

DOCUMENT RESUME

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[Weaknesses in the Financial Controls of the National Flood Insurance Program]. B-114860; CED-77-47. March 21, 1977. 9 pp.

Report to Patricia Farris, Secretary, Department of Housing and Urban Development; by Henry Eschwege, Director, Community and Economic Development Div.

Issue Area: Accounting and Financial Reporting (100); Automatic Data Processing (103); Automatic Data Processing: Using Results of ADP Systems (2600).

Contact: Community and Economic Development Div.

Budget Function: Miscellaneous: Financial Management and Information Systems (1002).

Organization Concerned: National Flood Insurers Association.

Congressional Relevance: House Committee on Banking, Currency and Housing; Senate Committee on Banking, Housing and Urban Affairs.

Authority: National Flood Insurance Act of 1968 (42 U.S.C. 4011; 42 U.S.C. 4071). Flood Disaster Protection Act of 1973. Government Corporation Control Act.

There are numerous weaknesses in the ability of the National Flood Insurers Association (NFIA) to generate accurate financial data on its operations relating to the National Flood Insurance Program. Findings/Conclusions: These weaknesses could adversely affect the Government's ability to determine reasonable amounts payable to NFIA under the program; determine flood insurance premium rates; prepare financial statements of the program's condition and results of its operations; and make management decisions. Both accuracy of financial data and timeliness of such data are seriously lacking in the National Flood Insurance Program. Recommendations: Every effort should be made to assure that adequate financial control over the flood insurance program is established as quickly as possible. The Secretary of Housing and Urban Development should: 1) direct the Federal Insurance Administration (FIA) to review financial control problems with NFIA with the objective of establishing a plan that will result in the receipt from NFIA of reliable financial and statistical data necessary to manage the program; 2) direct the Inspector General to review the plan developed to make sure such data will meet FIA's needs; and 3) give consideration to a partial or full assumption by the Government of necessary functions as permitted under Part B of the National Flood Insurance Act of 1968, if adequate financial control cannot be established through arrangements with NFIA. (SC)

00289



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

MAR 21 1977

B-114860

The Honorable
The Secretary of Housing and
Urban Development

Dear Mrs. Harris:

We have reviewed the National Flood Insurers Association's (NFIA) financial controls over its operations relating to the National Flood Insurance Program. We found numerous weaknesses in NFIA's ability to generate accurate financial data. These weaknesses could adversely affect the Government's ability to

- determine reasonable amounts payable to NFIA, under the program;
- determine flood insurance premium rates;
- prepare financial statements of the program's condition and results of its operations; and
- make management decisions.

The purpose of this letter is to bring these weaknesses to your attention so that timely corrective action can be taken.

The National Flood Insurance Program was established under authority of the National Flood Insurance Act of 1968 (42 U.S.C. 4011). It is a subsidized, Government-sponsored program designed to help owners of real or personal property, in areas designated as eligible for flood insurance, purchase such insurance. The program is administered by your Federal Insurance Administration (FIA).

The 1968 act authorized the Secretary of Housing and Urban Development to encourage and assist insurance companies to form a pool for the purpose of providing the flood insurance coverage authorized by law. On June 6, 1969, NFIA,

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through its member companies, began providing the authorized insurance coverage. Membership in NFIA is open to all companies licensed under the laws of any State to write property insurance. NFIA acts as a liaison between member companies and FIA, makes the public aware of the flood insurance program through advertising, and conducts educational seminars for insurance agents. Further, it is responsible for maintaining accounting and administrative records of the program's operations and for reporting on its financial condition to the Administrator, FIA, at least quarterly. FIA sets policy; establishes premium rates; designates areas eligible for insurance; and reinsures, for a fee, the insurers that sell flood insurance.

The 1973 Flood Disaster Protection Act provided for a mandatory rather than voluntary flood insurance program. FIA concluded that the impact of this legislation on the program would be massive. In March 1974, to avoid operating obstacles resulting from accelerating program growth, the administrator of FIA ordered the development of a computerized accounting system for the program's activities. NFIA entered into a contract with Bradford Computer & Systems, Inc. (Bradford), for the development and implementation of the computerized system. The contract became effective in August 1974, but was terminated in November 1976 because many problems developed between NFIA and Bradford. Subsequently, NFIA began operating the system on its own.

The flood insurance program has grown considerably since its inception. By December 31, 1975, an estimated 680,000 policies, representing about \$18.6 billion of insurance, were in force. During calendar year 1975, about \$48 million in premiums was collected and about 23,000 claims were settled for almost \$97 million.

LOSS OF FINANCIAL CONTROL OVER FLOOD INSURANCE PROGRAM

Our review of the financial controls of the National Flood Insurance Program showed that NFIA has been unable to generate accurate financial and statistical data. As a result, it can neither produce its own financial statements nor supply FIA with the kind of data it needs to make program decisions, determine subsidy amounts and premium rates, or produce the financial statements for the program.

NFIA's financial statements at June 30, 1975, were audited and certified by Arthur Andersen & Co. The company's representatives informed us that the certification was possible because necessary financial information was generated by (1) mechanized procedures in place throughout the year at NFIA and (2) manual procedures used and special analyses provided by NFIA. However, since October 1975, NFIA has been unable to prepare financial statements on the results of its operations or to prepare proper billings to the Department of Housing and Urban Development (HUD) for its share of NFIA's costs and flood losses. Arthur Anderson & Co. concluded, after a review of the status of NFIA's records as of June 30, 1976, that, if an audit is at all feasible, the scope of the work would necessarily be so extensive that the cost would make it prohibitive. The audit firm suggested that a 24-month audit be made at June 30, 1977, since it believed that the current problems could be solved by that time.

The Controller, NFIA, informed us that NFIA's inability to prepare financial statements was caused by the failure of Bradford to properly meet its contractual obligations and that such failure created multiple financial and statistical problems during the period Bradford was responsible for the NFIA system. Bradford, in a March 1976 letter to NFIA, stated that all significant difficulties in performance clearly have been caused by NFIA's failure to fulfill its own obligations, by the serious deficiencies in the data made available to Bradford, and by NFIA's lack of cooperation.

System development problems became evident during the first contract year, and by the latter part of 1975, NFIA became increasingly concerned because of what it considered to be a lack of progress. In October 1975, NFIA stopped making payments to Bradford under the contract.

FIA was cognizant of the system development problems since at least January 1975. However, by February 1976, FIA considered that the situation had deteriorated to the point that NFIA no longer wanted to solve the contractual problems but, rather, wanted to terminate the Bradford contract. NFIA concluded that Bradford was in default under the contract and offered a settlement agreement to Bradford to terminate it. Bradford, in March 1976, rejected the settlement, choosing instead to formally arbitrate their differences as provided for in the contract. Arbitration began in September 1976. The arbitrators were dismissed in November 1976, however, because Bradford and NFIA agreed to terminate the contract.

We were informed by the Controller, NFIA, that NFIA has taken over operation of the Bradford system. In so doing they have hired clerical personnel from Bradford and are utilizing the services of several other Bradford people during a transitional period. The NFIA Controller informed us also that NFIA paid about \$4.3 million of about \$5.7 million billed by Bradford since payment to Bradford was stopped in October 1975.

Extent of financial control problems

In November 1975, NFIA engaged Arthur Andersen & Co. to review the system's problems relative to the Bradford contract. In February 1976 Arthur Andersen & Co. reported that the Bradford system did not meet the criteria established by FIA and NFIA for accountability of the flood insurance operations. They cited about 75 deficiencies covering 22 major system requirements. Examples of deficiencies included problems in the areas of premium calculations, error editing, processing of agent commissions, policy statistics, policy servicing, financial statements, policy master files, claims administration, and system controls. In February 1976 Arthur Andersen & Co. was retained by NFIA to develop support for potential legal proceedings pursuant to the Bradford contract, to develop a plan to purify data files and implement effective file maintenance, and to provide system specifications and planning. When the parties entered into the arbitration proceedings, NFIA engaged Arthur Andersen & Co. to assist it and its attorneys in preparing for the case.

NFIA paid Arthur Andersen & Co. over \$1 million in fees and expenses for its services as follows.

--Review of Bradford system resulting in February 1976 report on system deficiencies	\$ 169,400
--Arbitration support	447,000
--File testing	60,600
--System specifications and planning	<u>351,500</u>
	<u>\$1,028,500</u>

As of January 1977, Arthur Andersen & Co. was assisting NFIA in the assumption of the Bradford system, evaluation of system deficiencies, and correction of problems. Payment for these services is at the audit firm's standard billing rates, plus expenses.

FIA also reviewed problems associated with the contractual relationship between NFIA and Bradford. The primary purpose of its review was to determine whether problems with the system were having an adverse impact on policyholders. The review was also intended to identify particularly annoying problems so FIA could work with the parties and seek solutions to them. FIA's report identified numerous problems relating to poor financial control.

Our review was conducted to determine whether the controls over computer operations could be relied upon to make sure that automated accounting and administrative records contain accurate and reliable information. We did not perform a follow-up examination of control deficiencies to determine specific effects. We did, however, observe control weaknesses that could directly affect the accuracy and reliability of data recorded in the automated general ledger and reported in the annual financial statements. Because of these control weaknesses, incorrect information could be entered into accounting records, and financial statements prepared from these records could be misleading. Specifically, our review indicated that controls over NFIA's automated accounting system were not adequate to make sure that all

--cash receipts were deposited in banks and properly recorded in the general ledger,

--flood insurance information received by NFIA from servicing companies was properly entered into the financial records, and

--flood insurance forms containing incorrect or missing information were identified and rejected before final computer processing.

We discussed these control weaknesses with the Controller, NFIA, on December 9, 1976. He stated that the problems resulted from deficiencies in the computerized accounting system and that corrections to the system were being made with the aid of specialists from Arthur Andersen & Co. He stated that cash

controls have been improved; however, improvements were still being developed to make sure that (1) all data received from the various member insurance companies is ultimately recorded in the accounting records and (2) editing procedures are adequate to identify incorrect or missing information.

Effects of inadequate financial controls

One effect of inadequate financial control is that the Federal Government cannot properly calculate subsidy payments due insurers. Premium rates for flood insurance are established on an actuarial basis and, insofar as practicable, at a level sufficient to cover the estimated full cost of insurance claims and to help in the accumulation of reserves to pay anticipated losses. To encourage the purchase of flood insurance, the Administrator established lower than full-cost rates, referred to as chargeable rates. The difference between chargeable rates and full-cost actuarial rates provided the basis for a Federal Government subsidy. 1/

The subsidy, referred to as a premium equalization payment, is made to the insurer after flood losses covered by chargeable rate policies are paid. During the 3-year period ending June 30, 1975, NFIA was paid equalization payments of about \$22 million, \$37 million, and \$47 million, respectively.

On June 2, 1976, FIA requested NFIA to submit, for budget purposes, an estimate of certain financial data including the equalization payment due NFIA. On June 11, 1976, NFIA submitted the data requested with the qualification that the estimates were based on numerous assumptions and projections, due to the problems with Bradford, and should be used accordingly. The estimates included \$41 million (about \$62 million less credits of about \$21 million) due NFIA for equalization payment. Without accurate financial statements and statistical program data, FIA has little assurance that subsidy payments to NFIA are proper.

1/ Pursuant to an amendment in the Flood Disaster Protection Act of 1973, the Secretary changed the formula for determining the subsidy payment to one based on actual premiums collected and actual losses incurred.

A second effect is that the amount of the operating allowance to be retained by NFIA cannot be properly determined. NFIA may retain as an operating allowance a part of the operating profit earned in an accounting period in an amount not to exceed 5 percent of the policyholders' premiums applicable to the period. Operating profit in excess of 5 percent of the policyholders' premiums is to be paid to the Administrator and held in the U.S. Treasury for the payment of future NFIA losses, operating costs, and operating allowances. The inability of NFIA to provide accurate income and expense statements has a direct effect on the determination of the operating allowance.

A third effect concerns the setting of premium rates. Under section 1307 of the National Flood Insurance Act, the Secretary is required to estimate the premium rates necessary to cover the estimated full cost of insurance claims. However, NFIA does not have its claim payment process under adequate financial control. Thousands of claims have been paid since September 1975, but because claims processing had not yet been computerized these claims have not been entered into the financial records. One FIA official informed us that FIA has not received adequate data on which to determine such premium rates.

A fourth effect concerns FIA's financial statements. Under the provisions of the Government Corporation Control Act, FIA is required to prepare annually a statement of financial condition, an income and expense statement, an analysis of surplus or deficit, and a statement of sources and application of funds. FIA cannot prepare accurate financial statements required by the act because it depends on reliable financial data from NFIA to reasonably state part of the financial data in its statements.

The weaknesses in financial control over the flood insurance operations discussed in this report could, in our opinion, result in other serious program deficiencies. Accurate financial statements and statistical reports are essential to enable management to make proper decisions in many of their programs and to keep the Congress informed on program activities. Not only is accuracy of financial data required, but also timeliness. Both are seriously lacking in the National Flood Insurance Program.

CONCLUSIONS AND RECOMMENDATIONS

Accurate financial data from NFIA is essential to FIA in performing tasks applicable to the National Flood Insurance Program. Because FIA does not have such data, it cannot properly prepare budgets and statements showing the financial condition of the program, accurately determine premium rates, or calculate accurate subsidies and operating allowances payable to NFIA. Also, the ability to make proper management decisions is limited without accurate statistical and financial reports. This condition has existed for over a year; therefore, we believe that every effort should be made to assure that adequate financial control over the flood insurance program is established as quickly as possible.

Accordingly, we recommend that you:

- Direct FIA to review financial control problems with NFIA with the objective of establishing a plan that will result in the receipt from NFIA of reliable financial and statistical data necessary to manage the program.
- Direct the Inspector General to review the plan developed to make sure such data will meet FIA's needs.
- Give consideration to a partial or full assumption by the Government of necessary functions as permitted under Part B of the National Flood Insurance Act of 1968 (42 U.S.C. 4071), if adequate financial control cannot be established through arrangements with NFIA.

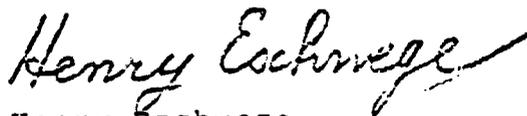
We discussed our findings and recommendations with HUD officials of FIA and the Inspector General's office. The official at FIA generally agreed with our findings and recommendations, and the official of the Inspector General's office concurred with our proposal for review of FIA plans.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the House Committee on Government Operations, the Senate Committee on Governmental Affairs, the House and Senate Committees on Appropriations; the House Committee on Banking, Currency and Housing; and the Senate Committee on Banking, Housing, and Urban Affairs. Copies are also being sent to the Director, Office of Management and Budget.

We would be pleased to discuss the matters included in this report with you or your representatives, and we request that you advise us of any corrective action you plan to take.

Sincerely yours,

A handwritten signature in cursive script that reads "Henry Eschwege". The signature is written in black ink and is positioned above the typed name and title.

Henry Eschwege
Director