to discuss SBA's loan sales and financial reporting.

Before presenting my testimony, I should state that I have worked in three capacities related to SBA's credit programs. From 1986 to 2001, I worked for the Office of Management and Budget and had a substantial role in the implementation of credit reform, including the development of the concepts and methods used for estimating credit subsidies. My OMB work included a significant amount of work specifically with SBA's credit programs. I retired from OMB in 2001. From June 2002 through January 2003, I was an advisor to the audit team for Cotton & Company. In that capacity, I contributed the analysis of the disaster loan sales and the Master Reserve Fund, which, in turn, contributed to the disclaimed opinion. Then, in March 2003, several weeks after the audit engagement was concluded, SBA contracted with me to advise them on the resolution of the disaster loan issue.

This morning, my testimony will focus on three themes drawn from my experience with the 2002 financial audit:

> First, on the role of credit estimates in financial statements;
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> Second, on the current state of standards and guidance for estimates used in accounting for loan asset sales; and,
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> Third, on the need to help other Federal credit agencies benefit from SBA's recent experience.

You have already heard that SBA's financial statements received a disclaimed opinion largely, though not exclusively, because the gain or loss on over $5 billion in loan sales could not be stated accurately. I will add a few details to what you have heard already to lay the basis for a point I wish to make.

The gain or loss on loan sales is substantially determined by *estimates* of loan cash flows

Briefly, a loan sale results in a gain when the <u>net proceeds</u> from the sale exceed the <u>book value</u> of the loans sold and a loss when the opposite is the case. In this equation, the net proceeds are calculated using actual cash transactions. However, the book value, contrary to what the name might suggest, is a present value calculation of the estimated cash flows that would have taken place had the loans been kept rather than sold.

In drawing attention to the distinction between actual accounting for cash transactions and cash flow estimates, I wish to emphasize where we must go to find solutions. The problems that led to a disclaimed opinion on SBA's financial statement did not result from errors in accounting for the cash proceeds. The problems resulted from faults in the statistical model used by SBA estimate the remaining cash flows. Therefore, the problems will be resolved by replacing the existing disaster loan with a new model that meets all standards – both explicit and implied – and provides cash flow estimates on a loan-by-loan basis. This is exactly what SBA has engaged me to assist them in doing.

The distinction between estimates and actual accounting transactions is important for another reason. While there is a substantial body of standards for the accounting of actual cash transactions, the body of standards for estimates, particularly as regards future cash flows for Federal credit programs, does not have the same degree of evolution and refinement.

And, this leads to my second theme.

Standards and guidance for estimates need to evolve further

In recent years, the disaster loan model has been the subject of a broad review. In addition to SBA staff and SBA's auditors, the model was reviewed by outside firms to validate its methods and by OMB and GAO. I am not aware of any instance where the fundamental issue – that the model could not adequately identify the cash flows of loans sold and, therefore, the book value of loans sold – was identified.

The failure to identify a serious defect, despite the time and talent available, is curious indeed. In my view, it cannot be attributed to a lack of seriousness of purpose or shortfall in professional capabilities among those involved. Based on my professional contact and experience, I have a high regard for the capabilities and dedication of all who were involved.

Instead, I would like to suggest another explanation: that the standards and guidance for such estimates did not evolve as quickly as was needed. In particular, while guidance is provided for cash flow estimates and, elsewhere, guidance is provided for loan sales, there is little guidance provided regarding the *incremental* requirements for cash flow estimates when they are used for loan sales.

I believe it is fair to say that, as a result of SBA's experience with disaster loans, more explicit guidance can be given now for the preparation of estimates used for loan sales. Had the need for such guidance been apparent earlier, I believe it would have been made available. If so, it would have accelerated the diagnosis of this problem and repairing the defects.

In any case, I trust that this experience will have a beneficial effect on the evolution of standards and guidance in this area.

Other credit agencies can benefit from SBA's experience

My final theme is a suggestion for how other credit agencies can benefit from SBA's experience. Other agencies are currently selling loan assets and additional agencies may sell them in the future. As we move toward a solution for the disaster loan program, I would encourage the development of a "lessons learned" document in which all of the parties – SBA, OMB, GAO, and SBA's auditors – contribute freely to a broad discussion that covers:

> The origins of the disaster loan defects and other areas where credit agencies might look for similar defects;
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> The kinds of changes in cash flow models and related methods that are required when loans sales are contemplated; and,
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> The specific ways in which standards, guidance, and case studies can be improved.

Thank you and I look forward to your questions.