



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

**AUDIT REPORT**

**Issue Date: January 22, 2001**

**Number: 1-04**

**To:** Robert J. Moffitt  
Associate Administrator, Office of Surety Guarantees

[ FOIA EX-6 ]

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

**Subject:** Audit of National American Insurance Company

Attached is the audit report on National American Insurance Company issued by Cotton & Company, LLP. The report discusses the following issues: (1) SBA was not timely notified of a principal's default on one bond, (2) incomplete underwriting information was maintained for one bond, and (3) written policies and procedures are needed for underwriting and servicing all SBA guaranteed bonds.

You may release this report to the duly authorized representative of National American Insurance Company. The findings included in this report are based on the auditors' conclusions. The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution. Please provide us your proposed management decision for each recommendation on the attached forms 1824, Recommended Action Sheet, within 80 days.

This report may contain proprietary information subject to the provisions of 18 USC 1905. Therefore, you should not release this report to the public or another agency without permission of the Office of Inspector General. Should you or your staff have any questions, please contact Robert Hultberg, Business Development Programs Group at (202) 205-7577.

Attachments

**INDEPENDENT ACCOUNTANT'S  
REPORT ON THE PERFORMANCE AUDIT OF  
NATIONAL AMERICAN INSURANCE COMPANY**

**Performed by:**

**Cotton & Company LLP  
Certified Public Accountants  
333 North Fairfax Street, Suite 401  
Alexandria, Virginia 22314**

# COTTON & COMPANY LLP

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September 29, 2000

U.S. Small Business Administration  
Office of Inspector General

## BACKGROUND

The Small Business Investment Act of 1958, as amended, authorized the Small Business Administration's (SBA) Surety Bond Guarantee Program (SBG) to assist small, emerging, and minority construction contractors. SBA indemnifies surety companies from potential losses by providing a Government guarantee on bonds issued to such contractors. SBA guarantees up to 90 percent for contracts not exceeding \$1.25 million. SBA's Office of Surety Guarantees (OSG) administers the SBG program.

## OBJECTIVE, SCOPE AND METHODOLOGY

SBA's Office of Inspector General (OIG) requested Cotton & Company LLP to conduct a performance audit of National American Insurance Company. The primary objectives were to determine if:

1. National complied with policies and procedures, including SBA's policies and standards generally accepted by the surety industry, in issuing SBA guaranteed bonds.
2. Claims and expenses submitted to SBA were allowable, allocable, and reasonable.
3. Fees due SBA were accurately calculated and remitted in a timely manner.

We obtained the universe of six bonds for which SBA had paid claims from October 1, 1996, through September 30, 1999. We judgmentally selected two sample bonds based on the largest claim amounts. In addition we selected one bond with claims activity that was originally approved in Fiscal Year (FY) 1997. We also selected one additional bond that was originally approved in FY 1999 for underwriting review only. Thus, our total sample size was 4 bonds with claims (net of recoveries) totaling [ Ex. 4 ] This represents 97 percent of the [ Ex. 4 ] total claim payments (net of recoveries) per SBA's Claim Payment History Reports.

We tested sample bonds for compliance with SBA regulations for underwriting and fees by reviewing underwriting files and National's accounting records. We tested claims incurred under sample bonds from October 1, 1996, through September 30, 1999, by reviewing National's supporting documentation in the claim files and accounting records. We obtained a list of all SBA-guaranteed final bonds from October 1, 1996, through September 30, 1999, and identified contractors with total bonds

exceeding \$1.25 million for contracts with the same obligee and bond issue dates within several months. We then reviewed project descriptions to determine if the bonds were for a single project divided into more than one contract.

We conducted fieldwork during September 2000 at National's offices in Chandler, Oklahoma. The audit was conducted in accordance with *Government Auditing Standards*, as revised, except as described below.

### FOLLOW-UP ON PRIOR AUDITS

The scope of our audit did not include following up on findings and recommendations from previous audit reports.

### AUDIT RESULTS AND RECOMMENDATIONS

We noted that National correctly calculated and remitted fees to SBA in a timely manner. We also noted, however, that National did not always comply with SBA regulations for underwriting bonds and processing claim payments. Specifically, National did not notify SBA of default for one bond in a timely manner or maintain complete underwriting documentation for another bond, as required by SBA regulations.

We concluded that management and financial controls were adequate to protect assets and prevent errors and fraud. We also concluded, however, that National did not comply in all material respects with SBA regulations.

We conducted an exit conference with National personnel on September 29, 2000. National representatives generally agreed with factual aspects of the findings.

Our findings and recommendations are discussed in detail below.

#### Timely Notification of Default

National did not notify SBA in a timely manner of the default of the principal for one of the three bonds reviewed with claims activity:

Contractor Name	SBG No.	Bond Default Date	Date SBA Notified
[ EX. 4 ]		April 13, 1998	July 28, 1999

Title 13 CFR 115.35, Claims for Reimbursement of Losses, defines events requiring notification as follows:

A Prior Approval Surety must notify OSG of the occurrence of any of the following:...(ii) The Obligee has declared the Principal to be in default...(iv) The Surety has received any adverse information concerning the Principal's financial condition or possible inability to complete the project or to pay laborers or suppliers...Notification must be made in writing at the earlier of the time the Surety applies for a guarantee on behalf of an affected Principal, or within 30 days of the date the Surety acquired knowledge of, or should have acquired knowledge, of any of the listed events.

**Recommendation:** We recommend that the OSG Associate Administrator advise National to revise its policies and procedures to ensure that SBA is notified of all defaults as required.

**National Response:** In its response to the audit report (appendix) National stated that it has implemented procedures in the claims area to assure future timely notification.

### **Record Retention**

National did not maintain copies of the contract, power of attorney, or SBA underwriting forms Nos. 994, 994F, 912, 1261, and 1624 for one bond, as required. Further, National does not have written policies and procedures for underwriting SBA bonds and ensuring compliance with record retention requirements. National is required to provide critical underwriting documents that may be necessary to settle existing claims or to defend or enhance any litigation actions against either indemnitors, obligees, or other claimants.

Title 13 CFR 115.21, Audits and Investigations, requires a surety to maintain all documentation for the term of each bond, plus any additional time required to settle any claims for reimbursement from SBA and to attempt salvage or other recovery, plus an additional 3 years.

**Recommendations:** We recommend that the OSG Associate Administrator advise National to implement written policies and procedures for underwriting and servicing SBA-guaranteed bonds and revise its procedures to ensure that all required, completed documents are retained as required by SBA regulations.

**National Response:** In its response to the audit report (appendix) National stated that the incomplete underwriting information occurred due to a misunderstanding with the agent issuing the Bond. The agent forwarded the originals to the SBA and did not maintain copies of the documents. National further stated that corrective steps have been taken to avoid this in the future and it is in the process of preparing written policies and procedures for underwriting and servicing all SBA-guaranteed bonds.

### **SBA MANAGEMENT'S RESPONSE**

The Associate Administrator, Office of Surety Guarantees, stated he had reviewed the draft audit report and agreed with the auditor's recommendations. He also stated that his office would implement these recommendations upon completion of our audit, as appropriate.

COTTON & COMPANY, LLP

By: Michael W. Gillespie, CPA  
FCM EX 6

## SAMPLE BONDS

Sample No.	Surety Bond Guarantee Number	National American Bond No.	Contractor Name	Bond Approval Date	Bond Default Date
1	P				7
2					
3		FOIA	EX. 4		
4	L				1

N/A=Sample bond selected for underwriting review only.

**APPENDIX**

**NATIONAL AMERICAN INSURANCE COMPANY  
RESPONSE TO THE DRAFT REPORT**

# NATIONAL AMERICAN INSURANCE COMPANY



November 28, 2000

Robert G. Seabrooks  
Small Business Administration  
Office of Inspector General  
Auditing Division, Mail Code 4112  
409 3<sup>rd</sup> Street, S.W.  
Washington, DC 20416

Dear Mr. Seabrook,

We have reviewed the audit report prepared by Cotton & Company LLP dated September 29, 2000. I will respond to the three exceptions noted in the report.

1. *Untimely notification of a principal's default on one bond.* We have implemented procedures in our claims area to assure future timely notification.
2. *Incomplete underwriting information for one bond.* This occurred due to a misunderstanding with the agent issuing the bond. The agent forwarded the originals to the SBA and did not maintain copies of the documents. Corrective steps have been taken to avoid this in the future.
3. *Need written policies and procedures for underwriting and servicing all SBA-guaranteed bonds.* We are in the process of preparing these written policies and procedures.

If you need any additional information or response concerning the audit, please advise.

Sincerely,

F  
FOIA Ex. 6

Dwight A. Pilgrim  
Vice President-Surety



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