



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

AUDIT REPORT
Issue Date: January 18, 2001
Number: 1-03

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

From: Robert G. Seabrooks
Assistant Inspector General for Auditing

Subject: Audit of Ranger Insurance Company

Attached is the audit report on Ranger Insurance Company issued by Cotton & Company, LLP. The report discusses the following issues: (1) SBA was not notified of adverse information for two bonds, (2) recoveries and overpayments were not credited to SBA within the required timeframe for one bond, and (3) incomplete underwriting documentation was maintained for two bonds.

You may release this report to the duly authorized representative of Ranger 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
RANGER 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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July 28, 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 Ranger Insurance Company, which is a prior approval surety. The primary objectives were to determine if:

1. Ranger 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 42 bonds for which SBA had paid claims from October 1, 1996, through September 30, 1999. We selected four of the bonds with the highest dollar claim amount for the test period. In addition, we selected one bond to review at the request of OSG and one bond with claims activity originally approved in the Fiscal Year (FY) 1999. Thus, our total sample size was 6 bonds with claims (net of recoveries) totaling \$[FOIA Ex. 4]. This represents 61 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 Ranger's accounting records. We tested claims incurred under sample bonds from October 1, 1996, through September 30, 1999, by reviewing Ranger'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 July 2000 at the offices of Ranger's third-party servicing agent, AMWEST Insurance Company, located in Calabasas, 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 Ranger correctly calculated and remitted fees to SBA in a timely manner. We also noted, however, that Ranger did not always comply with SBA's regulations for underwriting bonds and processing claims. Specifically, Ranger did not:

- Notify SBA of adverse financial information for two bonds in a timely manner, as required by SBA regulations.
- Remit or credit SBA for overpayments or its share of recoveries within the timeframe established in SBA regulations.
- Maintain complete underwriting documentation for two of the six sample bonds.

As a result, we questioned costs of \$180,762.

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

We conducted an exit conference with AMWEST and Ranger personnel on July 28, 2000. Ranger personnel generally agreed with factual aspects of the findings, and stated that they will review their records in an attempt to locate additional support for some of the findings noted.

Our findings and recommendations are discussed in detail below.

[FOIA Ex. 4]

Ranger did not notify SBA in a timely manner of adverse financial information related to SBG Nos. [FOIA Ex. 4]. These bond guarantees were approved [FOIA Ex. 4] respectively. Ranger received a substantial number of nonpayment notices on these bonds dating back as early as September 24, 1997, and continuing through September 1998, but did not provide SBA with any notice of this principal's deteriorating financial condition.

Even with nonpayment notices on the two bonds, Ranger issued a third bond (SBG No. [FOIA Ex. 4]) on May 26, 1998. Several of the nonpayment notices were made in [FOIA Ex. 4] one month before this third bond was executed. The same agent wrote all three of the bonds. The third bond went into default on [FOIA Ex. 4] claims paid under this bond were \$34,346.

Ranger's failure to notify SBA of the adverse information concerning [FOIA Ex. 4] financial condition was a material misrepresentation of fact and a substantial regulatory violation that prevented SBA from making an informed decision about whether to cancel the bonding line.

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

A Prior Approval Surety must notify OSG if 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.

Title 13, CFR 115.33, Surety Bonding Line, states:

Upon the receipt of any adverse information concerning the Principal, the surety must promptly notify SBA, and SBA may cancel the bonding line.

Finally, in accordance with Title 13, CFR 115.19, Denial of Liability, SBA is not liable under a bond if a material misrepresentation of fact or a substantial regulatory violation existed. A material misrepresentation includes both the making of an untrue statement of material fact and the omission of a statement of material fact.

We also noted that Ranger's files did not include a copy of the bonded contract for SBG No. [FOIA Ex. 4].

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:

1. Deny liability for all claims paid under SBG No. [FOIA Ex. 4] and require Ranger to reimburse SBA the \$34,346 paid to date in claims.
2. Advise Ranger to comply with written policies and procedures that include the requirements of 13 CFR 115.33 and 13 CFR 115.35 to ensure that SBA is given timely notification of **any** adverse information as required by federal regulations.
3. Advise Ranger to comply with written policies and procedures to ensure that all remaining underwriting records are retained until the applicable statute of limitations has expired.

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

1. Ranger Insurance respectfully disagrees with the evaluation as presented in the audit report. A review of the underwriting file reflects a financially stable Principal for the period in question who came to Ranger as a SBA 8A pre-qualified contractor.

We have prepared for your review a chronology of events on all three bonds above mentioned. The decision to declare an account “in claim” and therefore subject to reporting as such to the SBA is a very subjective call based on the unique facts of any given situation. This is not a decision taken lightly by responsible members of the surety community. Prior to declaring a Principal “in claim” or “in default”, the surety must be careful and mindful of the possible negative impact on the ability of the Principal to continue in business. This negative impact includes the fact that the SBA has a policy of cutting off the bond credit of a Principal declared to be “claim” or “in default”.

Ranger submits that the evidence in the file (copies attached) and the chronology provided with this response supports the conclusion that the Principal was capable of dealing with his own problems up to the date of 9/15/98.

Ranger submits that this contractor was not “in claim” or in “default” when the third bond was underwritten nor was there significant adverse information to warrant placing the Principal into claim.

2. Ranger’s third party Claims Administrator [FOIA Ex. 4] has procedures in place to timely notify the SBA of adverse information and default. [FOIA Ex. 4] has been instructed by Ranger to ensure compliance with federal regulations. As stated in Audit Response 1, it is Ranger’s position that federal regulations were not violated in this case.
3. Ranger’s third party Claims Administrator [FOIA Ex. 4] has procedures in place to retain all remaining underwriting records until the applicable statute of limitations has expired. [FOIA Ex. 4] has been instructed by Ranger to ensure compliance with federal regulations.

Cotton & Company Response: Ranger states in its response that the decision to declare an account “in claim” and therefore subject to reporting to the SBA is a very subjective call based on the unique facts of any given situation. Title 13, CFR 115.35 states that the surety must notify OSG if 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. Ranger’s policy of only reporting accounts that are in “claim” or “default” is in violation of SBA regulations and prevents SBA from making an informed decision about the financial condition of a Principal.

[FOIA Ex. 4]

Ranger did not reimburse SBA for a duplicate payment and two recoveries totaling \$146,416. Ranger received a \$110,406 claim reimbursement from SBA on July 7, 1998. It submitted a second claim payment request for \$114,890, which included the \$110,406 already paid by SBA. SBA paid the second claim amount of \$114,890 in total on December 1, 1998. Ranger had not returned this duplicate payment to SBA as of the audit date.

In addition, Ranger received two recoveries for \$16,300 on March 27, 1998, and \$34,781 on July 29, 1998. Subsequent expenses reduced the total amount to a net recovery of \$40,011. Ranger had not reimbursed SBA \$36,010 for its share of the recoveries.

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

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

Further, Title 13, CFR 115.17, Minimization of Surety's Loss, states:

The surety must reimburse or credit SBA (in the same proportion as SBA's share of loss) within 90 days of receipt of any recovery by the Surety.

Recommendations: We recommend that the OSG Associate Administrator:

1. Require Ranger to reimburse questioned costs of \$146,416.
2. Advise Ranger to revise its written policies and procedures to ensure that it reimburses or credits SBA within 90 days of receipt of any recovery as required by federal regulations.

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

1. Ranger concurs with this finding. Ranger has already returned \$142,236.25 to SBA on 8/25/00 per attached Form 994 and copy of check issued. Upon delivery of above non-compliance with federal regulation and notification of Ranger by Cotton & Company LLP, Ranger immediately refunded the overpayment to the SBA.

Internal investigation of the failure to follow the regulations disclosed that Ranger's Accounting staff was improperly offsetting the credit balance due SBA on this particular claim against other receivable balances due from SBA. It should be noted that this practice is very common and within accepted industry standards in commercial reinsurance transactions (offset clause).

2. Ranger has advised it's Accounting staff and financial management to process all credits due SBA at a claim level and not to offset credit balances against other receivables due from SBA. In the future all credits due SBA will be processed within 90 days of recovery as required by federal regulations.

Cotton & Company Response: Ranger's response indicated that it "advised" its personnel to process all credits due SBA as required. We recommend that Ranger revise its written policies and procedures to include this requirement.

[FOIA Ex. 4]

Ranger did not maintain SBA underwriting form Nos. 912, 994, 1261, and 1624, as required. Further, Ranger does not have written policies and procedures to ensure compliance with record retention requirements. Although Ranger no longer underwrites SBA-backed surety bonds; it must be able 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.

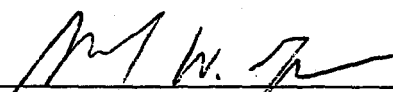
Ranger Response: In its response to the audit report (appendix) Ranger stated that it was the policy of its contract surety to allow the producing agent to retain copies of all SBA forms. Ranger stated that it has written policies and procedures in place to ensure that all underwriting documents are retained until the applicable statute of limitations has expired. Ranger also stated that those procedures have been sent to its Third Party Administrator, [FOIA Ex. 4].

Cotton & Company Response: As previously noted on page 3, we recommend that Ranger comply with written policies and procedures to ensure that all underwriting records are retained until the applicable statute of limitations has expired.

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

ATTACHMENT

SAMPLE BONDS

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

* Sample bond selected for underwriting review only.

APPENDIX

**RANGER INSURANCE COMPANY
RESPONSE TO THE DRAFT REPORT**



Peter J. Wiedemann
Director of Internal Audit, AVP
Internal Audit Department
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(713) 954-8376
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October 20, 2000

Ms. Laura Benton
U.S. Small Business Administration
Office of Inspector General
409 Third Street SW
Mail Code 4112
Washington, DC 20416

Fax (202) 205-7874

Re: Audit Response – Ranger Insurance Company

Dear Ms. Benton:

Attached please find Ranger Insurance Co.'s response to the findings as stated in the draft of the audit report from Cotton & Company LLP dated July 28, 2000.

As you may already know, Ranger is no longer in the Contractor Surety business since early 1999 when it was decided that the program was to be placed into runoff.]

Ex. 4

]

The audit results have been reviewed by the undersigned and [Ex 4 and 6
...] has been in the contract bonding business for more years than he wants to admit. We are
enclosing his resume for your review. [4 5 6] report and evaluation of the findings on
[Ex 4] is enclosed as part of Ranger's response.

Finally, Ranger would like to communicate to the SBA officials and staff of it's appreciation of the professionalism and caliber of the contractor performing the audit fieldwork.

Very truly yours,


Peter J. Wiedemann
AVP, Director of Internal Audit

FOIA Ex. 4

To: U.S. Small Business Administration
Office of Inspector General
October 20, 2000

Re: RANGER INSURANCE COMPANY AUDIT RESPONSE

EX. 4

Audit Finding:

Failure by Ranger Insurance Company to timely notify SBA of adverse financial information related to [EX. 4] and subsequent issuance of a third bond. [EX. 4]

Failure by Ranger Insurance Company to include a copy of the bonded contract for [EX. 4] in the bond file.

Audit Recommendation 1:

SBA should deny liability for all claims paid under [EX. 4] and require Ranger to reimburse the \$ 34,346 paid to date in claims.

Audit Response 1:

Ranger Insurance respectfully disagrees with the evaluation as presented in the audit report. A review of the underwriting file reflects a financially stable Principal for the period in question who came to Ranger as a SBA 8A pre-qualified contractor. Please refer to attached underwriting evaluation by [EX. 4] which concurs with Ranger's position.

We have prepared for your review a chronology of events on all three bonds above mentioned. The decision to declare an account "in claim" and therefore subject to reporting as such to the SBA is a very subjective call based on the unique facts of any given situation. This is not a decision taken lightly by responsible members of the surety community. Prior to declaring a Principal "in claim" or "in default", the surety must be careful and mindful of the possible negative impact on the ability of the Principal to continue in business. This negative impact includes the fact that the SBA has a policy of cutting off the bond credit of a Principal declared to be "claim" or "in default".

Ranger submits that the evidence in the file (copies attached) and the chronology provided with this response supports the conclusion that the Principal was capable of dealing with his own problems up to the date of [4] Please note that the SBA appointed mentor was in the negotiation process up to that point. Although slow at times, the Principal resolved and negotiated in good faith all slow payment issues with the suppliers. Ranger did not have to get involved directly with the suppliers, subcontractors or vendors until 9/15/98 when negotiations broke down.

As stated in the audit findings by Cotton & Co LLP, Ranger's claim file procedures define a "claim" as a formal, written demand for payment against the surety. "Rumbles" are defined as slow payment notices, indications of breakdowns in Principal and Obligee's working relationships, negative status inquiries etc. Please also note [4] comment relating to Florida statutes and reporting requirements. The file reflects what Ranger considered "rumbles". Ranger's pro-active approach in contacting the Agent and the Principal to assist in the resolution

FOIA EX. 4

of the "rumble" is consistent with Ranger's philosophy of "partnering" with the Principal to the advantage of all concerned in the surety relationship. Please note that many of the attached support documents indicate "CLOSED RUMBLE" once the file handler was convinced the problem was corrected. We submit that all "rumbles" had been closed or payment terms had been negotiated by the Principal prior to [4] when the third bond was written. Ranger submits that this contractor was not "in claim" or in "default" when the third bond was underwritten nor was there significant adverse information to warrant placing the Principal into claim.

It is our position that the approach as taken by Ranger is totally in keeping with a basic common sense tenet of all current contract bond claims administration which says: *The Principal should be allowed to run his own business without surety intervention until proven incapable.* This did not occur until 9/14/98 for the bonds written in [Ex. 4] Ranger immediately referred the claim notice to [Ex. 4] the third party claims administrator contracted with Ranger at that time.]

Ranger Insurance Co. hereby respectfully requests that the US Small Business Administration Office of Inspector General review enclosed documentation and determine whether the recommendation to deny the claim has sufficient merit based on these facts presented.

Audit Recommendation 2:

Advise Ranger to implement written policies and procedures to ensure that SBA is given timely notification of default and adverse information as required by federal regulations.

Audit Response 2:

Ranger's third party Claims Administrator [Ex. 4] has procedures in place to timely notify the SBA of adverse information and default [4] has been instructed by Ranger to ensure compliance with federal regulations. As stated in Audit Response 1, it is Ranger's position that federal regulations were not violated in this case.

Audit Recommendation 3:

Advise Ranger to implement written policies and procedures to ensure that all remaining underwriting records are retained until the applicable statute of limitations has expired.

Audit Response 3:

Ranger's third party Claims Administrator [Ex. 4] has procedures in place to retain all remaining underwriting records until the applicable statute of limitations has expired [4] has been instructed by Ranger to ensure compliance with federal regulations. The producing Agent, the Oblige and Principal have been contacted to obtain a copy of the bonded contract on [Ex. 4] Upon receipt, a copy will be forwarded to the OIG.

[Ex. 4]

Audit Finding:

Ranger did not reimburse the SBA for a duplicate payment and two recoveries totaling \$ 146,416. Ranger received a \$ 110,406 claim reimbursement from SBA on July 7, 1998. It submitted a second claim payment request for \$ 114,890 which included the \$ 110,406 already paid by SBA. SBA paid the second claim amount of \$ 114,890 in total on December 1, 1998. Ranger had not returned this duplicate payment to SBA as of the audit date.

FOIA EX. 4

Ranger received two recoveries for \$ 16,300 on March 27, 1998 and \$ 34,781 on July 29, 1998. Subsequent expenses reduced the total amount to a net cost of \$ 36,010. Ranger had not reimbursed the net amount of recoveries to SBA.

Audit Recommendation 1:

Require Ranger to reimburse questioned costs of \$ 146,416 plus interest to SBA.

Audit Response 1:

Ranger concurs with this finding. Ranger has already returned \$ 142, 236.25 to SBA on 8/25/00 per attached Form 994 and copy of check issued. Upon discovery of above non-compliance with federal regulation and notification of Ranger by Cotton & Co. LLP, Ranger immediately refunded the overpayment to the SBA.

Ranger will comply with the payment of interest once calculated by the OIG in accordance with federal regulations.

Internal investigation of the failure to follow the regulations disclosed that Ranger's Accounting staff was improperly offsetting the credit balance due SBA on this particular claim against other receivable balances due from SBA. It should be noted that this practice is very common and within accepted industry standards in commercial reinsurance transactions (offset clause).

Audit Response 2:

Ranger has advised it's Accounting staff and financial management to process all credits due SBA at a claim level and not to offset credit balances against other receivables due from SBA. In the future all credits due SBA will be processed within 90 days of recovery as required by federal regulations.

_____ Ex. 4 _____

Audit Finding:

Ranger did not maintain SBA underwriting form Nos. 912, 994, 1261, and 1624, as required. Further, Ranger does not have written policies and procedures to ensure compliance with record retention requirements.

Audit Recommendation:

Require Ranger to implement written policies and procedures to ensure all underwriting records are retained until the applicable statute of limitations has expired.

Audit Response:

Ranger agrees with the audit finding in that the forms referenced could not be located in the bond file. However, per ^{Ex. 4 § 6} it was Ranger's policy to allow the producing agent to retain copies of all SBA forms. Ranger has contacted the producing Agent for this bond. The Agent will retrieve the copies of the SBA forms referenced above for inclusion in the underwriting file. Upon receipt, Ranger will forward copies of the forms to the SBA if so required by the OIG. Ranger awaits a directive from the OIG in this matter.

FOIA Ex. 4

Ranger respectfully submits that it considers this issue resolved given the fact that the SBA already has all the originals of the forms in question and Ranger's agents are legally authorized to maintain records. Please also note that Ranger no longer writes SBA-backed surety bonds.

Ranger has written policies and procedures to ensure all underwriting records are retained until the applicable statute of limitations has expired. These procedures have been sent to Ranger's Third Party Administrator. EX. 4 We are enclosing a copy thereof.

This concludes Ranger's response. Please direct any question to the Internal Audit Department at Ranger Insurance Co.

FOIA EX. 4

REPORT DISTRIBUTION

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