



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

AUDIT REPORT

Issue Date: December 27, 2000

Number: 1-02

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

Robert G. Seabrooks

From: Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of American Contractors Indemnity Company

Attached is the audit report on American Contractors Indemnity Company issued by Cotton & Company, LLP. The report discusses the following issues: (1) untimely notification of the principal's default for three bonds, (2) incomplete underwriting documentation for two bonds, and (3) needed written policies and procedures for underwriting and servicing SBA guaranteed bonds.

You may release this report to the duly authorized representative of American Contractors. 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
AMERICAN CONTRACTORS INDEMNITY COMPANY**

Performed by:

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

COTTON & COMPANY LLP

CERTIFIED PUBLIC ACCOUNTANTS

333 NORTH FAIRFAX STREET • SUITE 401 • ALEXANDRIA, VIRGINIA 22314

CHARLES HAYWARD, CPA, CFE, CISA
MATTHEW H. JOHNSON, CPA, CCFM

DAVID L. COTTON, CPA, CFE, CCFM
MICHAEL W. GILLESPIE, CPA, CFE
SAM HADLEY, CPA, CCFM

CATHERINE L. NOCERA, CPA
COLETTE Y. WILSON, CPA

September 1, 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 American Contractors Indemnity Company, which is a prior approval surety. The primary objectives were to determine if:

1. American Contractors 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 15 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. We selected two other bonds originally approved in Fiscal Year (FY) 1998 with claims activity. Also, we randomly selected two bonds originally approved in FY 1999 for underwriting review only. Thus, our total sample size was six bonds with claims (net of recoveries) totaling \$858,171. This represents 87 percent of the \$989,628 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 American Contractors' accounting records. We tested claims incurred under sample bonds from October 1, 1996, through September 30, 1999, by reviewing American

Contractors' 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 August and September 2000 at American Contractors' offices in Los Angeles, California. 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

We noted that American Contractors correctly calculated and remitted fees to SBA in a timely manner. We also noted, however, that American Contractors did not always comply with SBA regulations for underwriting bonds and processing claim payments. Specifically, American Contractors did not maintain complete underwriting documentation for two bonds or notify SBA of default for three bonds 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. We also concluded, however, that American Contractors did not comply in all material respects with SBA regulations.

We conducted an exit conference with American Contractors personnel on September 1, 2000. American Contractors personnel generally agreed with the factual aspects of the findings.

Our findings and recommendations are discussed in detail below.

Timely Notification of Default

American Contractors did not notify SBA in a timely manner of the default of the principals for three of the four bonds reviewed with claims activity:

Contractor Name	SBG No.	Bond Default Date	Date SBA Notified
[FOIA Ex. 4]	[FOIA Ex. 4]	January 27, 1998	June 15, 1998
[FOIA Ex. 4]	[FOIA Ex. 4]	January 27, 1998	July 14, 1998
[FOIA Ex. 4]	[FOIA Ex. 4]	February 26, 1998	January 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 American Contractors to revise its policies and procedures to ensure that SBA is notified of all defaults as required.

American Contractors Response: In its response to the audit report (appendix) American Contractors stated that:

“Although ACIC agrees that it did not comply with the formal notification of the principal's default with regard to the three bonds identified, it should be noted in the final report that the untimely notification did not result in any additional liability to the SBA because ACIC did notify [FOIA Ex. 6] of the area office for Seattle District Office of the SBA program immediately upon receipt of initial claim notification on those three bonds.

ACIC believes that notification, while not in technical compliance with the SBA regulations, nonetheless accomplished the goal of the regulations to prevent additional loss to the SBA by preventing the SBA from considering the issuance of additional bonds for the principals in default. Your auditors noted the same during the exit interview conducted at the closing of the on-site performance audit.”

Cotton & Company Response: Cotton & Company did note that American Contractors had notified the SBA Seattle District Office of the defaults.

Records Retention

American Contractors did not maintain a copy of SBA underwriting form No. 1261 for two bonds, as required. Further, American Contractors does not have written policies and procedures for underwriting SBA bonds and ensuring compliance with record-retention requirements. American Contractors 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 American Contractors 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.

American Contractors Response: In its response to the audit report (appendix) American Contractors stated that:

ACIC has established an "Underwriting Guideline- Small Business Administration Surety Bond Program" which is a written policy and provides procedures for underwriting and servicing SBA-guaranteed bonds. A copy is enclosed for your information.

Cotton & Company Response: American Contractors' new written policies do not address the recommendation to implement record-retention requirements. We recommend that American Contractors revise its policies to incorporate SBA record-retention requirements, including a list of documents that must be retained and the period for which they must be retained.

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

SAMPLE BONDS

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

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

APPENDIX

**AMERICAN CONTRACTORS INDEMNITY COMPANY
RESPONSE TO THE DRAFT REPORT**



American Contractors Indemnity Company

VIA OVERNIGHT MAIL

October 24, 2000

Mr. Robert G. Seabrooks
Assistant Inspector General for Auditing
U.S. Small Business Administration
Office of Inspector General
Washington D.C. 20416

**Re: Draft Audit Report on the Performance Audit of American Contractors
Indemnity Company**

Dear Mr. Seabrooks:

Thank you for your October 10, 2000 letter providing us with a draft of the referenced audit report. We submit our response regarding the draft report for your consideration and inclusion in the final report.

In connection with the stated untimely notification of the principal's default for three bonds, we respond as follows:

Although ACIC agrees that it did not comply with the formal notification of the principal's default with regard to the three bonds identified, it should be noted in the final report that the untimely notification did not result in any additional liability to the SBA because ACIC did notify [FOIA EXC] of the area office for Seattle District Office of the SBA program immediately upon receipt of initial claim notification on those three bonds.

ACIC believes that notification, while not in technical compliance with the SBA regulations, nonetheless accomplished the goal of the regulations to prevent additional loss to the SBA by preventing the SBA from considering the issuance of additional bonds for the principals in default. Your auditors noted the same during the exit interview conducted at the closing of the on-site performance audit.

It should also be noted that ACIC has now revised its policy and procedures in connection with SBA guaranteed bonds and is now complying, both with the technical regulations and is continuing to immediately notify [EXC] of any claims notifications immediately upon receipt of same.



Robert G. Seabrooks
U.S. Small Business Administration
October 17, 200
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In response to the incomplete underwriting documentation for two bonds to the needed written policies and procedures for underwriting and servicing SBA-guaranteed bonds, ACIC responds as follows:

ACIC has established an "Underwriting Guideline - Small Business Administration Surety Bond Program" which is a written policy and provides procedures for underwriting and servicing SBA-guaranteed bonds. A copy is enclosed for your information.

If you have any questions or require any other information, please contact me.

Very Truly Yours,

FRANK M. LANAK
Director of Claims
FML/

Enclosure

cc: Andy Faust, President

FOIA Ex. 6



American Contractors Indemnity Company

UNDERWRITING GUIDELINE SMALL BUSINESS ADMINISTRATION SURETY BOND PROGRAM

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FOIA Ex. 4

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American Contractors Indemnity Company

FOIA EX. 4

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