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Accounting and Information
Management Division

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August 14, 1998

The Honorable Donna A. Tanoue
Chairman, Board of Directors
Federal Deposit Insurance Corporation

Subject: Financial Audit: Other Matters Identified During GAO's 1997 Financial Statement Audits

Dear Chairman Tanoue:

In June 1998, we issued our opinions on the calendar year 1997 financial statements of the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and FSLIC Resolution Fund (FRF). We also issued our opinion on the Federal Deposit Insurance Corporation (FDIC) management's assertions regarding the effectiveness of its internal controls as of December 31, 1997, and reported on FDIC's compliance with significant provisions of selected laws and regulations for the three funds for the year ended December 31, 1997 (GAO/AIMD-98-204, June 29, 1998). We conducted our audit pursuant to the provisions of section 17(d) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1827(d)), and in accordance with generally accepted government auditing standards.

The purpose of this letter is to advise you of internal control and accounting policies and procedures weaknesses identified during our audits of the 1997 financial statements and to suggest improvements to address those weaknesses. Although these matters were not material in relation to the financial statements, we believe that they warrant the attention of management.

We provided FDIC officials with a draft of this letter and discussed the matters addressed in the following sections with them. FDIC officials agreed with our findings and suggestions. We will follow up on these matters during our audits of the 1998 financial statements.

In a separate letter, we are also communicating several additional sensitive matters concerning electronic data processing general control weaknesses.

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CALCULATION OF ASSET RECOVERIES

To estimate the recovery values for failed institution assets in liquidation, FDIC uses the Standard Asset Valuation Estimation (SAVE) methodology. An integral part of the SAVE methodology is the use of the Loss Reserve Estimation (LOREN) automated database, which processes the data gathered during asset file reviews and calculates estimated recoveries for individual assets. Our Standards for Internal Control in the Federal Government require that data entered into systems be checked for accuracy and completeness.

During 1997, we found internal control weaknesses in data input and processing in LOREN. Specifically, we found that the data entered from the Asset Data Sheet (ADS) to LOREN for performing loans had not been reviewed. As a result, data entry errors occurred and were not detected by FDIC. Data from the ADS represent a significant portion of the data being processed in LOREN for performing loans. Regarding the processing of data within LOREN, we found that (1) programming changes made to LOREN were not independently reviewed and tested and (2) LOREN did not automatically recalculate estimated recoveries when new data were entered or when data were changed. As a result of these control weaknesses, some individual asset recoveries were misstated.

To ensure the integrity of the data being used to calculate asset recoveries, we suggest that FDIC ensure all data entered into LOREN are reviewed for accuracy. We also suggest that FDIC take the following actions to ensure that the LOREN output is reliable and accurate: (1) establish written procedures for documenting, reviewing, and testing all programming changes to LOREN and (2) program LOREN so that global recalculations occur automatically after data have been entered or changed, or implement procedures to ensure that global recalculations occur prior to using LOREN output. FDIC agreed that errors occurred, and initiated action to strengthen the controls related to LOREN.

RECORDING REPRESENTATIONS AND WARRANTIES LIABILITY

Potential liability to FDIC arises from representations and warranties provided by the former Resolution Trust Corporation on loans and servicing right contracts sold while liquidating assets of failed financial institutions. For its

1997 financial statements, FDIC planned to incorporate the estimation of its representation and warranty liability into the automated portion of its Loan Loss Reserve (LLR) process. However, we found that FDIC did not recognize the full amount of its estimated liability for representations and warranties in its December 31, 1997, financial statements.

This error, which was not detected by FDIC, occurred because FDIC had not fully programmed the estimated representation and warranty liability into the LLR. The effect of this error was an understatement of estimated representation and warranty liability by $60 million in FDIC's December 31, 1997, allowance for losses on receivables from thrift resolutions, and an overstatement of the Receivables from Thrift Resolutions, Net line item by $60 million. The net impact to the Provision for Insurance Losses line item was an understatement of $60 million. To correct the error, we proposed an adjusting entry that was included with all other proposed adjustments resulting from our audit. FDIC considers all proposed adjustments in the aggregate. FDIC chose not to make any adjustments because the individual adjustments tended to offset one another, with the net effect not being significant.

We suggest that FDIC establish procedures to ensure that the LLR system includes all probable representation and warranty liabilities or adjust the general ledger to fully reflect FDIC's representation and warranty liability in its financial statements.

CONTRACTOR OVERSIGHT

FDIC procedures require the Division of Resolution and Receivership oversight personnel to verify the satisfactory delivery of contract items and prepare monthly Memos of Certification to document approval of the expense amounts that servicers retain from remittances to the FDIC. In addition, FDIC's Field Financial Operations Accounting Manual states that all transactions and the resulting entries to FDIC's records must be properly authorized, accurately recorded, appropriately classified, and fully supported by appropriate documentation.

During our review of FDIC's contractor oversight program, we found instances in which FDIC procedures were not followed. Specifically, we noted that

(1) some servicer expenses and fees netted from remittances to FDIC were not reviewed for validity and accuracy and the related Memos of Certification, to document approval of these transactions, were not prepared and (2) some securitization residual income included in remittances was not reviewed for validity and accuracy. The lack of review and validation of servicer transactions increases the risk that errors and omissions may occur and go undetected and that the related remittance of funds due to FDIC from servicers may not be accurate.

These control weaknesses occurred because FDIC's contractor oversight procedures had not been fully implemented in all offices and FDIC lacked current documentation standards necessary to substantiate the recording of servicer expense and remittance activity. FDIC officials acknowledged that implementation of the current contractor oversight procedures did not begin until late September 1997 and not all offices fully complied. To enhance the new procedures, FDIC also plans to conduct periodic reviews of the contractor oversight function and develop more detailed written procedures for servicer remittance activity.

We suggest that FDIC proceed with its plans to fully implement its contractor oversight procedures and ensure that servicer expenses and fees and securitization residual income are reviewed for validity and accuracy. Also, we suggest that FDIC continue with plans to update written procedures specifying the documentation requirements to support servicer transactions.

RECEIPTS PROCESSING AT FDIC BUSINESS CENTERS

The FDIC Field Financial Operations Accounting Manual (FFOAM) states that FDIC business centers should not hold checks, but may request that FDIC's Field Finance Center (FFC) hold them. Checks are sometimes held for a period of time so that the proper application of the receipts can be determined prior to deposit. Business centers make this request by preparing a Receipt Disposition Form for each check to be held from deposit.

However, we found that the Northeast Business Center (NBC) held some checks rather than forwarding them to the FFC to be held. After we notified FDIC of what we found at the NBC, NBC was instructed to discontinue its practice of holding checks. Also, FDIC established a procedure to perform a daily management review of the Transmittal and Hold logs to ensure compliance with the FFOAM.

We suggest that the FDIC periodically review the practices of its business centers to ensure that checks are properly forwarded to the FFC for processing.

CONSIDERATION OF SUBSEQUENT EVENTS

Generally accepted accounting principles require that the impact of certain events, which occur between the date of the financial statements and the financial statement issuance date, be considered by management. If these subsequent events provide additional evidence affecting estimates in the financial statements, management should determine if adjusting entries and/or disclosure is necessary in the financial statements.

Our 1997 audit of the estimated liabilities for anticipated failures and litigation revealed that FDIC did not have procedures in place to review events occurring subsequent to its December 31, 1997, financial statements but before issuance of the year-end financial statements. For both of these estimated liabilities, we found events not material to FRF's and BIF's 1997 financial statements that occurred after December 31, 1997, and before the issuance of the financial statements that should have been addressed by FDIC. FDIC stated that through its informal subsequent event procedures, it considered a $2.5 million overstatement in FRF's financial statements and a $30 million understatement in BIF's financial statements, but decided not to make any adjustments or disclosures to the financial statements. However, FDIC did not document its actions.

As a result of our findings, FDIC plans to formalize its process for considering necessary adjustments due to subsequent events after closing its accounting records at year-end. FDIC will keep a running list of all issues considered for adjustment or disclosure along with a short narrative description of its decisions. Also, FDIC plans to obtain an assistant director's signature on this subsequent event list and maintain this documentation with its year-end records.

INCOME EARNED ON FRF'S SECURITIZATION RESERVE

FDIC presents FRF's financial statements in accordance with generally accepted accounting principles (GAAP). Accrual accounting concepts, which are an integral part of GAAP, require that revenues be recognized when they are earned as opposed to when cash is received.

Last year, in our management letter,[1] we suggested that FDIC review the impact of using cash-based amounts for recording interest income earned by the FRF securitization reserve fund (established to cover losses on securitization transactions) as opposed to using accrual-based figures. FDIC agreed to evaluate whether the cash-based income amount approximates an accrual-based figure and whether the accrued interest receivable should be recorded in the year-end financial statements.

However, FDIC did not estimate or evaluate the accrued interest receivable impact on the December 31, 1997, FRF financial statements. Because FDIC did not determine the appropriateness of its cash-based interest income amount related to FRF's securitization reserve fund, during May 1998, we asked FDIC to calculate the accrual for the estimated interest receivable amount for purposes of the audit. FDIC estimated that the unrecorded interest receivable was approximately $37.5 million at December 31, 1997, and approximately $41.3 million at December 31, 1996. Therefore, FRF's assets and accumulated deficit were both understated by approximately $37.5 million at December 31, 1997. In addition, the interest revenue reported for 1997 was overstated by approximately $3.8 million. To correct the errors, we proposed adjusting entries. FDIC did not make the adjustments due to the offsetting nature of our proposed adjustments in the aggregate.

We suggest that FDIC annually estimate the interest income receivable at year-end and consider whether an adjustment is needed to ensure that the financial statements are fairly stated. This potential adjustment, if not posted, should be tracked along with other unrecorded items for overall financial reporting decisions.

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We would appreciate receiving a description and status of your planned corrective actions within 30 days of the date of this letter. We appreciate the cooperation and assistance the FDIC management and staff provided during our

[1]FDIC Management Letter (GAO/AIMD-97-142R, August 1, 1997).

1997 audits. We are sending copies of this letter to the members of the FDIC Audit Committee and the FDIC Inspector General. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-9406 or Jeanette Franzel, Assistant Director, at (202) 512-9471.

Sincerely yours,

Robert W. Gramling

Robert W. Gramling
Director, Corporate Audits
and Standards

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