**US SMALL BUSINESS ADMINISTRATION**
**OFFICE OF INSPECTOR GENERAL**
**Washington, DC 20416**

| AUDIT REPORT |
| --- |
| **Issue Date:** **August 19, 1999** |
| **Number: 9-17** |

TO: Robert J. Moffitt
Associate Administrator
Office of Surety Guarantees

[Ex. 6]

FROM: Victor R. Ruiz
Acting Assistant Inspector General for Auditing

SUBJECT: Audit of Insurance Company of the West/Explorer Insurance Company

The attached Independent Accountant's Audit Report (Attachment 1) presents the results from their audit of Insurance Company o the West/Explorer Insurance Company (ICW). The report by Cotton & Company, CPAs, discusses problems related to (1) surety and contractor fees that were not remitted to SBA from contract increases, and (2) claim recoveries which were not remitted to SBA in a timely manner.

You may release this report to the duly authorized representative of ICW at your discretion. 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.

Please provide us your proposed management decision for each recommendation within 80 days on the attached SBA Forms 1824, Recommendation Action Sheet. If you disagree with the recommendations, please provide us your reasons.

**The findings in this report are based on the auditor's conclusions and the report recommendations are subject to review, management decision, and action by your office in accordance with existing Agency procedures for audit follow-up and resolution.** Should you or your staff have any questions, please contact me at (202) 205 [Ex 2]

Attachments

# INDEPENDENT ACCOUNTANT'S

# REPORT ON THE PERFORMANCE AUDIT OF

# INSURANCE COMPANY OF THE WEST/ EXPLORER INSURANCE COMPANY

**Performed by:**

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

# COTTON & COMPANY

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September 25, 1998

U.S. Small Business Administration
Office of Inspector General

## BACKGROUND

The Small Business Administration's (SBA) Surety Bond Guarantee Program (SBG) was authorized by the Small Business Investment Act of 1958, as amended. It was created 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 70 percent for contracts not exceeding $1.25 million under the Preferred Surety Bond (PSB) Program. The SBG program is administered by SBA's Office of Surety Guarantees (OSG).

## OBJECTIVE, SCOPE AND METHODOLOGY

SBA's Office of Inspector General (OIG) requested Cotton & Company to conduct a performance audit of Insurance Company of the West/Explorer Insurance Company (ICW). The primary objectives were to determine if:

1. ICW complied with SBA's and its own policies and procedures in applying for bond guarantees for which SBA paid claims.

2. Claims and expenses paid by SBA were allowable, allocable, and reasonable.

3. Fees due SBA were accurately calculated and remitted in a timely manner.

We obtained SBA's Claim Payment History report, which lists all claim payments made to and recoveries received from ICW from its inception in SBA's surety bond guarantee program through July 31, 1998. This report showed that SBA made claim payments for 13 defaulted bonds. We judgmentally selected 6 of the 13 bonds for the purpose of testing claims and underwriting procedures. The sample was comprised of $458,036, or 78.07 percent of the $586,723 total claim payments (net of recoveries) shown on SBA's Claim Payment History report. We selected four additional bonds for testing ICW's compliance with underwriting procedures; these bonds were executed during Fiscal Year 1998 and showed no claims paid by SBA. Sample bonds are listed in the attachment.



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We tested sample bonds for compliance with SBA regulations for underwriting and fees by reviewing underwriting files and ICW's accounting records. We tested claims incurred under defaulted sample bonds through July 31, 1998, by reviewing ICW's supporting documentation in the claim files and accounting records. We obtained a list of all SBA-guaranteed final bonds through July 31, 1998, 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 also determined if any bonds issued to the sampled contractors were in default status prior to sampled bond execution dates and if bonds were issued to these contractors after the sampled bonds were placed in default. Finally, we calculated the outstanding fee amount ICW owed SBA as of July 31, 1998.

We conducted fieldwork during September 1998 at ICW's offices in San Diego, 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

ICW complied with SBA's policies and procedures for underwriting bonds. It did not, however, always comply with SBA's policies and procedures for remitting claim recoveries and fees due SBA. Although ICW calculated fees correctly, it failed to remit to SBA additional fees resulting from contract increases for one bond that aggregated to more than 25 percent or $50,000. Also, ICW failed to remit to SBA its share of recoveries in a timely manner for four bonds. As a result, we questioned $1,124.

We conducted an exit conference with ICW personnel on September 25, 1998. ICW personnel generally agreed with the factual aspects of the findings. ICW's written response to the draft audit report is in the appendix.

Our findings and recommendations are discussed in detail below.

### 1. Additional Fees Related to Contract Increases Not Remitted to SBA

ICW did not assess or remit additional surety and contractor fees to SBA for increases in contract amounts resulting from change orders or notify SBA of increased bond liability [Ex. 2] The contract amount increased by $115,267, or 13 percent, as a result of approved contract change orders. ICW stated that although job status reports were submitted by ICW's agent showing contract increases, they were not provided to ICW's underwriting department to generate a bill for the additional fees.

The principal was able to complete the contract, and ICW granted the standard 50-percent reduction in retainage based on the principal's assertion that all vendors and suppliers had been paid with joint checks to the principal and the suppliers. Subsequently, one supplier submitted a substantial claim, resulting in a $160,000 loss under the payment bond. To date, ICW has not received any contract funds or recovery from its indemnitors, but is continuing to pursue recovery.

Title 13, CFR 115.65(c), Notification to SBA, states that a PSB surety must notify SBA by electronic submission or monthly bordereau of surety approval of increases or decreases in the contract or bond amount. SBA may deny liability with respect to final bonds for which SBA has not received timely notification. In addition, Title 13, CFR 115.67, Changes in Contract or Bond Amount, states that a PSB surety must process contract or bond amount increases in the same manner as it processes initial guaranteed bond issuances and must present checks for additional fees due from the principal and the surety on increases aggregating 25 percent of the contract or bond amount, or $50,000.

We questioned the additional surety and contractor fees totaling $1,124 that should have been remitted to SBA resulting from contract increases.

***Recommendation:*** We recommend that the associate administrator, OSG:

- Require ICW to submit additional surety and contractor fees totaling $1,124.
- Advise ICW that in the future, liability may be denied if premiums are not paid on a timely basis in accordance with Title 13, CFR 115.65(c).

***ICW's Response:*** ICW stated that it had made changes in its internal procedures to prevent this condition from occurring again. ICW disputed the amount questioned in the draft report ($1,227) and stated it calculated additional fees of $1,124. This amount was paid to SBA on the October 1998 bordereau.

***Accountants' Additional Comments:*** Cotton & Company accepts ICW's calculation of additional fees owed and has changed the final report accordingly.

## 2. Recoveries Not Remitted to SBA in a Timely Manner

ICW did not remit SBA's share of claim recoveries to SBA within 90 days for four sample bonds. Although ICW recorded the recoveries on its bordereau in a timely manner, it did not remit the recoveries to SBA until an average of 256 days after receipt.

| PSB No. | Contractor Name | Recovery Received | Recovery Remitted to SBA | SBA Share of Recovery | Days Elapsed from Receipt to Remittance[1] |
|---|---|---|---|---|---|
| | | 07/21/97 | 12/24/97 | $ 40,491 | 156 |
| | | 08/21/97 | 12/24/97 | 630 | 125 |
| | | | | $ 41,121 | |
| | | 12/11/96 | 09/29/98 | $ 37,207 | 657 |
| | | 12/17/96 | 09/29/98 | 14,005 | 651 |
| | | 01/16/97 | 06/18/97 | 8,773 | 153 |
| | | 02/25/97 | 06/18/97 | 23,325 | 113 |
| | | 03/18/97 | 06/18/97 | 36,460 | 92 |
| | | 05/02/97 | 12/24/97 | 6,304 | 236 |
| | | | | $126,074 | |

FOIA Ex. 4

[1]Average equals 256 days [3,584 days ÷ 14 items]

| PSB No. | Contractor Name | Recovery Received | Recovery Remitted to SBA | SBA Share of Recovery | Days Elapsed from Receipt to Remittance[1] |
|---|---|---|---|---|---|
| FOIA Ex. 4 | | 11/06/96 | 06/18/97 | $ 2,770 | 224 |
| | | | | $ 2,770 | |
| FOIA Ex. 4 | | 01/20/97 | 06/18/97 | $ 350 | 149 |
| | | 06/17/97 | 12/24/97 | 42,962 | 190 |
| | | 06/17/97 | 12/24/97 | 17,453 | 190 |
| | | 10/24/97 | 10/07/98 | 140 | 348 |
| | | 12/03/97 | 09/29/98 | 140 | 300 |
| | | | | $ 61,045 | |

Title 13, CFR 115.17 and 115.61, require PSB sureties to reimburse or credit SBA within 90 days of any recovery or salvage by the surety. Because ICW did not remit recoveries within the required time period, SBA is unable to put these funds to immediate use.

***Recommendation:*** We recommend that the associate administrator, OSG, request ICW to revise its procedures to ensure that recoveries are remitted to SBA within 90 days of receipt by ICW.

***ICW's Response:*** ICW stated that the recommendation to remit recoveries to SBA more timely has been discussed with all staff involved and internal controls have been strengthened to ensure recoveries are remitted within 90 days.

## MANAGEMENT CONTROLS

The scope of our audit did not include assessing management controls, and thus we did not identify or test such controls.

## SBA MANAGEMENT RESPONSE

The Associate Administrator, OSG, agreed with the findings and recommendations.

COTTON & COMPANY, LLP

B: [Ex. 6] For

Catherine L. Nocera, CPA

Attachment

## SAMPLE BONDS

| Sample No. | Preferred Surety Bond (PSB) No. | ICW Bond No. | Contractor Name | Bond Approval Date | Bond Default Date |
|---|---|---|---|---|---|
| 1 | | | | 09/05/95 | 11/12/96 |
| 2 | | | | 11/07/96 | 01/30/98 |
| 3 | | | | 04/24/96 | 09/11/96 |
| 4 | | | | 04/23/96 | 09/11/96 |
| 5 | | FOIA Ex. 4 | | 10/13/94 | 11/14/95 |
| 6 | | | | 05/02/95 | 04/16/96 |
| 7 | | | | 05/06/98 | * |
| 8 | | | | 03/19/98 | * |
| 9 | | | | 07/23/98 | * |
| 10 | | | | 02/09/98 | * |

*Sample bonds selected for underwriting review only.

# APPENDIX

## INSURANCE COMPANY OF THE WEST/ EXPLORER INSURANCE COMPANY RESPONSE TO THE DRAFT REPORT

# ICW GROUP

INSURANCE COMPANY OF THE WEST
EXPLORER INSURANCE COMPANY
INDEPENDENCE CASUALTY AND SURETY COMPANY

A Tradition Of Innovation

AUG 5 2 13 PM '99
OFFICE OF SURETY GUARANTEES

August 5, 1999

Mr Robert J. Moffitt
U S Small Business Administration
Associate Administrator
Office of Surety Guarantees
409 Third Street, S.W
Washington, DC 20416

Dear Mr Moffitt:

Thank you for the draft copy of the audit report conducted by Cotton & Company dated 9/25.98. This is our response, per your request.

Page Two of the audit discusses Additional Fees Related To Contract Increases Not Remitted To SBA. We have made changes in our internal procedures to prevent this from occurring again. An increase of $115,277 was made on [Ex. 2 ] our bond #1484467 The principal on this bond is [FOIA Ex. 4] The audit says we owe additional surety and SBA fees of $1,227. We dispute this amount. The additional SBA fee is based on a rate of $7.45 per thousand, which equals $859. This was the fee rate when this bond was written in November, 1996. The extra surety fee is 23% of $10. per thousand, the third layer in our rating plan. Additional surety fee is $265.19. Total additional amount is $1,124.19. This was paid to SBA on our October, 1998 Bordereau. A copy is attached, along with canceled checks.

The audit mentions more timely remittance of claim recoveries to the SBA. This has been discussed with all individuals involved. Internal controls have been strengthened to make sure recoveries on SBA claims are submitted in the required 90 day time period.

We appreciate the recommendations made to improve the way we handle SBA business. Please let me know if anything further is needed.

Very truly yours,

[Ex 6 ]

Jeffrey D Sweeney
encls

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