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

AUDIT REPORT
Issue Date: February 14, 1997
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TO: Robert J. Moffitt
Associate Administrator
Office of Surety Guarantees

Peter L. McClintock

FROM: Peter L. McClintock
Assistant Inspector General for Auditing

SUBJECT: Audit of Fidelity and Deposit Company of Maryland's Underwriting Process

BACKGROUND

Federal construction contracts of $100,000 or more, as well as certain private, state and local government contracts, require contractors to be bonded. Surety bonds ensure that should a bonded contractor default, a construction project will be completed and the contractor's employees and material suppliers will be paid. SBA can guarantee bonds for construction and services contracts up to $1,250,000 if (1) the principal is a small business, (2) the bonds are required to obtain the contract, and (3) the business is unable to obtain a bond without the SBA guarantee. SBA guarantees up to 90 percent of losses incurred and paid on bonds that the surety company would not underwrite without SBA's guarantee.

The surety bond guarantee program consists of two programs--the prior approval program and the preferred program. Any surety company certified by the U.S. Treasury to issue bonds may be eligible to participate in the prior approval program, but the bonds are subject to SBA's prior review and approval. In the preferred program, SBA certifies "preferred" surety companies to issue, monitor, and service SBA guaranteed bonds without SBA's prior review and approval. SBA reimburses a preferred surety an amount not to exceed 70 percent of the loss incurred and paid. Fidelity and Deposit Company of Maryland (F&D), located in Baltimore, Maryland, was granted preferred surety status in May 1990.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine whether F&D underwritings conformed to SBA requirements. The audit covered F&D's underwritings from October 1, 1994 to July 31, 1996. We selected for review 50 bonds totaling $35.7 million where the contractors received two or more bonds on the same day, consecutive numbered bonds, or bonds exceeding $1,000,000. Field work was conducted from August 1996 to November 1996 at the F&D's office in Baltimore, Maryland. The audit was performed in accordance with Government Auditing Standards.

FOLLOW-UP ON PRIOR AUDITS

We issued audit report No. 3-2-W-404-008 on F&D dated October 19, 1992. There were no unresolved issues.

RESULTS OF AUDIT

F&D's underwritings were not always consistent with SBA requirements. We found SBA provided guarantees of $5.3 million for 10 bonds when F&D split contracts to avoid SBA's limits and issued bonds after work was shown as commencing. Also, F&D's application form did not capture the actual start dates for the bonded contractor. As a result, SBA's potential liability increased and SBA did not have sufficient information on actual start dates to determine whether the guarantee should be honored.

Finding 1. SBA Guarantees Issued For Ineligible Contracts

F&D did not follow SBA policies and procedures for underwritings by splitting contracts and issuing bonds on an untimely basis; as a result, SBA guaranteed $5.3 million of ineligible bonds. The Code of Federal Regulations, at 13 CFR 115.12(e), sets the limit of contracts to be bonded at $1,250,000 and generally requires the amounts of two or more contracts for a "single project" to be aggregated to determine the amount. Also, 13 CFR 115.64 states no bonds can be issued after commencement of work without SBA approval. The following chart shows the ineligible contracts.

INELIGIBLE BONDS

		INELIGIBLE DUE TO	
BOND NUMBER	AMOUNT	CONTRACT SPLIT	BONDS ISSUED AFTER WORK COMMENCED[1]
[	$ 1,100,000	$ 1,100,000	$ 1,100,000
	1,200,000	1,200,000	1,200,000
	445,184	445,184	445,184
	490,992	490,992	490,992
	593,824	593,824	593,824
	655,212		655,212
	649,000	649,000	
	874,000	874,000	
	694,000	694,000	
]	895,000	895,000	
TOTALS	$ 7,597,212	$ 6,942,003	$ 4,485,212
SBA GUARANTY PERCENTAGE	.70		
INELIGIBLE GUARANTEE	$ 5,318,048		

Split Contracts

[ ]

F&D issued [ ] five SBA guaranteed bonds related to two contracts which exceeded the SBA eligibility requirement. The contracts were split into different projects even though they related to the same prime contractor, location, specific work and time period. An F&D official agreed that the contracts were split and should not have been eligible for the SBA surety bond guarantees.

[ ]

F&D issued [ ] four SBA guaranteed bonds related to two projects which exceeded the SBA eligibility requirement. The projects were split between plumbing, heating and air conditioning which covered the same general

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[1] F&D records showed that six bonds were issued during March [ ] whereas work had begun for five during January [ ] and December [ ] in the other case.

FOIA Ex. 4

contractors, time periods and locations. The broker stated they were each only one contract, however, they had each of the prime contractors write two contracts so they would meet SBA requirements.

On October 14, 1996, F&D issued a memorandum to all surety branch and satellite managers informing them of our findings on splitting contracts so they could avoid the same scenario in the future. On November 13, 1996, F&D issued a memorandum to its [redacted] Surety Office informing them that the SBA guarantees on the [redacted] bonds were being removed.

Commencement of Work

The records of F&D show that F&D inappropriately issued six SBA surety bond guarantees to [redacted] after the commencement of work by the contractor. Title 13 CFR 115.64 prohibits the execution or approval of a bond by preferred sureties after commencement of work unless written approval is obtained from SBA. Written approval from SBA was not obtained.

Recommendations

We recommend that the Associate Administrator, Office of Surety Guarantees, notify F&D:

1A. That SBA will deny liability for those bond guarantees where contract work was split to avoid SBA's limits or the contractor started work prior to the bond being issued without written approval from SBA.

1B. To follow their established written procedures prohibiting the splitting of contracts to meet SBA guarantee eligibility.

1C. To establish written procedures to ensure that bonds are not issued after work has commenced without SBA approval.

SBA Management's Response

The AA/OSG agreed with the recommendations.

FOIA Ex. 4

Finding 2. Start Date Not Documented

The form used by F&D does not capture the actual start date for the bonded contractor. The regulations, at 13 CFR 115.64, prohibit the execution or approval of a bond by preferred sureties after commencement of work unless written approval is obtained from SBA. F&D officials agreed and initiated action during the audit to redesign the form to include the actual start date. Without an actual start date, SBA would be unable to determine if the SBA guarantee should be honored.

Recommendation

2. We recommend that the Associate Administrator, Office of Surety Guarantees, followup with F&D to ensure that their proposed procedures to identify actual start dates has been implemented.

SBA Management Response

The AA/OSG agreed with the recommendations.

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The findings included in this report are the conclusion of the Office of Inspector General's Auditing Division based on testing of the auditee's operation. **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 sign the attached SBA Forms 1824, Recommendation Action Sheet. Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations, at (202) 205-7204.

Attachments