

INDEPENDENT ACCOUNTANTS'
REPORT ON THE PERFORMANCE AUDIT OF
FARMINGTON CASUALTY COMPANY

Performed by:

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



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

AUDIT REPORT
Issue Date: September 21, 2001
Number: 1-18

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

From: Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of Farmington Casualty Company

Attached is the audit report on Farmington Casualty Company issued by Cotton & Company LLP. The report discusses the following issues: (1) claim payments were not supported by invoices or other proof of claim for two bonds, (2) status reports were not requested and maintained for one bond, and (3) SBA was not notified in a timely manner of the default of the principal for one bond.

You may release this report to the duly authorized representative of Farmington Casualty 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

COTTON & COMPANY LLP

auditors • advisors

DAVID L. COTTON, CPA, CFE, CGFM • CHARLES HAYWARD, CPA, CFE, CISA • MICHAEL W. GILLESPIE, CPA, CFE • CATHERINE L. NOCERA, CPA
MATTHEW H. JOHNSON, CPA, CGFM • SAM HADLEY, CPA, CGFM • COLETTE Y. WILSON, CPA

March 30, 2001

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 (\$2 million effective January 25, 2001). 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 to conduct a performance audit of Farmington Casualty Company. The primary objectives were to determine if:

1. Farmington 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. Farmington accurately calculated fees due to SBA and remitted them in a timely manner.

We obtained the universe of bonds for which SBA had paid claims from October 1, 1997, through September 30, 2000. This universe contained 20 bonds, and we selected 4 as sample bonds for review. We also randomly selected one additional bond originally approved in [Ex. 4] for underwriting review only. Thus, our total sample size was 5 bonds with claims (net of recoveries) totaling [Ex. 4]. This represents [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 Farmington's accounting records. We tested claims incurred under sample bonds from October 1, 1997, through September 30, 2000, by reviewing Farmington's supporting documentation in the claim files and accounting records. We obtained a list of all SBA-guaranteed final bonds from October 1, 1997, through September 30, 2000, 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.

C&C
established 1982

FOIA Ex. 4

We conducted fieldwork during March 2001 at Farmington's offices in Philadelphia, Pennsylvania. The audit was conducted in accordance with *Government Auditing Standards*, 1994 Revision, 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

Farmington correctly calculated and remitted all sample bond fees to SBA in a timely manner. Farmington did not always comply with SBA regulations for underwriting and servicing bonds and processing claim payments. Specifically, Farmington did not maintain copies of invoices or other proof of claim to support claim payments for two of five bonds tested. In addition, Farmington did not request and maintain status reports in its files for one of five bonds tested or notify SBA of default for one bond in a timely manner as required by SBA regulations.

We concluded that management and financial controls were adequate to protect assets and prevent errors and fraud, except as follows. We concluded that Farmington did not comply in all material aspects with SBA regulations for obtaining and maintaining documents to support claim payments and status reports. We also concluded that Farmington did not have procedures in place to ensure timely notification of default to SBA.

We conducted an exit conference with Farmington personnel on March 30, 2001. They generally agreed with factual aspects of the findings.

Our findings and recommendations are discussed in detail below.

Unsupported Claims Payments

Farmington did not provide invoices or other proof of claim to support claim payments as follows:

Contractor	SBG Bond No.	Item	Amount
[Ex. 4]	
		Missing Invoices	\$68,179.69
		Missing Invoices	<u>3,129.61</u>
Total Claims Paid			<u>\$71,309.30</u>

We questioned SBA's 70-percent guaranteed portion of \$71,309.30, or \$49,916.51.

Sureties are required to maintain all documents for the term of each bond, plus any additional time required to settle reimbursement claims from SBA and to attempt salvage or other recovery, plus an additional 3 years [*Code of Federal Regulations* (CFR), Title 13, CFR 115.21, Audits and Investigations].

Recommendations: We recommend that the Associate Administrator, Office of Surety Guarantees:

- (1) Take appropriate actions to recover \$49,916.51 for the unsupported claim payments.
- (2) Advise Farmington to implement and enforce policies and procedures that would ensure future compliance for the retention of required documents in accordance with SBA regulations.

Progress Status Requests

Farmington did not request status reports from obligees and maintain such reports in its files for one of the five bonds tested for underwriting. For [Ex. 4] we found no documented evidence that status requests were obtained from the obligee. Farmington relied on its agent to comply with SBA requirements for requesting status reports, and the agent could not confirm that status reports were requested for the sample bond. If the viability and eligibility of guaranteed principals are not monitored, SBA exposure could be increased by the issuance of additional bonding to an affected principal.

Title 13, CFR 115.15, Underwriting and Servicing Standards, (b) Servicing, states:

The Surety must ensure that the Principal remains viable and eligible for SBA's Surety Bond Guarantee Program, must monitor the Principal's progress on bonded Contracts guaranteed by SBA, and must request job status requests from Obligees of Final Bonds guaranteed by SBA. Documentation of the job status requests must be maintained by the Surety.

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees advise Farmington to implement written policies and procedures to ensure that its agents comply with SBA's requirements for obtaining project status reports.

Timely Notification of Default

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

Contractor	SBG No.	Bond Default Date	Date SBA Notified
[Ex. 4]

Title 13 CFR 115.65, General PSB Procedures, (c)(2) Other Events Requiring Notification, states:

The PSB Surety must notify SBA within 30 calendar days of the name and address of any Principal against whom legal action on the bond has been instituted; whenever an Obligee has declared a default; whenever the surety has established or added to a claim reserve; of the recovery of any amounts on the guaranteed bond; and of any decision by the Surety to bond any such Principal again.

FOIA Ex. 4

Recommendation: We recommend that the Associate Administrator, Office of Surety Guarantees advise Farmington to review and revise its policies and procedures to ensure that SBA receives timely notification of default in accordance with SBA regulations.

SBA MANAGEMENT'S RESPONSE

The Associate Administrator, Office of Surety Guarantees (AA/OSG) disagreed with the recommendations in our draft audit report related to unsupported claim payments. He stated that he could request or notify, but cannot require sureties to do anything. He agreed with all other recommendations.

EVALUATION OF MANAGEMENT'S RESPONSE

SBA's Office of Inspector General, Counsel Division, opined on the AA/OSG's authority to recover questioned costs resulting from an audit. The Counsel Division concluded that the AA/OSG has broad authority to require corrective action of sureties that have violated SBA regulations. Accordingly, the AA/OSG has authority to require Farmington to substantiate its claims through appropriate documentation. If Farmington is unable to substantiate its claims, then the AA/OSG should notify Farmington that it has thirty days to repay the specified amounts to SBA in accordance with SBA regulations. If the amounts are not repaid, the AA/OSG should then pursue appropriate collection actions with the advice and assistance of SBA's Office of General Counsel. The disputed recommendations have been reworded in the audit report.

COTTON & COMPANY LLP

By: 
Michael W. Gillespie, CPA, CFE

APPENDIX

**FARMINGTON CASUALTY COMPANY
RESPONSE TO THE DRAFT REPORT**

Travelers Insurance
A member of citigroup



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July 9, 2001

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

Re: Report on Draft Audit Report for Farmington Casualty Co.
Performed by Conon & Company, LLP in March, 2001

Dear Mr. Seabrooks:

We received a draft copy of the Audit Report with regard to Farmington Casualty that was performed by Cotton & Company and, we wish to advise you that we generally find it to be in order. There were two claim files, however, that we were unable to produce sufficient documentation for the audit. In May of 2000, Travelers Insurance purchased the Reliance Surety book of business. As that transition occurred some claims handled in Philadelphia were transferred to other claim managers and other locations, and in that transition a few documents were misplaced. We are continuing to search those files to find the documents, and when we find them we will then forward them to you which will then complete the Audit.

If you have any further questions, please call me directly.

Sincerely,

Kim McNaughton
Kim McNaughton *JOB*

Cc: Doreen Spadorcia
Kevin Hughes

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