

**INDEPENDENT ACCOUNTANTS’
REPORT ON THE PERFORMANCE AUDIT OF
CNA SURETY COMPANIES**

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: February 28, 2002

Number: 2-06

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

From: Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of CNA Surety Companies

Attached is the audit report on CNA Surety Companies issued by Cotton & Company LLP. The report discusses the following issues: (1) status reports were not maintained for one bond, and (2) a duplicate claim payment was made on one bond that was reimbursed by SBA.

You may release this report to the duly authorized representative of CNA Surety Companies. 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 • COLLETTE Y. WILSON, CPA

November 20, 2001

U.S. Small Business Administration
Office of Inspector General

BACKGROUND

The Small Business Investment Act of 1958, as amended, authorized the U.S. 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 CNA Surety Companies (CNA). CNA Financial Corporation operates two surety companies that participate in SBA's Preferred Surety Program, Continental Casualty Company and American Casualty Company. The primary objectives were to determine if:

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

We obtained the universe of bonds identified by SBA as having claims activity from October 1, 1999, through September 30, 2001. This universe contained six bonds, and we selected three as sample bonds for review. We also randomly selected two additional bonds originally approved in Fiscal Years (FYs) 2000 and 2001 for underwriting review only. Thus, our total sample size was five bonds with claims (net of recoveries) totaling \$681,582.01. [FOIA Ex. 4]

We tested sample bonds for compliance with SBA regulations for underwriting and fees by reviewing underwriting files and CNA's accounting records. We tested claims incurred under sample bonds by reviewing CNA's supporting documentation in claim files and accounting records. We



obtained a list of all SBA-guaranteed final bonds from October 1, 1999, through September 30, 2001, and identified contractors with total bonds exceeding \$1.25 million (\$2 million for bonds issued after January 25, 2001) 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 in November 2001 at CNA's offices in Chicago, Illinois. The audit was conducted in accordance with *Government Auditing Standards*, 1994 Revision.

AUDIT RESULTS AND RECOMMENDATIONS

CNA correctly calculated and remitted all sample bond fees to SBA in a timely manner. CNA did not always comply with SBA regulations for underwriting and servicing bonds and processing claims. Specifically, we found no documented evidence that a status request was obtained from the obligee for one bond guarantee tested for underwriting standards. In addition, the claim files reviewed for one bond indicate that a duplicate payment was made to a claimant in the amount of \$4,052.87. SBA reimbursed the duplicate payment to CNA in the amount of the 70-percent guarantee rate, or \$2,837.01. As a result, we questioned \$2,837.01.

We concluded that management and financial controls were adequate to protect assets and prevent errors and fraud, except as noted below. We concluded that CNA did not comply in all material aspects with SBA regulations for obtaining and maintaining documents to support proper underwriting of SBA bond guarantees. We also concluded that CNA did not have procedures in place to ensure that it did not make duplicate claim payments.

We conducted an exit conference with CNA personnel on November 20, 2001. They generally agreed with factual aspects of the findings.

Our findings and recommendations are discussed in detail below.

Progress Status Reports

CNA did not request and maintain required obligee status reports for one of the five bonds tested in our sample. We found no evidence that CNA obtained status reports for a bond made to [FOIA Ex. 4].

Title 13, CFR 115.65, General PSB procedures, (b) states that the Surety must request job status reports from Obligees in accordance with its own procedures. CNA's policy is to request status reports from obligees for all bonds greater than \$500,000.

Recommendation: We recommend that the OSG Associate Administrator advise CNA to adhere to its own policy for maintaining job status reports.

Duplicate Payment

CNA made a duplicate payment for one bond in our sample, [FOIA Ex. 4]. CNA learned of the duplicate payment as a result of the audit and verified that the [FOIA Ex. 4] payment was a duplicate. CNA had previously requested reimbursement from SBA for both payments at the 70-percent guaranteed rate and was reimbursed \$2,837.01 for the duplicate payment.

Title 13 CFR 115.16, Determination of Surety's Loss, defines losses as:

Amounts actually paid by the Surety which are specifically allocable to the investigation, adjustment, negotiation, compromise, settlement of, resistance to a claim for Loss resulting from the breach of the terms of the bonded contract.

Recommendation: We recommend that the OSG Associate Administrator:

1. Take appropriate actions to recover \$2,837.01 for the amount of the duplicate claim payment.
2. Advise CNA to review and revise its policies and procedures to ensure that all further claims for reimbursement are allocable and allowable.

CNA's Response: CNA stated that they agree with the findings and recommendations outlined in the draft audit report and will be returning to the SBA Office of Surety Guarantees the \$2,837.01 relating to the duplicate payment made to American Construction Services (see appendix).

SBA MANAGEMENT'S RESPONSE

The Associate Administrator, Office of Surety Guarantees, agreed with the recommendations in our draft audit report. He stated that his office will implement the recommendations upon completion of the audit, as appropriate.

COTTON & COMPANY LLP

By: _____

Michael W. Gillespie, CPA. CFE

SAMPLE BONDS

Sample No.	Surety Bond Guarantee No.	CNA Bond No.	Contractor Name	Bond Approval Date	Bond Default Date
1	[FOIA Ex.4 and 6]				
2					
3					
4					
5					

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

APPENDIX

**CNA SURETY COMPANIES
RESPONSE TO THE DRAFT REPORT**



CNA Plaza Chicago IL 60685-0001

Ex. 6

February 14, 2002

Robert G. Seabrooks
U.S. Small Business Administration
Office of Inspector General
Auditing Division, Mail Code 4112
409 Third Street, S.W.
Washington, D.C. 20416

Re: Independent Accountants' 11/20/01 Draft Audit
Report on CNA Surety Companies

Dear Mr. Seabrooks:

Regarding your letter of January 30, 2002, we agree with the findings and recommendations outlined in the Independent Accountants' Draft Audit Report dated November 20, 2001. Further, we will be returning to the SBA / OSG the \$2,837.01 relating to the duplicate payment made on

Ex. 4 and 6

Sincerely,

Ex. 6

Cc:

Ex. 6

Robert Moffitt -- SBA / Office of Surety Guarantees

REPORT DISTRIBUTION

<u>Recipient</u>	<u>No. of Copies</u>
Associate Deputy Administrator for Capital Access	1
General Counsel.....	2
Office of the Chief Financial Officer Attention: [FOIA Ex. 6].....	1