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BY THE COMPTROLLER GENERAL

# Report To The Congress

OF THE UNITED STATES

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## Examination Of Financial Statements Of The National Flood Insurance Program As Of December 31, 1977



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COMPTROLLER GENERAL OF THE UNITED STATES

WASHINGTON, D.C. 20548

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To the President of the Senate and the  
Speaker of the House of Representatives

This report summarizes the results of our examination of the financial statements of the National Flood Insurance Program as of December 31, 1977, our opinion thereon, and other information concerning the program's operation and financial condition.

The National Flood Insurance Act of 1968 (U.S.C. 4001 et seq.) subjected the program to the Government Corporation Control Act (31 U.S.C. 841). As a result, we are required to examine the program's financial statements at least once every 3 years and report the results to the Congress.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretaries of the Treasury and Housing and Urban Development; and the Acting Director, Federal Emergency Management Agency. Effective April 1, 1979, program functions and authorities previously performed by the Department of Housing and Urban Development were vested in the Director of the new Federal Emergency Management Agency.

  
Comptroller General  
of the United States

D I G E S T

THE NATIONAL FLOOD INSURANCE PROGRAM

From June 6, 1969, to December 31, 1977, the National Flood Insurance Program was a two part operation. The Federal Insurance Administration, a component of the Department of Housing and Urban Development, set policy, established premium rates, designated areas eligible for insurance, subsidized the insurance written, and offered reinsurance to the insurers that sold flood insurance.

The National Flood Insurers Association, a pool of private insurance companies, participated in the program under an agreement with the Secretary of Housing and Urban Development. The Association conducted day-to-day insurance activities, such as selling insurance, collecting premiums, and settling claims. This relationship continued until the Secretary decided on November 2, 1977, to convert the program from an industry to a Government operation, effective January 1, 1978. (See pp. 1 to 4.)

Program financial information is reflected in the statements of both the Federal Insurance Administration and the Association, and, accordingly, GAO must examine both. GAO last reviewed the program's fiscal year 1974 statements and planned to conduct an audit as of September 30, 1977, the close of the Government's third fiscal year since the 1974 audit. However, GAO extended the period under audit to December 31, 1977, to coincide with the conversion. (See p. 1.)

OPINION ON FINANCIAL STATEMENTS

GAO qualified its opinion on the December 31, 1977, statements of both the Association and the Department for these reasons:

- Final settlement of program accounts, as described in a December 30, 1977, assumption agreement between the Department and the Association, has not yet been reached. The Department estimates

the amount to be within a range of \$0.5 to \$1.3 million due the Association. (See p. 6.)

--GAO was unable to determine whether the Association's \$5.4 million estimate of losses incurred but not reported was stated fairly because data necessary to evaluate the liability was not available from the Department. This also affects about \$2.6 million of the Department's equalization balance, representing its share of the losses. This does not, however, affect the amount of final settlement between the Department and the Association. (See pp. 6 and 8.)

In addition, the Association's statements were qualified due to the uncertainty that exists as to its exemption status for Federal income taxes. (See note F, app. VII.)

GAO requested comments from the Department on its draft report, and from both the Association and its public accountants on the portions relating to their activities. Comments were provided and GAO has reflected suggested changes in this report, as appropriate. None of these parties took exception to GAO's opinion on the financial statements. (See p. 8.)

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ABBREVIATIONS

EDSF	E.D.S. Federal Corporation
FEMA	Federal Emergency Management Agency
FIA	Federal Insurance Administration
GAO	General Accounting Office
HUD	Department of Housing and Urban Development
NFIA	National Flood Insurers Association

## CHAPTER 1

### INTRODUCTION

The National Flood Insurance Program was established under authority of the National Flood Insurance Act of 1968 (42 U.S.C. 4001 et seq.). The act subjected the program to the Government Corporation Control Act. As a result, we are required to audit its financial statements at least once every 3 years and report the results to the Congress.

Our last report to the Congress was for the fiscal year ended June 30, 1974. This report provides our opinions on the program's December 31, 1977, financial statements and includes additional comments concerning program changes in the intervening period. We extended the period under audit from September 30, 1977--the close of the Government's third fiscal year since our 1974 audit--to December 31, 1977, because the program was converted at that date from an industry-operated program to a Government-operated program with industry assistance. The conversion is described in detail on pages 3 and 4.

### LEGISLATIVE HISTORY

Prior to the 1968 act, special disaster loans had been the sole source of relief to victims of flood destruction. Because of the high risks and the lack of underwriting standards, flood insurance had not been made available through the private insurance industry. The 1968 act authorized the Secretary, Department of Housing and Urban Development (HUD), to establish a voluntary National Flood Insurance Program to provide limited indemnification to owners of real and personal property for flood losses. The act's principal objectives were to:

- Make flood insurance available to residents of flood-prone areas at reasonable premium rates through a Federal subsidy.
- Require local jurisdictions to enact land use and control measures designed to guide the rational use of the flood plain as a condition for the availability of federally subsidized flood insurance.

The Secretary, HUD, delegated administration of the program to the Administrator, Federal Insurance Administration (FIA), an organizational component within HUD. FIA is also responsible for directing programs that provide crime insurance and reinsurance against abnormal losses resulting from riots and civil disturbances.

Sale of regular flood insurance began in June 1969 when the Secretary designated the first two communities eligible for flood insurance coverage. Under the regular program, as enacted in 1968, insurance could not be made available until a detailed flood insurance study had been made in the community to establish actuarially sound rates for the coverage and to determine and map the level at which new construction would be reasonably safe from flooding. This requirement severely restricted the rate at which communities could be brought into the regular program. At HUD's urging, the 1968 act was amended on December 24, 1969, to implement an emergency program.

Under the emergency program, property owners in eligible communities could obtain insurance coverage on structures at federally subsidized rates even though the detailed study and rate map required for the regular program would not be completed for some time. The coverage was generally limited to one-half the maximum amount available under the regular program. To be eligible for the emergency program, the community is required to (1) apply officially to participate and (2) adopt minimum flood plain management regulations to guide new construction in flood-prone areas. Although the emergency program was originally established for a 2-year period ending December 31, 1971, subsequent amendments have extended it through September 30, 1980.

From passage of the 1968 act through 1973, the program operated on a voluntary basis. Few communities, however, entered the program during that period, and nationwide flood losses increased at an alarming rate. Recognizing the national need for a more reliable and comprehensive flood insurance program, the Congress passed the Flood Disaster Protection Act of 1973 (42 U.S.C. 4002). This legislation changed the nature of the program markedly. Whereas, previously, the purchase of flood insurance was completely voluntary, the 1973 act provided for certain incentives to purchase flood insurance, which resulted in thousands of home buyers purchasing the insurance.

Specifically, the law made the purchase of flood insurance, where available, a condition of receiving any Federal financial assistance for construction or acquisition purposes in identified flood-prone areas or of obtaining from a federally regulated lender a conventional mortgage secured by property in a flood plain. Further, in communities identified as having flood-hazard areas but not participating in the program, Federal agencies were prohibited from approving financial assistance for construction and acquisition purposes in a flood-hazard area, and federally supervised lenders were barred from

making, increasing, extending, or renewing any loans secured by improved real estate or a mobile home located in the identified flood-hazard area. The latter prohibition affecting conventional mortgages was rescinded by an amendment contained in the Housing and Community Development Act of 1977 (42 U.S.C. 4106). The 1973 act also substantially increased the insurance coverage limits and broadened the scope of coverage to include losses resulting from erosion caused by abnormally high water levels.

Actuarial premium rates must be established for each community before it is eligible for flood insurance coverage under the regular program. The FIA Administrator establishes the full-cost actuarial rates based on accepted actuarial principles, taking into consideration the risk involved and certain administrative expenses. In doing so, the Administrator is authorized to carry out studies and investigations to obtain the necessary information, as well as to prescribe less than full-cost premium rates when necessary to encourage purchase of flood insurance.

At the end of 1977 there were nearly 1.2 million policyholders with more than \$36 billion of insurance in force and almost 16,000 communities participating in the program.

#### RECENT PROGRAM CHANGES

The 1968 enabling legislation for the National Flood Insurance Program identified two possible methods of operating the program:

- An industry program with Federal financial assistance (part A).
- A Government program with industry assistance (part B).

The act provided that the Secretary, HUD, implement part A initially. It encouraged insurance companies to form a pool to provide the flood insurance coverage authorized by law. HUD, however, was allowed to convert the program to part B if the Secretary determined it could not be carried out under part A or its operation would be assisted materially by Federal Government assumption.

From the program's inception in 1969 through December 1977, a part A program existed under an agreement with the National Flood Insurers Association (NFIA), a pool of insurance companies, to provide the authorized insurance coverage on a limited risk-sharing basis. Membership in NFIA was open to all companies licensed under the laws of any

State to write property insurance and having at least \$1 million in assets. In addition to the sale of insurance and settlement of claims, NFIA was responsible for many of the administrative and accounting functions related to the program.

Over the years, however, numerous problems developed between NFIA and HUD. Among the more important issues were (1) HUD wanted the right to review and approve NFIA's overhead operating budget, but NFIA refused to accede to that point, (2) NFIA refused to bid its servicing contracts competitively, and (3) HUD and NFIA disagreed on the extent of the HUD Secretary's authority over the program regarding policy decisions and regulatory authority. These issues eventually resulted in the drafting of a new part A agreement.

In October 1977 HUD prepared a cost comparison between part A and part B and concluded that an estimated \$15 million might be saved in 1978 alone if HUD managed the program directly. On November 2, 1977, the Secretary, HUD, decided to convert the program to part B, effective January 1, 1978. This decision was based on the premise that Federal Government assumption would materially assist the program.

Under the part B program, HUD contracted with E.D.S. Federal Corporation (EDSF), a computer operations and management firm, to handle the administrative and clerical duties of the insurance aspects of the program. Its responsibilities include records maintenance, marketing, claims settlement, and preparation of program financial and statistical data. The contract between HUD and EDSF extended to November 3, 1978, and has since been renewed through November 3, 1980.

On June 19, 1978, the President proposed in Reorganization Plan No. 3 of 1978 that FIA's responsibilities be transferred to a Federal Emergency Management Agency (FEMA). The proposal was to merge several closely allied Federal programs involved with emergency preparedness, mitigation, and response to national emergencies into a single agency. On March 31, 1979, Executive Order 12127 (44 FR 19367) placed the plan into effect. Functions and authorities previously performed by HUD with respect to the program are now vested in the Director, FEMA, effective April 1, 1979.

## CHAPTER 2

### COMMENTS ON FINANCIAL STATEMENTS

Financial information on the program is reflected in both the FIA and NFIA financial statements and, accordingly, our review encompassed both.

#### FEDERAL INSURANCE ADMINISTRATION

FIA combined financial information for its fiscal year ended September 30, 1977, with that for the 3 months ended December 31, 1977, the date of Government assumption of the program. Its financial statements for the resulting 15-month period are presented on a comparative basis with those for the 15-month period ended September 30, 1976. (See schedules 1 to 3.)

The 1968 act authorized the Secretary of HUD to borrow up to \$250 million from the U.S. Treasury to establish the National Flood Insurance Fund. This limit has since been increased to \$500 million without the President's approval and up to \$1 billion with the President's approval. At December 31, 1977, FIA's outstanding borrowings totaled \$158.8 million.

Other program receipts have consisted of (1) reinsurance premiums from insurers that purchased reinsurance coverage from FIA to cover excessive flood losses, (2) appropriations for administration, surveys, and studies, (3) transfers from NFIA of the amount by which its operating balance for any accounting period exceeded 5 percent of policyholders premiums (held by the Administrator, FIA, for payment of losses, and operating costs and allowances to NFIA in the future), and (4) any other receipts accruing from the insurance operations.

Program funds have been available for (1) premium equalization payments to insurers, (based on the difference between the actuarially determined, full-cost premium rates and the chargeable or less than full-cost rates established by the FIA Administrator), (2) repayment of Treasury borrowings and interest, (3) payment of incurred losses, operating costs, and operating allowances to NFIA (not exceeding the balance of funds previously paid to the Administrator for this purpose), (4) payment of claims of insurers that purchased reinsurance coverage, (5) payment of administrative expenses necessary to carry out the program as determined by the Secretary, HUD, and (6) financing the transition of the program from industry to Government operation. Program operating expenses have

consistently exceeded income, with a cumulative deficit at December 31, 1977, of \$264 million. The deficit has been financed through borrowing from Treasury on interest-bearing notes.

Program costs for administration, surveys, and studies are financed through annual appropriations. Obligations through December 31, 1977, for these purposes totaled about \$270 million.

Information necessary for FIA to determine the amount of reinsurance premium income, premium equalization expense, and operating balance due to or from NFIA had to be obtained from NFIA. Beginning with fiscal year 1976, NFIA was unable to provide the actual financial data and instead reported estimates to HUD. NFIA subsequently made needed improvements to its automated accounting system; after audit of its statements by an independent public accounting firm, Touche Ross & Co., NFIA provided HUD with the actual figures through December 31, 1977. FIA adjusted its records so that the financial statements in this report reflect the actual data.

Our opinion on FIA's December 31, 1977, statements is qualified because HUD and NFIA have not yet reached final settlement of program accounts. On December 30, 1977, they entered into an assumption agreement which provides for final settlement no later than June 30, 1979. Agreement as to the responsibility for certain costs incurred has not yet been reached. HUD's Office of Inspector General is in the process of reviewing program funds transferred to HUD at the termination of NFIA operations as well as transition billings of \$737,000 submitted by NFIA. HUD estimates final settlement to be within a range of \$0.5 to \$1.3 million due NFIA.

We further qualified our opinion because FIA's calculation of its equalization balance includes about \$2.6 million, representing HUD's share of NFIA's estimate of losses incurred but not reported on which we were unable to express an opinion. This does not, however, affect the amount of final settlement between HUD and NFIA. NFIA's estimate of losses incurred but not reported is discussed further on page 8.

#### NATIONAL FLOOD INSURERS ASSOCIATION

Appendixes III to VI contain NFIA's financial statements for its fiscal years ended June 30, 1976 and 1977, and for the 6 months ended December 31, 1977. In examining these statements, we reviewed work performed by Touche Ross on the NFIA accounting records and were able to substantially reduce our audit work.

In 1975 both NFIA and FIA became aware of numerous weaknesses in NFIA's automated accounting system. The system was developed by a private computer services company using specifications provided by NFIA. At NFIA's request, its independent auditors at the time, Arthur Andersen & Company reviewed the system and in February 1976 reported that serious deficiencies existed covering several major system requirements. The auditors found that the system could not produce accurate financial data and concluded that if an audit as of June 30, 1976, was 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 as of June 30, 1977, since it believed that the current problems could be solved by that time.

After we became aware of the status of the flood program's accounting system and because of our responsibility to audit the program's records, we issued a letter to the Secretary, HUD, in March 1977 concerning the loss of financial control over the flood insurance program (CED-77-47). Our report reiterated that NFIA had been unable to generate accurate financial and statistical data. As a result, it could neither produce its own financial statements nor provide FIA with the data needed to make program decisions, determine subsidy amounts and premium rates, or produce its financial statements.

The NFIA Controller stated that the problems noted by Arthur Andersen and us resulted from deficiencies in the computerized accounting system and that specialists from Arthur Andersen were assisting NFIA in correcting the system deficiencies. While improvements did not correct system deficiencies completely, by mid-1977 they enabled NFIA to prepare financial statements. In July 1977 NFIA engaged Touche Ross to examine the financial statements for the 2 fiscal years ending June 30, 1976 and 1977. Touche Ross later audited the financial statements for the 6 months ended December 31, 1977.

In the case of both premium and claim transactions, which together affect a large number of the NFIA accounts, Touche Ross found it could not rely on data initially produced by the automated system. After preliminary tests, Touche Ross recommended changes to the computer-produced data bases, then tested the modified data bases for reliability.

Based on the results of Touche Ross' work, NFIA made several adjustments to its statement balances so that they would be fairly presented at June 30, 1976. While the auditors also proposed adjustments to the June and December 1977 statements, they had found the system which generated the financial statement data for these periods to be improved and more reliable.

Touche Ross concluded that, with the exception of qualifications pertaining to final settlement with HUD, NFIA's \$5.4 million estimate of losses incurred but not reported, 1/ and its Federal income tax exemption status, the NFIA financial statements presented fairly its financial position and the results of its operations for the periods reported. (See pp. 20 to 22.)

Based on our review of the accounting firm's work, we believe the audit approach used provided adequate coverage and afforded a reasonable basis for an opinion regarding the financial statements under examination.

#### COMMENTS AND OUR EVALUATION

We requested comments from FIA on our draft report, and from NFIA and Touche Ross on the portions relating to their activities. Comments were provided and we have reflected suggested changes in this report, as appropriate. None of these parties took exception to our opinion on the financial statements.

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1/ This estimate, combined with reported unpaid losses and loss expenses of \$15.4 million (a total of \$20.8 million) is shown on app. III under the caption "Unpaid losses and loss expenses." Since issuance of the public accounting firm's report, HUD has developed an automated claims system. However, we were still unable to verify the accuracy of the reported \$5.4 million balance because the system data base does not identify specific claims incurred before December 31, 1977, but not reported until after that date. This qualification does not, however, affect the amount of final settlement between HUD and NFIA. The December 30, 1977, assumption agreement provided specifically for HUD to assume from NFIA the obligations for adjustment, payment, or settlement of these losses as claims were filed.

## CHAPTER 3

### SCOPE OF EXAMINATION AND OPINION

#### ON FINANCIAL STATEMENTS

##### SCOPE

Our examination of FIA's financial statements pertaining to the National Flood Insurance Program for the 15-month period ended December 31, 1977, was made in accordance with generally accepted auditing standards and included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

NFIA engaged a public accounting firm to examine its financial statements. Our examination of NFIA's financial statements for the fiscal year ended June 30, 1977, and the 6 months ended December 31, 1977, included a review of the firm's audit work on the balance sheet and income and expense accounts which enabled us to reduce our audit work.

##### OPINIONS

###### Federal Insurance Administration

In our opinion, the accompanying financial statements (schs. 1 to 3), subject to the effects of final settlement with NFIA and the accuracy of the amount of losses incurred but not reported that should be included in its reported equalization balance (see p. 6), present fairly the financial position of the Federal Insurance Administration as of December 31, 1977, and the results of its operations and the sources and applications of its funds (changes in financial position) for the 15-month period then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

###### National Flood Insurers Association

In our opinion, the accompanying financial statements of NFIA (apps. III to VI), subject to the qualifications discussed in the following paragraphs, present fairly the financial position of NFIA at December 31, 1977, and the results of its operations and changes in financial position for the 6 months ended December 31, 1977, and the fiscal year ended June 30, 1977, in conformity with generally accepted accounting principles applied on a consistent basis.

We were unable to determine whether NFIA's \$5.4 million estimate of losses incurred but not reported was stated fairly because data necessary to evaluate the liability was not available from HUD. Although HUD has developed an automated claims system, the system data base does not identify specific payments applicable to incurred but not reported losses at December 31, 1977. This does not, however, affect the amount of final settlement with HUD.

HUD and NFIA entered into an assumption agreement on December 30, 1977, which provides for final settlement of program accounts no later than June 30, 1979. Although agreement has not yet been reached as to the responsibility for certain costs incurred, HUD estimates the amount to be within a range of \$0.5 to \$1.3 million due NFIA.

As indicated in previous years, an uncertainty exists with respect to NFIA's exemption status for Federal income taxes.

## SCHEDULES

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
 FEDERAL INSURANCE ADMINISTRATION  
 NATIONAL FLOOD INSURANCE PROGRAM  
 COMBINED COMPARATIVE BALANCE SHEETS  
 FOR THE FIFTEEN MONTH PERIODS ENDED SEPTEMBER 30, 1976 AND DECEMBER 31, 1977

SCHEDULE I

ASSETS

	National Flood Insurance Fund		Appropriated Funds		Total	
	1977	1976	1977	1976	1977	1976
Cash and Fund Balances:						
On deposit with U.S. Treasury (note 6)	\$ (133,215)	\$ -	\$149,109,603	\$ 68,024,086	\$148,976,388	\$ 68,024,086
Accounts Receivable:						
Reinsurance premiums from NFIA	17,059,154	6,641,120	-	-	17,059,154	6,641,120
Trust deposit from NFIA (note 2)	13,410,019	21,835,461	-	-	13,410,019	21,835,461
<u>Total assets</u>	<u>\$30,335,958</u>	<u>\$ 28,476,581</u>	<u>\$149,109,603</u>	<u>\$ 68,024,086</u>	<u>\$179,445,561</u>	<u>\$ 96,500,667</u>

LIABILITIES

Accounts payable:						
Studies and surveys - Government	\$ -	\$ -	\$ 2,110,986	\$ 17,277,717	\$ 2,110,986	\$ 17,277,717
Studies and surveys - Other	-	-	569,069	15,886,470	569,069	15,886,470
Equalization payments due NFIA (note 3)	83,535,718	71,342,017	-	-	83,535,718	71,342,017
Accrued interest payable	4,708,415	2,121,067	-	-	4,708,415	2,121,067
Trust and deposit liabilities	46,754,348	33,001,186	-	-	46,754,348	33,001,186
<u>Total liabilities</u>	<u>\$134,998,481</u>	<u>\$106,464,270</u>	<u>\$ 2,680,055</u>	<u>\$ 33,164,187</u>	<u>\$137,678,536</u>	<u>\$139,628,457</u>

INVESTMENT OF THE U.S. GOVERNMENT

Notes payable to the U.S. Treasury	158,850,956	119,843,120	-	-	158,850,956	119,843,120
Congressional appropriations (net of amounts returned to the U.S. Treasury)	-	-	353,218,778	187,437,828	353,218,778	187,437,828
Cumulative deficit ( )	(263,513,479)	(197,830,809)	(206,789,230)	(152,577,929)	(470,302,709)	(350,408,738)
Investment of U.S. Government (impairment)	(104,662,523)	(77,987,689)	146,429,548	34,859,899	41,767,025	(43,127,790)
<u>Total liabilities and investment of the U.S. Government</u>	<u>\$ 30,335,958</u>	<u>\$ 28,476,581</u>	<u>\$149,109,603</u>	<u>\$ 68,024,086</u>	<u>\$179,445,561</u>	<u>\$ 96,500,667</u>

The notes on pages 15 to 17 are an integral part of this statement. The opinion of the General Accounting Office on these statements appears on page 9.

SCHEDULE I

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
 FEDERAL INSURANCE ADMINISTRATION  
 NATIONAL FLOOD INSURANCE PROGRAM  
 COMBINED COMPARATIVE STATEMENTS OF INCOME AND EXPENSE AND CUMULATIVE  
 DEFICIT FOR THE FIFTEEN MONTH PERIODS ENDED SEPTEMBER 30, 1976 AND DECEMBER 31, 1977

	National Flood Insurance Fund		Appropriated Funds		Total	
	1977	1976	1977	1976	1977	1976
<b>Income:</b>						
Reinsurance premiums	\$ 10,418,034	\$ 8,182,271	\$ -	\$ -	\$ 10,418,034	\$ 8,182,271
<b>Total income</b>	<u>10,418,034</u>	<u>8,182,271</u>	<u>-</u>	<u>-</u>	<u>10,418,034</u>	<u>8,182,271</u>
<b>Expense:</b>						
Interest expense	11,580,184	8,919,918	-	-	11,580,184	8,919,918
Premium equalization expense	64,387,305	79,785,134	-	-	64,387,305	79,785,134
Other	133,215	-	-	-	133,215	-
Administrative expense (note 5)	-	-	-	6,284,000	-	6,284,000
Studies and survey expenses	-	-	54,211,300	88,726,098	54,211,300	88,726,098
<b>Total expense</b>	<u>76,100,704</u>	<u>88,705,052</u>	<u>54,211,300</u>	<u>95,010,098</u>	<u>130,312,004</u>	<u>183,715,150</u>
<b>Net loss for the fiscal year</b>	65,682,670	80,522,781	54,211,300	95,010,098	119,893,970	175,532,870
<b>Prior fiscal years deficit</b>	<u>197,830,809</u>	<u>117,308,028</u>	<u>152,577,930</u>	<u>57,567,831</u>	<u>350,408,739</u>	<u>174,875,860</u>
<b>Cumulative Deficit at September 30, 1976 and December 31, 1977</b>	<u>\$263,513,479</u>	<u>\$197,830,809</u>	<u>\$206,789,230</u>	<u>\$152,577,929</u>	<u>\$470,302,709</u>	<u>\$350,408,739</u>

The notes on pages 15 to 17 are an integral part of this statement. The opinion of the General Accounting Office on these statements appears on page 9.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
 FEDERAL INSURANCE ADMINISTRATION  
 NATIONAL FLOOD INSURANCE PROGRAM  
 COMBINED COMPARATIVE STATEMENTS OF SOURCE AND APPLICATION OF FUNDS  
 (COMBINED COMPARATIVE STATEMENTS OF CHANGES IN FINANCIAL POSITION)  
 FOR THE FIFTEEN MONTH PERIODS ENDED SEPTEMBER 30, 1976 AND DECEMBER 31, 1977

	National Flood Insurance Fund		Appropriated Funds		Total	
	1977	1976	1977	1976	1977	1976
Source of Funds:						
Borrowing from U. S. Treasury	\$39,007,836	\$49,919,561	\$ -	\$ -	\$ 39,007,936	\$ 49,919,561
Congressional appropriations	10,418,034	8,182,272	166,000,000	93,750,000	166,000,000	93,750,000
Reinsurance premiums	26,674,834	30,603,219	-	-	10,418,034	8,182,272
Decrease in working capital				1,481,673		32,084,992
Total source of funds	\$76,100,704	\$88,705,052	\$166,000,000	\$95,231,673	\$215,425,870	\$183,936,725

	Application of Funds:		Total application of funds	
	1977	1976	1977	1976
Congressional appropriations returned to U. S. Treasury	\$ -	\$ -	\$ 219,050	\$ 221,575
Interest expense	11,580,184	8,919,918	-	-
Premium equalization expense	64,387,305	79,785,134	-	-
Other expenses	133,215	-	-	-
Administrative expense (note 5)	-	-	-	6,284,000
Studies and surveys expenses	-	-	54,211,300	88,726,098
Increase in working capital	-	-	111,569,650	-
Total application of funds	\$76,100,704	\$88,705,052	\$166,000,000	\$95,231,673
			\$215,425,870	\$183,936,725

The notes on pages 15 to 17 are an integral part of this statement. The opinion of the General Accounting Office on these statements appears on page 9.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
FEDERAL INSURANCE ADMINISTRATION  
NATIONAL FLOOD INSURANCE PROGRAM  
NOTES TO FINANCIAL STATEMENTS  
DECEMBER 31, 1977

1. On December 30, 1977, the Secretary of Housing and Urban Development (HUD) and the National Flood Insurers Association (NFIA) entered into an Assumption Agreement to effect an orderly transition from the flood insurance program operated by NFIA to a flood insurance program operated by HUD as of January 1, 1978. The Assumption Agreement in summary provides for:

- a/ Assignment of policies from NFIA to HUD and Assumption by HUD of all rights and obligations arising under any flood insurance policy in NFIA's name issued before 12:00 a.m. on January 1, 1978, including claims for losses arising before January 1, 1978 whether or not filed before that date, as well as claims for losses arising after that date.
- b/ The settlement of accounts between NFIA and HUD for prior and current accounting period, including a provision to settle the trust account through June 30, 1975 in the amount of \$22,178,604.
- c/ The final settlement of accounts between HUD and NFIA subject to completion of an audit by the General Accounting Office or HUD's Office of Inspector General, but not later than June 30, 1979.

HUD has signed a contract with E.D.S. Federal Corporation of Bethesda, Maryland commencing January 1, 1978 to act as servicing agent for issuing policies, settling claims and maintaining accounting and statistical records.

2. Effective as of July 1, 1971, the 1969 agreement between the Secretary and NFIA was amended to provide for the payment to the Administrator for that portion of NFIA's operating balance which in any accounting period exceeds 5 percent of the earned policy-holder premiums. The agreement specifies that the amount paid is to be held in the Treasury of the United States for the payment of future losses, operating costs, and operating allowances as allowed by the Administrator. The Administrator and NFIA agreed that computation of the amount due to or from NFIA would be on the basis of a policy participation year. On this basis insurance premiums are considered income in the year that the policies become effective and losses and expenses related to the policies are deducted from the income, regardless of the year incurred or paid. The balance of \$13,410,019 shown in schedule 1 as an account receivable due from NFIA was computed on the basis of the following policy participation year data.

Participation year ending June 30	Participation year operating balance or (loss)	5 percent of earned policyholder premiums a/	Amount due FIA or (due NFIA) a/
1972	\$ 8,184,397	\$ 676,758	\$ 7,507,629
1973	4,424,490	757,069	3,667,421
1974	14,327,174	1,302,479	13,024,695
1975	11,332,737	2,048,624	9,284,113
1976	15,572,405	2,667,005	12,905,400
1977	2,679,578	2,744,000	(64,422)
1978 b/	<u>239,193</u>	<u>(190,319)</u>	<u>429,512</u>
Total all years	<u>\$56,759,974</u>	<u>\$10,005,526</u>	<u>\$46,754,348</u>

Less, Distribution of:

Participation years 1971 - 1975  
operating allowance to members,  
companies and balance due HUD in  
fiscal years 1972, 1973, 1974  
and 1975

<u>2,736,316</u>	<u>33,344,329</u>
<u>\$ 7,269,310</u>	<u>\$13,410,019</u>

a/ The contract provides that if in any accounting period NFIA incurs an operating loss or does not earn a profit equal to 5 percent of earned policyholder premiums, it is entitled to payment from the funds previously paid to the Administrator, FIA, in an amount (not to exceed the balance of such funds) sufficient to provide NFIA with an operating balance equal to 5 percent of earned policyholder premiums.

b/ For period ended December 31, 1977.

3. The agreement between the NFIA and the Secretary of HUD as it pertains to equalization operating costs states that periodic payment shall be made to NFIA for the Government's share of paid flood insurance claims and for equalization of operating costs. Payments were made on this basis through the fiscal year ended June 30, 1972. In fiscal year 1973, NFIA with the acquiescence of FIA, redefined incurred losses to include "Incurred but not Reported Losses" (IBNR) and related loss adjustment expenses. However, FIA stipulated that reimbursement would not be made until actual incurred amounts of losses were determined and paid, or were in the process of being paid.

The equalization payments due NFIA shown in schedule 1 in the amount of \$83,535,718 include IBNR and related loss adjustment expenses in the amount of \$2,592,511 subject to the FIA stipulation.

4. The Insurance in force as of December 31, 1977 was:

<u>Number of policies</u>	<u>Amount</u>
1,176,215	\$36,437,950,700

As of December 31, 1977, HUD was contingently liable for flood insurance losses incurred after December 31, 1977 on insurance in force through December 31, 1977. Starting January 1, 1978, the Department of Housing and Urban Development assumed all rights and obligations rising under any flood insurance policy in the NFIA's name issued before January 1, 1978 whether or not filed before that date as well as claims for losses arising after that date.

5. In fiscal year 1976 and the prior fiscal year, funds for administrative expenses were appropriated in the Flood Insurance Account and transferred to the Administrative Operations Fund. Pursuant to 12 U.S.C. 1701(b)(3), the administrative expense funds of the Department of Housing and Urban Development were consolidated within a single fund, Salaries and Expenses.

The estimated administrative cost associated with the administering of the National Flood Insurance Program for the fifteen month period ended December 31, 1977 is \$8,097,000.

6. The National Flood Insurance Fund is authorized to borrow funds from the U.S. Treasury to carry out the program. A note in the amount of \$250,000,000 was executed July 1969, between the Secretary of HUD and the Secretary of Treasury on behalf of the program. As of December 31, 1977, the balance available under this note is \$91,149,044.

The negative cash balance as of December 31, 1977 is the result of not having borrowed adequate cash from Treasury as of that date. As a cash management practice for the program, cash advances are requested from the U.S. Treasury as needed to pay obligations when they become due. In January 1978, cash was borrowed to cover the deficit at 12/31/77.

## APPENDIXES

NATIONAL FLOOD INSURERS ASSOCIATION  
PUBLIC ACCOUNTANT'S OPINION OF ITS  
DECEMBER 31, 1977, FINANCIAL STATEMENTS

*Touche Ross & Co.*

June 28, 1978

Executive Committee  
National Flood Insurers Association  
Arlington, Virginia

We have examined the balance sheet of National Flood Insurers Association (an unincorporated association) as of December 31, 1977, and the related statements of operations, changes in undistributed operating balance and changes in financial position for the six months then ended. Except as explained in the following paragraph, our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In connection with the transfer of operational responsibility for the flood insurance program to the Department of Housing and Urban Development as explained in Note C, insurance records were turned over to HUD on December 31, 1977. Due to the manual claims processing system used by HUD after that date, data necessary for us to satisfy ourselves as to the portion of the liability for unpaid losses relating to losses incurred before December 31, 1977 but not reported until after that date estimated at \$5,414,600. was not available.

As discussed in Notes C and D to the accompanying financial statements, the Association's flood insurance contract with HUD expired on December 31, 1977 and HUD has assumed operational responsibility for the flood insurance program. An Assumption Agreement has been entered into with HUD which, among other matters, makes provision for final settlement of program accounts after audit by the General Accounting Office or HUD's Office of Inspector General but in any case no later than June 30, 1979, and provides that HUD is responsible for transition costs and the Association for its termination costs, although the parties are not in agreement as to the responsibility for certain transition costs.

As discussed in Note F to the accompanying financial statements, an uncertainty exists with respect to the Association's exemption status for Federal income taxes.

*Touche Ross & Co.*

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matters referred to in the preceding paragraphs, the financial statements referred to above present fairly the financial position of National Flood Insurers Association as of December 31, 1977, and the results of its operations and the changes in its financial position for the six months then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

*Touche Ross & Co.*  
Certified Public Accountants

NATIONAL FLOOD INSURERS ASSOCIATION  
PUBLIC ACCOUNTANT'S OPINION OF ITS  
JUNE 30, 1977 AND 1976 FINANCIAL STATEMENTS

*Touche Ross & Co.*

December 14, 1977

Executive Committee  
National Flood Insurers Association  
Arlington, Virginia

We have examined the balance sheets of National Flood Insurers Association (an unincorporated association) as of June 30, 1977 and 1976, and the related statements of operations, changes in undistributed operating balance and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in Note C to the accompanying financial statements, the Association's contract with the Department of Housing and Urban Development (HUD) expires on December 31, 1977 and no new or renewal insurance coverage will be written after that date by the Association. A transition and termination assumption agreement with HUD is presently being negotiated.

As discussed in Notes E and F to the accompanying financial statements, uncertainties exist with respect to the recoverability from HUD of a portion of the Equalization Receivable as reflected in the financial statements and the Association's exemption status for Federal income taxes.

In our opinion, subject to the effects, if any, on the financial statements of the ultimate resolution of the matters referred to in the preceding paragraphs, the financial statements referred to above present fairly the financial position of National Flood Insurers Association as of June 30, 1977 and 1976, and the results of its operations and the changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

*Touche Ross & Co.*

Certified Public Accountants

NATIONAL FLOOD INSURERS ASSOCIATIONBALANCE SHEETAT DECEMBER 31, 1977, JUNE 30, 1977 AND 1976

	<u>December 31, 1977</u>	<u>June 30, 1977</u>	<u>June 30, 1976</u>
<u>ASSETS</u>			
Cash	\$ 6,220,751	\$ 928,058	\$ 1,291,146
U.S. Government Treasury Bills, at amortized cost, which approximates market	4,397,205	17,877,900	23,795,232
Premiums receivable		1,594,000	1,256,000
Premium taxes and other receivables	664,959		
Receivable from HUD for loss and operating costs equalization (Notes D and E)	83,511,424	89,999,508	61,683,424
Deferred policy acquisition costs (Note B-1)	10,739,150	13,528,896	9,623,240
	<u>\$105,533,489</u>	<u>\$123,928,362</u>	<u>\$97,649,042</u>
<u>LIABILITIES, UNDISTRIBUTED OPERATING BALANCE, AND MEMBERS' ADMISSION FEES</u>			
<u>LIABILITIES:</u>			
Unpaid losses and loss expenses (Note B-2)	\$ 20,797,150	\$ 13,583,576	\$29,355,114
Unearned premiums (Note B-1)	39,207,841	43,321,625	28,245,368
Loss drafts payable	4,191,892	3,735,664	2,889,835
Accounts payable and accrued expenses	3,485,428	7,280,042	9,277,052
Reinsurance ceded premiums payable to HUD (Note E)	17,222,976	12,887,896	4,533,876
	84,905,287	80,808,803	74,301,245
UNDISTRIBUTED OPERATING BALANCE (Note E)	20,539,800	43,031,157	23,261,095
MEMBERS' ADMISSION FEES	88,402	88,402	86,702
	<u>\$105,533,489</u>	<u>\$123,928,362</u>	<u>\$97,649,042</u>

The notes on pages 28 to 33 are an integral part of this statement. The opinion of GAO on the December 31, 1977, balance sheet appears on page 9. GAO did not audit the June 30, 1977 and 1976 balance sheets and accordingly is not expressing an opinion on them.

NATIONAL FLOOD INSURERS ASSOCIATIONSTATEMENT OF OPERATIONSFOR THE PERIODS ENDEDDECEMBER 31, 1977, JUNE 30, 1977 AND 1976

	<u>Six months ended</u> <u>December 31, 1977</u>	<u>Year ended</u>	
		<u>June 30, 1977</u>	<u>June 30, 1976</u>
<b>INCOME:</b>			
Premiums written	\$40,235,594	\$83,783,714	\$57,524,951
Less reinsurance ceded	(4,335,081)	(8,354,019)	( 5,911,206)
Net premiums written	35,900,513	75,429,695	51,613,745
Decrease (increase) in unearned premiums	4,113,784	(15,076,257)	(8,051,676)
Premiums earned	<u>40,014,297</u>	<u>60,353,438</u>	<u>43,562,069</u>
Interest income	<u>367,756</u>	<u>961,904</u>	<u>1,303,905</u>
	<u>40,382,053</u>	<u>61,315,342</u>	<u>44,865,974</u>
<b>EXPENSES:</b>			
Losses incurred	56,482,801	43,912,683	84,163,480
Loss expenses	4,161,607	2,682,143	5,219,438
Commissions	7,719,968	13,297,829	9,469,117
Service fees	4,677,413	7,735,907	6,206,163
Premium taxes	802,657	2,388,872	1,462,661
General and adminis- trative expenses	<u>4,440,880</u>	<u>7,958,929</u>	<u>7,566,575</u>
	<u>78,285,326</u>	<u>77,976,363</u>	<u>114,087,434</u>
Less loss and operating cost equalization (Note E)	<u>37,590,520</u>	<u>36,431,083</u>	<u>70,040,605</u>
	<u>40,694,806</u>	<u>41,545,280</u>	<u>44,046,829</u>
OPERATING BALANCE	<u>\$ (312,753)</u>	<u>\$19,770,062</u>	<u>\$ 819,145</u>

The notes on pages 28 to 33 are an integral part of this statement. The opinion of GAO on the December 31 and June 30, 1977, statements of operations appears on page 9. GAO did not audit the June 30, 1976, statement of operations and accordingly is not expressing an opinion on it.

NATIONAL FLOOD INSURERS ASSOCIATION  
STATEMENT OF CHANGES IN UNDISTRIBUTED OPERATING BALANCE  
FOR THE PERIODS ENDED DECEMBER 31, 1977, AND JUNE 30, 1977 AND 1976

	Six months ended			Year ended June 30,					
	December 31, 1977			1977			1976		
	Members' Share	Trust Share	Total	Members' Share	Trust Share	Total	Members' Share	Trust Share	Total
UNDISTRIBUTED OPERATING BALANCE AT JULY 1:	\$9,117,923	\$33,913,234	\$43,031,157	\$4,928,737	\$18,332,358	\$23,261,095	\$3,354,968	\$20,389,461	\$23,744,429
ADJUSTMENTS BASED ON ASSUMPTION AGREEMENT (Note C):									
Trust share for participation years through June 30, 1975 to be settled by HUD		(22,178,604)	(22,178,604)						
Adjustment of members' operating allowance to earned premium basis	(2,166,081)	2,166,081							
Portion of settlement adjustment relating to period prior to June 30, 1977	(950,000)	950,000							
OPERATING BALANCE	6,001,842	14,850,711	20,852,553	4,928,737	18,332,358	23,261,095	3,354,968	20,389,461	23,744,429
FOR SIX MONTHS ENDED DECEMBER 31, 1977:	2,217,468	(2,530,221)	(312,753)						
Less: Portion of settlement adjustment relating to six months ended December 31, 1977	(950,000)	950,000							
FOR FISCAL YEAR ENDED JUNE 30:	7,269,310	13,270,490	20,539,800	4,189,186	15,580,876	19,770,062	2,876,248	(2,057,103)	819,145
DISTRIBUTIONS:				9,117,923	33,913,234	43,031,157	6,231,216	18,332,358	24,563,574
Participation year 1974 operating allowance to members							(1,302,479)		(1,302,479)
UNDISTRIBUTED OPERATING BALANCE AT DECEMBER 31, 1977:	\$7,269,310	\$13,270,490	\$20,539,800						
JUNE 30:	\$9,117,923	\$33,913,234	\$43,031,157	\$4,928,737	\$18,332,358	\$23,261,095			

The notes on pages 28 to 33 are an integral part of this statement.

The opinion of the General Accounting Office on these statements appears on page 9 .

NATIONAL FLOOD INSURERS ASSOCIATION  
STATEMENT OF CHANGES IN FINANCIAL POSITION  
FOR THE PERIODS ENDED  
DECEMBER 31, 1977, JUNE 30, 1977 AND 1976

SOURCE OF FUNDS

	<u>Six months ended</u>	<u>Year ended</u>	
	<u>December 31, 1977</u>	<u>June 30, 1977</u>	<u>June 30, 1976</u>
Operating balance	-	\$19,770,062	\$ 819,145
Increase in unearned premiums	-	15,076,257	8,051,676
Increase in reinsurance ceded premiums payable	\$ 4,335,081	8,354,020	1,980,646
Increase in unpaid losses and loss expenses	7,213,574	-	1,734,914
Decrease in receivable from HUD	6,488,084	-	-
Increase in accounts payable and accrued expenses	-	-	4,495,863
Decrease in deferred policy acquisition costs	2,789,746	-	-
Decrease in premiums and other receivables	929,041	-	1,681,700
Increase in loss drafts payable	456,227	845,829	58,683
Increase in Members' admission fees	-	1,700	400
Decrease in cash and U.S. Government Treasury Bills	8,188,002	6,280,420	10,307,494
	<u>\$30,399,755</u>	<u>\$50,328,288</u>	<u>\$29,130,521</u>

The notes on pages 28 to 33 are an integral part of this statement. The opinion of GAO on the December 31 and June 30, 1977 statements of changes in financial position appears on page 9. GAO did not audit the June 30, 1976, statement and accordingly is not expressing an opinion on it.

## APPLICATION OF FUNDS

	Six months ended	Year ended	
	<u>December 31, 1977</u>	<u>June 30, 1977</u>	<u>June 30, 1976</u>
Operating balance	\$ 312,753	-	-
Increase in receivable from HUD	-	\$28,316,084	\$25,361,678
Trust share of operating balance for participation years through June 30, 1975 to be settled by HUD (Note C)	22,178,604	-	-
Decrease in unpaid losses and loss expense	-	15,771,538	-
Decrease in unearned premiums	4,113,784	-	-
Increase in deferred policy acquisition costs	-	3,905,656	2,466,364
Decrease in accounts payable and accrued expenses	3,794,614	1,997,010	-
Increase in premiums receivable	-	338,000	-
Distribution of operating allowance to Members			1,302,479
	<u>\$30,399,755</u>	<u>\$50,328,288</u>	<u>\$29,130,521</u>

NATIONAL FLOOD INSURERS ASSOCIATIONNOTES TO FINANCIAL STATEMENTSSIX MONTHS ENDED DECEMBER 31, 1977YEARS ENDED JUNE 30, 1977 AND 1976A. Organization

National Flood Insurers Association is a voluntary, unincorporated association of insurance companies organized for the purpose of cooperating with the Secretary of Housing and Urban Development in establishing and administering a nationwide program of flood insurance pursuant to the National Flood Insurance Act of 1968. The Association was a party to an agreement with the Secretary of Housing and Urban Development (HUD) which covered various aspects of the Flood Insurance Program. This agreement expired on December 31, 1977.

Membership was open to all insurance companies having total assets of at least \$1,000,000 and qualified to engage in the business of flood insurance in the United States. Each Member was required to pay an admission fee equal to \$50 for each \$25,000 of participation. Participation is the amount the Member agreed to assume of the total underwriting loss in any one year.

As of December 31, 1977 and June 30, 1977 and 1976, the Members had committed total participation of \$48,107,364, \$48,795,595 and \$44,616,858 respectively. Each Member's proportionate participation is the basis for distribution of any losses or operating allowances.

The Association retained by contract insurance entities, twenty-five of which are Members, in specified geographical areas as servicing companies to promote the flood insurance program and to process premiums and claims for the Association. These servicing companies were paid fees on the basis of policies and claims processed.

B. Significant Accounting Practices

The accompanying financial statements have been prepared on a basis consistent with prior periods even though the Association is not responsible for the flood insurance program after December 31, 1977. This basis has been used

to present the financial condition of the flood insurance program at December 31, 1977 (the last day of its operation by the Association) and June 30, 1977 and 1976, and the results of its operations for the periods then ended. The significant accounting practices used are:

- (1) Insurance Premiums and Policy Acquisition Costs - Premiums written are taken into income on a prorata basis over the terms of the policies. Unearned premiums represent the portion of premiums written which apply to the unexpired terms of policies in force.

Policy acquisition costs (commissions, state premium taxes and service fees) have been deferred and are being charged against income on a prorata basis over the terms of the policies to which they relate.

- (2) Losses and Loss Expenses - Liabilities for losses and loss expenses are based on aggregate case basis estimates for claims reported and estimated for claims incurred but not reported. Such estimates include the cost of investigating and settling all claims.

As all insurance records were turned over to HUD on or about December 31, 1977, the estimate for losses incurred but not reported at December 31, 1977 was made without data on losses reported during the period after December 31, 1977.

- (3) Furniture and Fixtures - Additions to furniture and fixtures are expensed as acquired due to their immateriality.

C. Assumption Agreement with the Department of Housing and Urban Development

In November 1977, HUD announced the decision that the Federal Government would assume operational responsibility for the National Flood Insurance Program under Part B of the National Flood Insurance Act rather than entering into a new contract with the Association under Part A of the Act. The existing contract with HUD, described in Note E, expired on December 31, 1977.

On December 30, 1977, the Association entered into an Assumption Agreement with HUD which in summary includes:

- (1) Assignment by the Association to HUD and assumption by HUD, effective January 1, 1978, of all rights and obligations arising under any flood insurance policy in the Association's name issued before that date including specifically all claims for losses arising before January 1, 1978 whether or not filed before that date, as well as claims for losses arising after that date.
- (2) Provisions for an orderly transition of operational responsibility of the program to HUD including record transfer and access provisions, specific transition functions to be carried out by the Association and reimbursement of the costs relating thereto by HUD, use of program funds, etc.
- (3) Provision for settlement of accounts between the Association and HUD for prior and current periods, including a provision for HUD to settle the Trust share of the operating balance through June 30, 1975 in the amount of \$22,178,604, calculation of the Members' operating allowance at 5% of earned premiums for the period July 1, 1975 to December 31, 1977, resolution of items previously questioned by HUD through reduction of Members' share of the operating balance and thereby the final amount of the settlement by \$1,900,000 as a service fee adjustment and provision that final settlement is subject to completion of an audit by the General Accounting Office or HUD's Office of Inspector General, but in any case no later than June 30, 1979.

D. Termination of Operations

Subsequent to January 1, 1978, the Association carried out the transition functions referred to in Note C and closed down its operations. As of June 30, 1978 the Association will no longer have offices or employees, although certain officers will continue to carry out the remaining business on a part time, consulting basis. The costs of transition and termination incurred and estimated to be incurred aggregate \$1,070,000 of which \$740,000 has been invoiced to HUD as reimbursable transition costs under the Assumption Agreement, leaving a balance of \$330,000 to be paid by the Members out of the undistributed operating allowance.

HUD has questioned the recoverability of any costs incurred after January 31, 1978 as transition costs. The Association is of the opinion that the Assumption Agreement clearly provides for reimbursement of the costs of therein defined transition functions, some of which are envisioned in the agreement to be carried out after that date. Of the transition costs of \$740,000 which have been billed to HUD, \$210,000 were incurred after January 31, 1978.

The balance sheet of the Association of January 1, 1978 after giving effect to the Assumption Agreement and providing for the termination costs is as follows:

<u>ASSETS</u>	
Cash	\$ 6,220,751
U.S. Government Treasury Bills	4,397,205
Premium tax refunds receivable	643,981
Receivable from HUD	<u>3,009,842</u>
 TOTAL ASSETS	 <u>\$14,271,779</u>
<u>LIABILITIES AND MEMBERS' EQUITY</u>	
Drafts payable	\$4,191,892
Accounts, premium taxes and commissions payable	2,722,175
Estimated termination costs	<u>330,000</u>
 TOTAL LIABILITIES	 <u>\$7,244,067</u>
 Members' admission fees	 88,402
Undistributed operating allowances	<u>6,939,310</u>
 TOTAL MEMBERS' EQUITY	 <u>\$7,027,712</u>
 TOTAL LIABILITIES AND MEMBERS' EQUITY	 <u>\$14,271,779</u>

E. Agreement with Department of Housing and Urban Development

The Association was a party to an agreement dated June 10, 1969 with the Secretary of Housing and Urban Development (HUD) relating to the Association's operation of the National Flood Insurance Program. This agreement terminated December 31, 1977 and an Assumption Agreement was entered into with HUD (see Note C) which resulted in termination of the Association's obligations under its flood insurance policies at that date.

The agreement was based on accounting periods referred to as participation periods. A participation period, which ran from July 1 to June 30, encompassed the operating results relating to policies written or renewed during that period. Since policies written or renewed during a participation period continued in force beyond the end of that period, losses and expenses relating to those policies continued to be incurred during the subsequent twelve months. Therefore, the operating results for a participation period could not be determined until after the subsequent June 30 and the operating results of a fiscal year related to more than one participation period.

Among other matters, the 1969 agreement:

- (1) Restricted the portion of the operating balance which could be retained and distributed to the Association's Members to an operating allowance of a maximum of 5% of each participation period's premiums written with amounts in excess of this limitation to be held in trust in the Treasury of the United States. If, for any participation period, the Association's operating balance was not sufficient to provide an operating allowance of 5% of premiums written, funds accrued to the Trust for prior participation periods would be available. In case of a negative operating balance in excess of funds available from the Trust, the Members would be required to assume the deficit up to their participation commitment.
- (2) Provided that HUD would determine the premium rates and share in losses, loss expenses and operating costs (other than commissions, premium taxes, and reinsurance ceded premiums), at rates determined in accordance with the agreement (approximately 48%, 58%, and 68% in participation periods ended December 31, 1977 and June 30, 1977 and 1976 respectively).
- (3) Provided for reinsurance by HUD against excess losses for which reinsurance premiums were \$4,335,081, \$8,354,019, and \$5,911,205 for the six months ended December 31, 1977 and the fiscal years ended June 30, 1977 and 1976 respectively.

F. Federal Income Taxes

Management is of the opinion that the Association is not subject to Federal income taxes, as revenues in excess of expenses must be distributed to Members in the form of operating allowances and to the Trust, thus no provision for taxes has been made. The Association has applied for a tax exempt ruling at various dates since its inception but has been unable to obtain one. Federal income tax returns for all years through June 30, 1977, were filed showing no taxable income.

The Federal income tax returns for the years ended June 30, 1972 and 1974 have been examined by the Internal Revenue Service and have been accepted as filed. However, until an exemption has been obtained or the Federal income tax status otherwise resolved, no final determination of the Association's ultimate liability for Federal income taxes can be made.

G. Pension Plan

In July 1975, the Association became a member of a group pension plan covering all employees. The total pension expense was \$43,045, \$65,200, and \$27,300 for the periods ended December 31, 1977 and June 30, 1977 and 1976 respectively. The Association will terminate its membership in the plan when operations are terminated but as only three individuals are vested no significant additional costs will be incurred.

H. Lease Commitments

At December 31, 1977 the Association was lessee under several operating leases for premises and equipment. Total rent expense for the six months ended December 31, 1977 and the years ended June 30, 1977 and 1976 were \$174,166, \$183,000, and \$55,000 respectively. Subsequent to December 31, 1977 all leases were terminated. Total lease termination costs, which are recoverable transition costs, are approximately \$9,000.

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