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

From: Robert G. Seabrooks  
Assistant Inspector General for Auditing

Subject: Audit of Indemnity Insurance Company of North America

Attached is the audit report on Indemnity Insurance Company of North America issued by Cotton & Company, LLP. The report discusses the following issues: (1) fees were not remitted to SBA in a timely manner, (2) status reports were not obtained for three bonds, and (3) incomplete underwriting documentation was maintained for one bond.

You may release this report to the duly authorized representative of Indemnity Insurance Company of North America. 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
INDEMNITY INSURANCE COMPANY OF NORTH AMERICA

Performed by:
Cotton & Company LLP
Certified Public Accountants
333 North Fairfax Street, Suite 401
Alexandria, Virginia 22314
October 20, 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 to conduct a performance audit of Indemnity Insurance Company of North America. The primary objectives were to determine if:

1. Indemnity Insurance 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 bonds for which SBA had paid claims from October 1, 1996, through September 30, 1999. This universe contained three bonds, and we selected all three as sample bonds for review. We also randomly selected one additional bond originally approved in Fiscal Year (FY) 1999 for underwriting review only. Thus, our total sample size was 4 bonds with claims (net of recoveries) totaling [FOIA Ex. 4]. This represents 100 percent of the [FOIA 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 Indemnity Insurance’s accounting records. We tested claims incurred
under sample bonds from October 1, 1996, through September 30, 1999, by reviewing Indemnity Insurance’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 October 2000 at Indemnity Insurance’s offices in Philadelphia, Pennsylvania. 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

Indemnity Insurance correctly calculated fees; it did not, however, remit all fees to SBA in a timely manner. Also, Indemnity Insurance did not always comply with SBA regulations for underwriting and servicing bonds. Specifically, Indemnity Insurance did not maintain complete underwriting documentation for one bond and did not request and maintain status reports in its files for three of four bonds tested, as required by SBA regulations.

We concluded that management and financial controls were adequate to protect assets and prevent errors and fraud, except as noted below. We also concluded that Indemnity Insurance did not comply in all material aspects with SBA regulations for retaining records and obtaining and maintaining status reports. In addition, we concluded that Indemnity Insurance did not have procedures in place to ensure its timely payment of surety fees due SBA.

We conducted an exit conference with Indemnity Insurance personnel on October 20, 2000. They generally agreed with factual aspects of the findings.

Our findings and recommendations are discussed in detail below.

Past Due and Unpaid Fees

Indemnity Insurance did not remit surety fees to SBA in a timely manner. For one of the SBA-guaranteed bonds tested, over 10 months elapsed from bond-guarantee issuance until Indemnity Insurance paid the fee to SBA. For two others, Indemnity Insurance had not as of audit fieldwork completion remitted surety fee payments of $409 and $300 to SBA on bond guarantees issued by SBA on [FOIA Ex. 4] 1998, and [FOIA EX. 4] 1999, respectively.

Indemnity Insurance did not access SBA’s optional online system, which would have provided monthly billing information. Instead, it waited for invoices from SBA, which it did not process in a timely manner. Indemnity Insurance acknowledged that it did not have adequate procedures for timely payment of fees to SBA and did not consider such payments a higher priority than other business concerns.

SBA submitted an invoice to Indemnity Insurance on July 6, 1998, for 32 outstanding fee payments totaling $25,771. Indemnity Insurance paid $24,536 on October 12, 1998. SBA submitted a second invoice to Indemnity Insurance on February 17, 2000, for 298 outstanding fee payments totaling

Title 13, Code of Federal Regulations (CFR), Section 115.32, Fees and Premiums, (c) SBA Charge to Surety, states: The Surety must pay SBA a guarantee fee on each guaranteed bond (other than a bid bond) in the ordinary course of business.

Indemnity Insurance did not meet SBA regulatory requirements for submission of surety fees in a timely manner. We question the unpaid $709.

**Recommendation:** We recommend that the OSG Associate Administrator advise Indemnity Insurance to implement written policies and procedures to ensure that it remits fees due SBA in the ordinary course of business. In addition, we recommend that Indemnity Insurance remit to SBA the questioned $709.

**Indemnity Insurance Response:** In its response to the audit report (appendix) Indemnity Insurance stated that:

We will implement written policies and procedures to ensure that fees due the SBA are remitted in a timely manner. We request a visit from the SBA to provide us with training for using the SBA web site. We can only ensure timely payment if we are properly trained to use the SBA web site.

**Cotton & Company Response:** None

**Progress Status Requests**

Indemnity Insurance did not request status reports from obligees and maintain such reports in its files for projects with SBA-guaranteed bonds. For three of the four bonds tested for underwriting standards, we found no documented evidence that status requests were obtained from the obligees. Indemnity Insurance relies on its agents to comply with SBA requirements for requesting status reports, and the agent was unaware of this specific requirement. If the viability and eligibility of guaranteed principals are not monitored, SBA exposure could be increased by the issuance of additional bonding to an affected principal.

Title 13, CFR, Section 115.15, Underwriting and Servicing Standards, (b) Servicing, states:

The Surety must ensure that the Principal remains viable and eligible for SBA’s Surety Bond Guarantee Program, must monitor the Principal’s progress on bonded Contracts guaranteed by SBA, and must request job status requests from Obligees of Final Bonds guaranteed by SBA. Documentation of the job status requests must be maintained by the Surety.

**Recommendation:** We recommend that the OSG Associate Administrator advise Indemnity Insurance to implement written policies and procedures that would ensure that principals of bonded contracts guaranteed by SBA are monitored as required by SBA regulations.
**Indemnity Insurance Response:** In its response to the audit report (appendix) Indemnity Insurance stated that:

Our SBA agents are required to complete status inquiries and keep the records in their files. Our agency agreement requires the agent to provide us with complete file access on all accounts immediately upon request. We do not agree that we should be required to receive and retain the additional paper on progress status requests. We will require that inquiries be completed on a consistent basis but we believe the inquiry should be done in ninety day intervals. Unless a contractor requests another project in less than ninety days from the last bond approval a ninety day interval should be sufficient for monitoring progress with the Obligee.

**Cotton & Company Response:** During the audit, the Agent for Indemnity Insurance acknowledged that they had not obtained the required status inquiries and were unaware of the requirement to obtain and maintain these records. The Agent was therefore not in compliance with their Agency Agreement with Indemnity Insurance. Indemnity Insurance stated in their response that they will require that inquiries are completed on a consistent basis. We agree that the completed status inquiries may be maintained in the Agent’s files provided that these records are maintained as required by SBA regulations.

**Record Retention**

Indemnity Insurance did not maintain copies of SBA underwriting Forms 1624 and 912 for one sample bond, as required by SBA regulations. Further, Indemnity Insurance did not have written policies and procedures for underwriting SBA bonds and ensuring compliance with record-retention requirements. Indemnity Insurance is required to provide critical underwriting documents that may be necessary to settle existing claims or to defend or enhance any litigation actions against indemnitors, obligees, or other claimants.

Title 13, CFR, Section 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.

**Recommendation:** We recommend that the OSG Associate Administrator advise Indemnity Insurance to implement written policies and procedures for underwriting and servicing SBA-guaranteed bonds and revise its procedures to ensure that all completed documents be retained as required by SBA regulations.

**Indemnity Insurance Response:** In its response to the audit report (appendix) Indemnity Insurance stated that:

SBA Form 1624 – This is the document concerning disbarment or decertification by a contractor as pertains to the federal government. We are a Plan A underwriting company and not Plan B. The SBA Regional Offices are the ones determining when and how often we get the 1624’s signed by the contractor. Also, when a bond line is secured for our contractors, the individual 1624 form is not required until a new
financial statement is submitted or a request for a line extension is submitted. This paperwork would be in the files at our appointed agents/attorney-in-fact offices. Again our agency agreement requires the agent to provide us with complete file access on all accounts immediately upon request. The Regional SBA office is the one requiring the Form 1624 for their files and use. Personal History Form 912 – Under Plan A there is no reason for our surety home office to have this form in file since the only action taken on this form is by the SBA when they check to see if the contractor is a subversive or a convicted felon. The original form 912 is sent to the Regional SBA Office with a copy held in the submitting agent’s office.

**Cotton & Company Response:** During the audit the Agent for Indemnity Insurance was not able to provide a copy of the documents as required for both Prior Approval sureties (Plan A) or PSB sureties (Plan B) by SBA regulations. The auditors obtained a copy of the missing documents directly from SBA files to facilitate the completion of testing. The two missing documents are required forms prepared by the Surety during the application process for the bond and must be maintained in accordance with SBA regulations.

**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. CFE
## SAMPLE BONDS

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

INDEMNITY INSURANCE COMPANY OF NORTH AMERICA
RESPONSE TO THE DRAFT REPORT
December 15, 2000

Mr. Robert G. Seabrooks, Asst. Inspector General for Auditing
U.S. Small Business Administration
Office of Inspector General
Auditing Division, Mail Code 4112
409 3rd Street, S.W.
Washington, DC 20416

Dear Mr. Seabrooks:

We have reviewed the draft audit report on the performance audit of Indemnity Insurance Company of North America. We will respond to the report in order of the issues mentioned in the report.

Surety Fees

We will implement written policies and procedures to ensure that fees due the SBA are remitted in a timely manner. We request a visit from the SBA to provide us with training for using the SBA web site. We can only ensure timely payment if we are properly trained to use the SBA web site.

Progress Status Requests

Our SBA agents are required to complete status inquiries and keep the records in their files. Our agency agreement requires the agent to provide us with complete file access on all accounts immediately upon request. We do not agree that we should be required to receive and retain the additional paper on progress status requests. We will require that inquiries be completed on a consistent basis but we believe the inquiry should be done in ninety day intervals. Unless a contractor requests another project in less than ninety days from the last bond approval a ninety day interval should be sufficient for monitoring progress with the Obligee.

Record Retention

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We would appreciate clarification on some of the report items discussed above. We will take all necessary action to be in full compliance with SBA Plan A requirements. If you have any questions please don’t hesitate to contact me.

Sincerely,

[Signature]

William Jungreis
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