FINANCIAL AUDIT

Federal Deposit Insurance Corporation's Internal Controls as of December 31, 1992
February 4, 1994

Mr. Andrew C. Hove, Jr.
Acting Chairman, Board of Directors,
Federal Deposit Insurance Corporation

Dear Mr. Hove:

This report presents the detailed results of our review of the Federal Deposit Insurance Corporation's (FDIC) system of internal accounting controls as of December 31, 1992. Our review was performed as part of our audits of the calendar year 1992 financial statements of the Bank Insurance Fund, the Savings Association Insurance Fund, and the Federal Savings and Loan Insurance Corporation Resolution Fund, for which FDIC, as administrator of the three funds, has responsibility. Our opinions on the financial statements of the three funds and on FDIC's system of internal accounting controls as of December 31, 1992, and our assessment of FDIC's compliance with laws and regulations during calendar year 1992 were presented in a separate report issued on June 30, 1993. We conducted our work pursuant to the provisions of section 17(d) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1827 (d)).

This report contains recommendations to you. We would appreciate receiving your written statement on actions taken on these recommendations within 60 days of the date of this letter.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System; the Comptroller of the Currency; the Acting Director of the Office of Thrift Supervision; the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs; the Secretary of the Treasury; the Director of the Office of Management and Budget; and other interested parties.

Please call me at (202) 512-9406 if you or your staff have any questions concerning the report. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Robert W. Gramling
Director, Corporate Financial Audits
Executive Summary

Purpose

This report presents findings from our review of the Federal Deposit Insurance Corporation's (FDIC) system of internal accounting controls, which we conducted as part of our audits of the 1992 financial statements of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund (FRF). The purpose of our review was to assess the effectiveness of FDIC's system of internal accounting controls as of year-end 1992 in providing reasonable assurance that the assets of the three funds were safeguarded against loss from unauthorized use or disposition; that transactions related to the three funds were executed in accordance with FDIC management's authority and in accordance with applicable laws and regulations; and that transactions were properly recorded, processed, and summarized to permit the preparation of the financial statements of the three funds in accordance with generally accepted accounting principles and to maintain accountability for the assets of the three funds.

Background

FDIC was established by the Banking Act of 1933 to provide deposit insurance to protect bank depositors. The act authorized FDIC to promulgate and enforce rules and regulations relating to the supervision of insured banks and to perform regulatory duties consistent with its responsibilities as insurer. In response to the rising number and cost of thrift failures in the 1980s and the resulting insolvency of FSLIC, the former federal insurer of thrift deposits, the Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The act abolished FSLIC and designated FDIC sole federal insurer of all banks and savings associations. FIRREA also created three funds—BIF, SAIF, and FRF—to be administered by FDIC.

When a BIF-insured institution fails and is closed by its chartering authority, FDIC is usually appointed receiver. In its receivership capacity, FDIC may acquire some or all of the assets of the failed institution and attempt to dispose of these assets to cover the cost of paying insured depositors and other obligations of the failed institution. Assets acquired on behalf of BIF through resolution activity are managed and liquidated by both FDIC personnel and by servicing entities under contract with FDIC. Failed thrift assets that FRF acquired from FSLIC are also managed and liquidated in this manner.
Executive Summary

FIRREA requires FDIC to account separately for the three funds under its control and to allocate personnel, administrative, and other overhead expenses among BIF, SAIF, and FRF. FDIC allocates a majority of these expenses based upon the percentage of time employees report having worked on activities related to each fund, as reflected in their time and attendance reports.

Results in Brief

GAO found weaknesses in FDIC’s internal controls over (1) ensuring consistent oversight of contractors engaged to service and liquidate significant pools of receivership assets associated with failed banks, (2) preventing or detecting errors in the data maintained in FDIC’s asset management information system and in ensuring that asset information in the system reconciled with its general ledger system, and (3) the timely completion of reconciliations between the loan system of FDIC’s primary servicer for performing commercial and residential loans and FDIC’s asset management information and general ledger systems. These weaknesses adversely affected FDIC’s ability to manage, liquidate, and report on the large volume of assets acquired from failed financial institutions.

These weaknesses also affected FDIC’s ability to accurately report transactions associated with BIF’s and FRF’s resolution and liquidation activity, and increased the risk of misappropriation of assets, possibly adding to the losses on receivership assets being incurred by the funds. This is of particular concern because FDIC is scheduled to assume responsibility for managing and disposing of the receivership assets currently under the control of the Resolution Trust Corporation (RTC) when RTC terminates its asset disposition operations on December 31, 1995. Unless FDIC acts to correct these internal control weaknesses, its ability to effectively manage and liquidate the additional assets will be hindered.

GAO also found that FDIC’s controls over its time and attendance reporting were not effective in ensuring that personnel adhered to the policies and procedures governing this activity. The weaknesses in FDIC’s time and attendance processing controls increased the risk of inappropriate payroll expenditures. In addition, these weaknesses exposed SAIF to significant misallocations of payroll and other overhead expenses, further decreasing its available resources at a time when the fund is not well-capitalized.
### Principal Findings

**Weaknesses in Asset Servicer Oversight Exposed BIF to Losses and Errors in Recovery Estimates**

GAO found that (1) asset balances reported by servicers were not always promptly or completely reconciled to related balances recorded in FDIC's financial information system, (2) FDIC did not have sufficient controls to ensure that servicers prepared complete and accurate estimates of recoveries on receivership assets and that the methodology used by servicers to estimate recoveries was consistent with the methodology used by FDIC personnel on assets managed internally, and (3) asset servicer internal audits, which FDIC relied on, were not consistently conducted to ensure coverage of critical areas of servicer operations, and significant findings from internal audits of servicer pool operations were not always communicated to the servicer's oversight committee in a timely manner.

These weaknesses hindered FDIC's ability to effectively safeguard receivership assets and exposed BIF to errors in the process used by FDIC to determine the Fund's estimated losses on bank resolution activity.

**Weak Controls Over FDIC's Asset Management Information System Affected Data Integrity**

Controls to ensure the integrity of data in FDIC's asset management information system were not working effectively throughout 1992. The lack of consistent maintenance and updating of data files within the system resulted in errors in system-generated information on estimated recoveries and related data on the condition of assets acquired from failed financial institutions and managed internally for BIF and FRF by FDIC personnel. Significant differences in receivership asset book values existed during 1992 between FDIC's receivership general ledger control accounts and the subsidiary records maintained on the asset management information system for both BIF and FRF. These weaknesses affected the reliability of system-generated information on asset recoveries, and could result in future misstatements to both BIF's and FRF's financial statements. These weaknesses also reduced FDIC's ability to adequately safeguard receivership assets and could result in additional losses to BIF and FRF.

**Lack of Reconciliations Exposed Funds to Potential Losses and Reporting Errors**

FDIC experienced significant delays during 1992 in reconciling receivership asset balances between its financial information and asset management information systems and the records of its primary servicer of performing commercial and residential loans acquired from failed financial institutions. As of March 1993, reconciliations of receivership asset book...
values through November 1992 had not been performed for approximately half of the $2.8 billion in assets managed by this servicer. The lack of complete and up-to-date monthly reconciliations between the servicer's and FDIC's records weakened FDIC's ability to adequately safeguard these assets, and exposed both BIF and FRF to additional losses and errors in financial reporting.

Weaknesses in Time and Attendance Processes Could Affect Expense Allocations Among Funds

FDIC did not consistently adhere to its time and attendance reporting policies and procedures in 1992. Also, certain responsibilities within the time and attendance reporting process were not segregated to provide additional assurance that errors or irregularities would be detected and corrected in a timely manner. Further, given the significance of employee and overhead costs required to administer and manage the assets of the three funds, and the fact that these expenses are material to SAIF, the improper allocation of employee time and associated costs to SAIF could result in material misstatements in SAIF's financial statements and could inappropriately decrease the fund's limited resources.

Other Weaknesses Inhibited the Effectiveness of FDIC's Internal Controls

GAO identified other weaknesses in FDIC's internal controls which affected its ability to ensure that internal control objectives were achieved. These weaknesses included (1) lack of safeguards to protect data files, computer programs, and computer hardware from unauthorized access and modification, (2) ineffective controls to ensure adequate safeguards over collections from the servicing and liquidation of failed institution assets and proper recording of these collections, and (3) ineffective controls to ensure that (a) assessment income due SAIF was properly recorded in the fund's financial records, (b) all exit fee income was recorded in SAIF's financial records when financial institutions changed their insurance coverage from SAIF to BIF, and (c) adjustments to the financial statements of the three funds were properly authorized.

Recommendations

GAO is making a number of recommendations to FDIC to improve internal controls over the (1) oversight of contracted asset servicing entities, (2) integrity of data in FDIC's asset management information system, (3) reconciliation process between FDIC and its principal performing loan servicer, (4) information systems access, (5) accounting for receivership collections, (6) recording of assessment and exit fee income, and (7) adjustments to the three funds' financial statements.
Executive Summary

Agency Comments

FDIC acknowledged that improvements are needed in its system of internal controls relating to the liquidation of receivership assets by outside servicing entities and stated that it was taking or intended to take action to address many of these weaknesses. FDIC has already taken actions designed to address weaknesses GAO identified in its time and attendance processing controls.

FDIC also acknowledged that improvements are needed to enhance the accuracy of data maintained in its asset management information system, but stated that GAO had not demonstrated that the weaknesses it identified have either resulted or could result in errors in estimates of asset recoveries that are considered material to BIF’s and FRF’s financial statements. FDIC also disagreed that delays in completing reconciliations between its financial and asset management information systems and the systems of its primary servicer of performing commercial and residential loans exposed BIF and FRF to additional losses. In several other cases, FDIC disagreed that weaknesses existed or disagreed with GAO’s assessment of the significance of weaknesses.

GAO believes that the examples of inadequate support for estimates of asset recoveries found in its review clearly demonstrate the potential for material misstatements to BIF’s and FRF’s financial statements. GAO also believes that current, routine reconciliations between control accounts and subsidiary records, particularly when the records reside with a servicing entity, are critical to ensuring the integrity of reported information and the safeguarding of assets. In addition, GAO believes that its review confirms the existence of other internal control weaknesses which, if not corrected, will continue to hinder FDIC’s ability to ensure accurate financial reporting and proper safeguarding of assets.

FDIC’s comments are discussed and evaluated in chapters 2 and 3 and are included in appendix I.
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### Abbreviations

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<td>ACF2</td>
<td>access control software package</td>
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<td>BIF</td>
<td>Bank Insurance Fund</td>
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<td>BLP</td>
<td>bypass label processing</td>
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<td>COMB</td>
<td>Contractor Oversight and Monitoring Branch</td>
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<td>DAS</td>
<td>Division of Depositor and Asset Services</td>
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<td>DOF</td>
<td>Division of Finance</td>
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<tr>
<td>EDP</td>
<td>electronic data processing</td>
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<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
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<td>FDICIA</td>
<td>Federal Deposit Insurance Corporation Improvement Act of 1991</td>
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<td>FICO</td>
<td>Financing Corporation</td>
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<td>FIRREA</td>
<td>Financial Institutions Reform, Recovery, and Enforcement Act of 1989</td>
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<td>FIS</td>
<td>Financial Information System</td>
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<td>FRF</td>
<td>FSLIC Resolution Fund</td>
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<td>FSLIC</td>
<td>Federal Savings and Loan Insurance Corporation</td>
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<td>GCR</td>
<td>gross cash recovery</td>
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<td>LAMIS</td>
<td>Liquidation Asset Management Information System</td>
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<td>OREO</td>
<td>other real estate owned</td>
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<td>RTC</td>
<td>Resolution Trust Corporation</td>
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<td>SAIF</td>
<td>Savings Association Insurance Fund</td>
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As part of our audits\(^1\) of the 1992 financial statements of the Bank Insurance Fund (BIF), the Savings Association Insurance Fund (SAIF), and the Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund (FRF), we conducted an evaluation of the Federal Deposit Insurance Corporation's (FDIC) internal accounting controls. The purpose of this report is to present the results of this review, along with recommendations to address weaknesses we identified in FDIC's system of internal accounting controls.

**Background**

FDIC was established by the Banking Act of 1933 to provide deposit insurance to protect bank depositors. The act authorized FDIC to promulgate and enforce rules and regulations relating to the supervision of insured banks and to perform regulatory duties consistent with its responsibilities as insurer. In response to the rising number and cost of thrift failures in the 1980s and the resulting insolvency of FSLIC, the former federal insurer of thrift deposits, the Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). FIRREA abolished FSLIC and designated FDIC sole federal insurer of all banks and savings associations. FIRREA created (1) BIF, which insures deposits of all BIF-insured commercial and savings banks, (2) SAIF, which insures deposits of all SAIF-member institutions (principally thrifts),\(^2\) and (3) FRF, which is responsible for liquidating assets and satisfying obligations associated with certain FSLIC resolution actions. The act also designated FDIC the administrator of the three funds.

FIRREA requires FDIC to account separately for the three funds under its control and to allocate personnel, administrative, and other overhead expenses among BIF, SAIF, and FRF. FDIC allocates a majority of these


\(^{2}\)FIRREA also established the Resolution Trust Corporation (RTC) to resolve thrifts whose deposits had been insured by FSLIC and that were placed into conservatorship or receivership from January 1, 1989, through August 8, 1992. The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (Public Law 102-233, enacted on December 12, 1991) extended RTC's resolution authority to thrifts placed into conservatorship or receivership through September 30, 1993. More recently, the Resolution Trust Corporation Completion Act (Public Law 105-204, enacted on December 17, 1997) further extended RTC's resolution authority to thrifts placed into conservatorship or receivership through such date as is determined by the Chairperson of the Thrift Depositor Protection Oversight Board, but no earlier than January 1, 1999, and no later than July 1, 1998. However, any thrift requiring resolution after the expiration of RTC's resolution authority which had previously been under RTC conservatorship or receivership may be transferred back to RTC for resolution. Through the expiration of RTC's resolution authority, SAIF is responsible for the resolution costs of any federally insured thrift that was not previously insured by FSLIC. Additionally, pursuant to section 5(d)(3) of the Federal Deposit Insurance Act, banks can acquire deposits of thrift institutions without changing insurance coverage for the acquired deposits.
expenses based upon the percentage of time employees report having worked on activities related to each fund, as reflected in their time and attendance reports. Consequently, the controls designed to ensure the accuracy of these reports play a major role in ensuring that such expenses are properly allocated.

**FDIC's Asset Management Process**

When a federally insured depository institution is closed by its chartering authority, FDIC is usually appointed receiver. FDIC establishes a receivership for the failed institution and advances the receivership funds to cover insured depositors and other obligations of the failed institution. These advances become a claim, or receivable, which FDIC has against the receivership's assets. FDIC records the amounts advanced to receiverships as receivables from bank resolutions for BIF and as receivables from thrift resolutions (initiated by the now-defunct FSLIC) for FRF. Amounts disbursed by FDIC to terminate receiverships, acquire receivership assets, or purchase covered assets are recorded as investments in corporate-owned assets for both funds. At December 31, 1992, BIF's and FRF's financial statements included $52.8 billion and $14.5 billion, respectively, in receivables from resolutions and investments in corporate-owned assets.

Funds used to repay amounts advanced are generated from FDIC's management and liquidation of BIF's and FRF's inventories of failed institution assets. Because the management and disposition of these assets normally will not generate amounts equal to the advances to resolve failed institutions or the book values of the corporate-owned assets in BIF's and FRF's inventories of failed institution assets, FDIC establishes an allowance for losses against the receivables and corporate-owned assets. The allowance for losses, which equaled $23.8 billion and $12.9 billion for BIF and FRF, respectively, at December 31, 1992, represents the difference between amounts advanced and the expected repayment, net of all estimated liquidation costs. The expected repayment is based primarily on the estimated recovery values of BIF's and FRF's inventories of failed institution assets.

FRF's inventory of failed institution assets has declined since the Fund's creation in 1989. At December 31, 1989, FRF held failed institution assets with a book value of $10.4 billion. At December 31, 1992, the book value of FRF's inventory of failed institution assets had declined to $5.2 billion. In contrast, BIF's inventory of failed bank assets has increased significantly in recent years as a result of the high level of bank failures that have occurred since the late 1980s. At December 31, 1989, BIF held assets from
failed banks with a book value of about $11.5 billion. By December 31, 1992, the book value of BIF’s failed bank asset inventory had increased to about $38.1 billion.

FDIC has traditionally managed and liquidated assets acquired from resolution activity through the use of permanent and temporary personnel in its Division of Depositor and Asset Services (DAS). DAS uses the Liquidation Asset Management Information System (LAMIS) to assist in managing the assets of failed institutions that are primarily serviced internally by DAS personnel. LAMIS serves as a subsidiary system of BIF’s and FRF’s general ledger, which is maintained by FDIC’s Financial Information System (FIS). LAMIS controls, accounts for, and reports upon the acquisition, management, and ultimate disposition of assets acquired through resolution activity. LAMIS also contains the estimates of recoveries anticipated from the management and disposition of assets maintained on the system. These estimates of recovery values, known as gross cash recovery values, are used by FDIC’s Division of Finance (DOF) in developing the allowance for losses on BIF’s and FRF’s receivables from resolution activity and investments in corporate-owned assets.

With the number and size of bank failures increasing in the latter half of the 1980s and early 1990s, FDIC began contracting with private-sector entities to service large pools of receivership and corporate-owned assets from failed banks resolved by BIF. By December 1992, FDIC had contracted with 10 outside servicing entities to manage and dispose of the assets of 10 asset pools from various failed banks. Seven of the pools are composed of assets from 26 receiverships, and their book value, as reflected in FIS, totaled $11.6 billion, or approximately 30 percent of the total book value of BIF’s entire failed bank asset inventory at December 31, 1992. The seven pools are referred to as “on-book” serviced asset pools. The remaining three pools were purchased by the servicing entity with the option to sell the assets back to FDIC at the end of their 5-year servicing term. These three pools are referred to as “off-book” serviced asset pools.

For both the on-book and off-book serviced asset pools, FDIC reimburses the servicers for the costs of managing and liquidating the pool assets and pays the servicers an incentive fee as defined under each servicing

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3This division was formerly called the Division of Liquidation. In October 1993, FDIC renamed it the Division of Depositor and Asset Services.

4LAMIS also maintains control totals for performing commercial loans and mortgages serviced for FDIC by two third-party asset servicing entities. These two servicing entities maintain detail information on the loans and mortgages they service.
agreement. For this purpose, FDIC provides oversight to both the on-book and off-book serviced asset pools. Proceeds from the management and disposition of the on-book assets will be used to repay approximately $11.8 billion in amounts BIF advanced to the 26 receiverships to satisfy insured depositors' and other creditors' claims, and amounts paid by BIF to purchase assets of failed institutions. Estimates of recoveries on the assets in the on-book asset pools, like those developed for assets managed internally and maintained on LAMIS, are a component used in developing BIF's allowance for losses from resolution activity and investments in corporate-owned assets.

DAS's Contractor Oversight and Monitoring Branch (COMB) is responsible for overseeing the asset servicing agreements FDIC established with the servicing entities. Specifically, COMB is responsible for approving servicers' annual business plans, operations and credit manuals, asset liquidation strategies, and overall compliance with the asset servicing agreements between the servicer and FDIC. COMB accomplishes these functions through (1) oversight committees established for each servicing pool, (2) COMB personnel on-site at each servicer, (3) visitation groups which visit each servicer at least twice a year, and (4) servicer internal audit departments. COMB is headquartered in Dallas, Texas, but reports directly to the Director of DAS in Washington.

The subsidiary records of the receivership assets managed by contracted asset servicers are maintained on each servicer's information and accounting systems. Control totals for each general ledger account are maintained by FDIC on FIS at a receivership level at the FDIC consolidated offices where the failed institution's assets would have been serviced had they been retained and managed internally by FDIC personnel. However, the FIS general ledger accounts are by major asset category or type, and are not specific to individual assets of the receivership. Therefore, transactions recorded by FDIC reflect monthly processing of activity and account balances as reported in the aggregate by the servicers. FDIC does not maintain a copy of the servicers' subsidiary records, nor does it have the ability to access the servicers' information and accounting systems. Consequently, the individual servicing entities maintain the only subsidiary records and support for these receivership assets.
The objectives of our review were to determine whether any material weaknesses or reportable conditions existed in FDIC's system of internal controls as of December 31, 1992. The objectives of FDIC's system of internal controls are to ensure that (1) assets of the three funds administered by FDIC are safeguarded against loss from unauthorized use or disposition, (2) transactions are executed in accordance with FDIC management's authority and with relevant laws and regulations, and (3) transactions are properly recorded, processed, and summarized to permit the preparation of financial statements of the three funds and to maintain accountability for fund assets.

To assess whether these internal control objectives were met during 1992, we reviewed policies and procedures and tested accounts and transactions related to the following significant transaction cycles:

- troubled institutions,
- assistance to closed institutions,
- assistance to open institutions,
- assessments,
- expenses,
- treasury, and
- financial reporting.

For each of the transaction cycles listed above, we interviewed FDIC officials; reviewed FDIC policy, procedure, and accounting manuals; and documented our understanding of the transaction processes and relevant internal controls. We then designed procedures to test the relevant controls in each of the transaction cycles, including tests for proper authorization, execution, accounting, and reporting of transactions comprising the activity in each of the transaction cycles.

We also assessed the adequacy of general controls over FDIC's information systems. To make this assessment, we interviewed FDIC officials on information systems configurations and general controls established for these systems. In addition, we reviewed relevant reports on information systems.
systems prepared by the FDIC’s Office of Inspector General and a report prepared by an independent contractor hired by FDIC to conduct a review of security controls over FDIC’s systems hardware and software. We interviewed inspector general personnel to discuss the scope of their work, the nature of their findings, and the status of corrective action to implement their report recommendations. We also reviewed the work of the inspector general and contractor to determine the extent to which we could rely on their respective report findings.

Due to the increasing significance of FDIC’s asset management and liquidation activities and FDIC’s strategy to contract more of this activity to third party servicers, we designed and performed procedures to test the existence and effectiveness of oversight controls over FDIC’s contracted asset servicers. We also designed and performed procedures to test controls over the completeness and accuracy of information on in-house managed assets maintained on LAMIS. In addition, we designed and performed procedures to test relevant internal accounting controls at FDIC’s consolidated receivership offices that impact the completeness and accuracy of asset management and liquidation activity reported on the financial statements of the funds.

To assess the adequacy of controls over FDIC’s contracted asset servicers, we reviewed FDIC’s reconciliations of the seven on-book serviced asset pool balances for 1992 between the servicers’ detail records and the control accounts maintained on FTS. In the case of performing commercial and residential loans serviced by one servicing entity, we also reviewed reconciliations prepared during 1992 between the servicer’s detail records and information maintained on LAMIS. We also reviewed FDIC’s procedures for ensuring the completeness and accuracy of servicer-prepared estimates of recoveries on serviced assets. In addition, we reviewed recovery estimates for a judgmental sample of 27 assets serviced by six of the seven on-book asset servicers to assess the reasonableness of the methodologies used by the servicers in developing these estimates and to compare these methodologies with those used by FDIC personnel to estimate recoveries on assets managed in-house. We also reviewed the scope, timing, and frequency of servicer-performed internal audits of servicing operations in 1992, and the nature of internal audit report findings as contained in 215 servicer internal audit reports issued in 1992, including the timing of communication of audit findings to servicer oversight committees and the extent of follow-up procedures performed as a result of significant audit findings.
Chapter 1
Introduction

To assess the adequacy of controls over the completeness and accuracy of information on assets managed internally by FDIC personnel, we selected samples of 562 assets from over 18,000 BIF and FRF assets maintained on LAMIS whose estimates of recoveries are developed by account officers. Our samples were selected on a statistically random basis to provide reasonable assurance that the samples would be representative of the population. Our sampling included assets at all 17 consolidated field offices that existed during 1992. We selected separate samples for BIF and FRF assets. Our sample sizes were based on a 95 percent confidence level.6

For the sampled assets, we reviewed the working files account officers maintained to determine whether adequate documentation was contained in the files to support the existence of the assets, FDIC’s ownership rights with respect to the assets, and the reasonableness of the recovery estimates established for the assets. We also reviewed asset certification reports to ensure appropriate account officer and supervisory sign-off with respect to the adequacy of the recovery estimates established for the assets. In addition, we reviewed reconciliations between asset balances reported in LAMIS at September 30, 1992, and December 31, 1992, and the applicable control accounts maintained on FIS to assess the completeness and accuracy of transactions reported in both subsidiary detail accounts and general ledger control accounts.

To assess the adequacy of controls at FDIC’s consolidated receivership offices, we tested controls over the conversion of failed institution assets and liabilities onto the FIS receivership general ledger and onto LAMIS for a judgmental sample of 30 bank failures out of a universe of 120 bank failures that occurred during 1992. We also tested controls for judgmental samples of 165 consolidated field office receipts and 322 check and wire disbursements related to 11 of the consolidated field offices we visited. We tested these receipts and disbursements for proper authorization, accounting, and reporting on both the receivership general ledger and LAMIS. In addition, we tested controls over reconciliations of several significant receivership general ledger accounts, including suspense accounts and cash accounts. Specifically, we reviewed account reconciliations for completeness, timeliness, and accuracy as well as evidence of supervisory approval.

The confidence level is a measure (usually expressed as a percentage) of the degree of assurance that the estimate obtained from a sample differs from the population parameter being estimated by less than the measure of precision (sampling error). This means that if you were to determine an estimate for 100 different random samples of the same size from this population, in this case, 95 out of 100 times the estimate would fall within the confidence interval. In other words, the true value is between the lower and upper limits of the confidence interval 95 percent of the time.
To test the adequacy of FDIC's time and attendance processing controls, we selected a judgmental sample of employee time cards and reviewed them for required signatures and agreement with certain payroll reports. In addition, we reviewed the time cards and related payroll reports for conformance with FDIC's applicable policies and procedures.

We performed our work from July 1992 through May 1993, in accordance with generally accepted government auditing standards. Our work was performed at FDIC's headquarters offices in Washington, D.C., and Arlington, Virginia, and at the following FDIC field office locations: Dallas, Houston, and San Antonio, Texas; Oklahoma City, Oklahoma; Franklin and Brockton, Massachusetts; East Hartford, Connecticut; Monmouth Junction, New Jersey; Irvine, San Jose, and Encino, California; Denver, Colorado; Rosemont, Illinois; Shreveport, Louisiana; Orlando, Florida; and Atlanta, Georgia.

We provided FDIC with all of our findings and conclusions, and with our recommendations to correct the material weaknesses presented in chapter 2, through briefings and correspondence. FDIC provided written comments, which are presented and evaluated in chapters 2 and 3 and are included in appendix I.
Chapter 2

Material Weaknesses Hampered FDIC's Ability to Safeguard Assets and Ensure Accurate Reporting

This chapter discusses material weaknesses that existed in FDIC's system of internal accounting controls during 1992 over its management and liquidation of assets acquired from failed financial institutions and over its time and attendance reporting processes, along with actions needed by FDIC management to correct these weaknesses. The weaknesses in FDIC's internal accounting controls over failed institution assets adversely affected its ability to safeguard these assets against loss from unauthorized use or disposition and ensure that transactions were executed in accordance with management's authority and were properly reported on the financial statements to maintain accountability for assets. These weaknesses increase the risk of additional losses to BIF and FRF in resolving failed banks and thrifts.

Weaknesses in FDIC's internal accounting controls over its time and attendance reporting process adversely affected its ability to ensure that payroll and other related expenses were properly allocated among BIF, SAIF, and FRF. Time and attendance reporting is the primary means by which FDIC allocates payroll and other overhead expenses among the funds it administers. Given the relative sizes of the three funds FDIC administers, only SAIF's financial statements are likely to be materially affected by misallocation of expenses caused by unreliable time and attendance reporting.

Controls Over Asset Servicers Exposed BIF to Losses and Errors in Asset Recovery Estimates

Internal accounting controls over entities contracted to service and liquidate significant pools of receivership assets from failed banks resolved by BIF were not consistently implemented or were too limited to effectively assist FDIC in overseeing these servicers. Several serviced asset pools, with combined asset book values totaling $6.7 billion at December 31, 1992, had not been reconciled to the asset balances recorded in FIS in a timely manner. Additionally, FDIC did not have adequate procedures to ensure that the servicers prepared complete and accurate gross cash recovery (GCR) estimates on pool assets in liquidation. The methodologies the servicers used to calculate GCRs were not consistent with those FDIC used on assets it manages, which could create significant differences in GCR values that would impact BIF's allowance for losses. Also, FDIC's audit oversight of servicers did not ensure that audits of all asset pool servicers included critical areas such as (1) inception asset pool balances, (2) general ledger reconciliations, and (3) GCR calculations. Finally, significant findings from internal audits of servicer pool

1At December 31, 1992, SAIF's total assets equaled about $471 million. In comparison, at December 31, 1992, BIF's and FRF's total assets equaled about $34.9 billion and $4.4 billion, respectively.
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operations were not communicated to the servicers' oversight committees in a timely manner. These weaknesses in oversight of the asset servicers could result in errors which affect BIF's estimated losses on bank resolution activity, and raise concerns about FDIC's ability to ensure adequate safeguarding of receivership assets. Additionally, the reconciliation problems FDIC experienced with three of the seven serviced asset pools diminished its ability to exercise the level of oversight necessary to prevent BIF losses and to help ensure servicer accountability.

Reconciliations of Serviced Asset Pools Not Completed Promptly

FDIC relies on contracted servicers to manage and dispose of assets of failed institutions and to retain detailed support for transactions related to the serviced pools. Thus, it is critical that FDIC perform, or instruct the servicing entities to perform, complete and timely reconciliations between the information on asset pool balances contained in FIS and that found in servicers' records to ensure the safeguarding of, and accountability for, the serviced assets and to ensure accurate financial reporting. We found that during 1992, neither FDIC nor the servicers had completed or performed timely reconciliations for several of the on-book serviced asset pools. Of the seven serviced asset pools, FDIC could not provide timely or current reconciliations for two pools, and FDIC excluded part of a third pool's balance from its reconciliation. These three asset pools collectively held $6.7 billion in assets at December 31, 1992, or 57 percent of the total book value of the seven asset pools and 17 percent of the total book value of BIF's failed bank asset inventory.

FDIC had not prepared a detailed reconciliation between FIS and the servicer's reported balance for one asset pool since its inception in August 1991. This asset pool had a reported balance of $1.3 billion per FIS as of December 31, 1992. Additionally, FDIC's reconciliations of another serviced asset pool, with a reported balance of $4.0 billion per FIS as of December 31, 1992, were not completed in a timely manner. At the end of our fieldwork, FDIC had only completed the reconciliation for this asset pool through August 1992. The August 1992 reconciliation identified over 250 reconciling items which netted to $93 million. Some of these reconciling items had existed since the serviced asset pool's inception in July 1991. Although FDIC did perform reconciliations for a third serviced asset pool, they excluded $25.2 million in pool assets that were recorded on FIS. Of this amount, $23.5 million in book value of loans had not been recorded on the servicer's records of the asset pool. This pool had a reported balance of $1.3 billion per FIS as of December 31, 1992.
Several factors prevented FDIC from reconciling the balances of these asset pools between FIS and the servicers' records in a timely manner. For example, one servicer did not provide sufficient supporting documentation to DOF personnel to enable them to adequately investigate and clear reconciling items in a timely manner. According to DOF personnel, the timely reconciliation of this servicer pool was further hampered by a 6-week time lag in obtaining and providing to the servicer copies of the FIS monthly general ledgers for those receiverships whose assets are included in this asset pool. For another servicer, FDIC did not include all of the necessary FIS accounts in the reconciliation because this asset pool shared a general ledger on FIS with a related, but separate, asset pool under the same receivership. Consequently, FDIC personnel were uncertain as to which FIS balances applied to the asset pool.

FDIC was aware of these reconciliation deficiencies during 1992 and assigned special task forces to resolve these conditions. We were able to verify that during 1993, significant progress had been made to complete the serviced asset pool reconciliations and resolve the reconciling items.

Servicer Oversight Not Effective in Ensuring Complete and Accurate Asset Recovery Estimates

During 1992, FDIC did not have adequate procedures in place to ensure that GCR estimates reported semi-annually by the contracted asset servicers to FDIC for use in estimating BIF's allowance for losses were complete, accurate, and developed on a consistent basis. FDIC's reviews of GCR estimates were limited in nature and scope, and follow-up reviews of exceptions were not sufficient to ensure the accuracy of the GCRS reported to DOF. Also, the methodologies the servicers used to estimate GCRS on their serviced asset pools were not consistent with the methodology FDIC used on internally managed assets. Finally, the reporting periods for servicer-prepared GCRS were not consistent among the servicers.

Because of the significance of GCR estimates to the reporting of BIF's allowance for losses on its balances of receivables from resolution activity and assets acquired from receiverships, it is critical that such estimates be based on complete and current information and be updated for changes in liquidation strategies. It is also critical that the servicers prepare estimates for consistent time periods and use consistent methodologies for similar assets.
FDIC requires that each asset servicer review the GCR calculations of the 25 largest loan relationships\(^2\) and the 25 largest other real estate owned (OREO) relationships on a quarterly basis, and document the results of this review on status reports prepared for each of these assets. The status reports resulting from these reviews are examined quarterly by the oversight committees for each servicer. This quarterly review is supplemented by semiannual reviews performed by the COMB visitation groups of the asset management and liquidation strategies, including the GCR calculation, of assets sampled from the servicers' loan and OREO portfolios.

However, we found that FDIC's review of the supportability and accuracy of the GCR estimates was typically cursory in nature. For most of the serviced asset pools, we found that the oversight committees did not review the asset files which contain, among other things, the underlying support for the estimates of cash recoveries, nor did they review the actual GCR calculations. Furthermore, COMB's visitation groups did not perform specific procedures to test the accuracy of GCR estimates for OREO.

The visitation groups did perform some review procedures of GCR estimates for loans. These procedures required the visitation groups to review GCRs for loans to ensure they were consistent with the liquidation strategy the servicers were following for the loans at the time of the review. In conducting these reviews, the visitation groups found numerous instances where GCRs were not consistent with the current liquidation strategy. However, the review procedures did not require the visitation groups to expand their reviews if significant exceptions were found, nor did they require follow-up on previously identified exceptions. Consequently, the visitation groups did not expand their reviews when they found significant exceptions in the GCRs for assets they reviewed, nor did they perform specific follow-up procedures to ensure that GCRs were corrected in time to prevent the exceptions from affecting FDIC's 1992 year-end calculation of BIF's allowance for losses. In addition, the loans of one serviced pool were not reviewed by the visitation groups during 1992, and only a small portion of another serviced pool's loans were subject to GCR review in 1992. These pools held assets with reported book values at December 31, 1992, of $1.3 billion and $1.4 billion, respectively.

The lack of adequate reviews of the supporting documentation and underlying assumptions used in servicer-prepared estimates of recoveries

\(^{2}\)Asset relationships refer to separate assets that are in some way related, either through the same borrower or backed by the same collateral.
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precluded FDIC from having reasonable assurance that the GCR values reported by the servicers and used in FDIC’s calculation of BIF’s allowance for losses reflected realistic estimates of the ultimate collectibility of the serviced assets. This weakness also increased the risk that errors in these estimates would not be identified or corrected in time to prevent a misstatement of the total estimated recoveries on assets in liquidation.

We also identified significant inconsistencies between the methodologies the servicers used to develop GCR estimates and the criteria used by FDIC on assets managed internally in our review of a sample of the quarterly status reports for the top 25 loan and OREO relationships. For example, on performing loans, we found that the servicers varied among themselves as to how interest was factored into their GCR estimates, and none of the servicers followed the criteria FDIC used on its internally managed assets. Some of the servicers projected both the principal and interest through the loan’s maturity, while one servicer projected interest through the term of the servicing agreement. In contrast, the GCRs for performing loans managed by FDIC internally included the total principal plus 4 quarters of interest. If the liquidation strategy for a particular performing loan is to dispose of the asset quickly, projecting future interest beyond the period in which the loan is anticipated to be sold overstates the estimated recovery by the amount of interest projected beyond the estimated disposition date. Inconsistencies in the methodologies used to develop GCR estimates significantly impact the reliability of the aggregate estimated recovery on BIF’s inventory of failed institution assets, and could lead to significant errors in the reported recovery estimates.

We also found that FDIC did not require uniform cut-off dates for GCR estimates. The cut-off dates for GCR estimates prepared by the servicers and used in the calculation of BIF’s year-end allowance for losses varied among servicers, and varied with the cut-off date used for internally managed assets. FDIC used a GCR cut-off date of September 30, 1992. However, the cut-off date used by two of the seven asset servicers differed. One of these servicers used a cut-off date of June 30, 1992, and the second servicer used a cut-off date of October 31, 1992. The lack of consistent cut-off periods for GCRs could result in recovery estimates being included for assets that have already been sold or liquidated and recovery estimates not being included for any assets transferred to the servicers’ pools after the servicer’s cut-off date.

The asset servicing agreements only require the servicers to calculate GCR estimates semiannually. The servicers were not required to update
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estimates of cash recovery values when the liquidation strategy for a given asset was changed or when more current information on the condition and outlook for the asset became available. Consequently, the servicers' estimates of cash recovery values may not reflect the impact of changes in liquidation strategies or current market conditions. Also, the asset servicing agreements provided guidance to servicers on the preparation of asset recovery estimates that varied by agreement and was inconsistent with the guidance in FDIC's Credit Manual. The asset servicing agreements also contained GCR cut-off dates that were inconsistent with the Credit Manual and inconsistent among the servicing entities.

Effectiveness of Servicers' Internal Audit Function

Limited

The internal audit departments of both the on-book and off-book asset servicers did not perform audit procedures on servicer functions critical to effectively manage and account for the serviced asset pools. Additionally, findings from internal audit reviews of serviced asset pool operations were not always communicated to the servicers' oversight committees in a timely manner. The absence of audit coverage over these functions, and significant delays in communicating audit findings to the oversight committees, prevented FDIC from having assurance that receivership assets managed by the servicing entities were adequately safeguarded and that transactions relating to the serviced asset pools were properly reported by the servicers and recorded in FDIC's general ledger.

The servicers' internal audit departments are a critical extension of FDIC's asset servicer oversight function. Their audits are the primary means by which FDIC, through COMB, obtains assurance that servicer billings are valid and accurate, that collections are remitted to FDIC completely and promptly, that balances reported to FDIC reconcile to the servicers' systems, and that internal controls over the servicers' operations related to its asset servicing activities adequately safeguard pool assets. Consequently, the internal audits must provide adequate coverage of servicer operations critical to the effective management of the asset pools, and findings from these audits must be communicated to FDIC in a timely manner to ensure that any corrective action necessary to address findings or control weaknesses is implemented as soon as possible.

We found that the timing and structure of audits conducted by the servicers' internal audit departments varied significantly. Internal audits of critical areas were not consistently conducted or were not performed on a timely basis by all servicers' internal audit departments. For most of the servicing entities, we found no evidence that audits were performed to
ensure coverage of critical control areas such as opening, or inception, balances of asset pools; general ledger reconciliation; and asset recovery estimates. While most servicers' internal audit departments did conduct reviews of controls over cash receipts and disbursement processes, we found two instances where controls over the servicers' cash receipt process were not reviewed and one instance where controls over the servicer's cash disbursement process were not reviewed during 1992.

We also found that significant delays existed between the time some of the servicing entities' internal auditors completed their reviews and the time the findings from these reviews were communicated to the servicers' oversight committees. During 1992, only two oversight committees received audit reports within an average of 8 weeks of completion of the auditors' fieldwork. Other oversight committees received audit reports ranging from 10 to 24 weeks after completion of the auditors' fieldwork. In one instance, we found that one audit report was submitted to the oversight committee 13 months after fieldwork was completed.

COMB's practice has been to allow the servicers' internal audit departments to assess the risks associated with their respective asset pool and structure the timing and scope of their audits accordingly. Consequently, no standardization exists regarding the frequency and structure of the internal audits to provide FDIC assurance that certain critical aspects of servicers' operations are subject to adequate and periodic review.

Weak Controls Over LAMIS Continued to Result in Data Integrity Problems

Controls to ensure the integrity of data provided by LAMIS for estimating recoveries from the management and liquidation of receivership assets were not working effectively. The lack of consistent maintenance and updating of data files within the system has resulted in significant errors in system-generated information on estimated recoveries and related data on the condition of receivership assets. These weaknesses, which were also identified during our audits of the 1991 BIF and FRF financial statements, resulted in misstatements in BIF's and FRF's December 31, 1992, allowance for losses on receivables from bank and thrift resolutions and investments in corporate-owned assets. Additionally, material differences in receivership asset book values existed at December 31, 1992, between FDIC's general ledger control accounts on FIS and the subsidiary records on LAMIS. Such differences reduced FDIC's ability to adequately safeguard receivership assets because, by not maintaining accurate and up-to-date

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records on its inventory of failed institution assets, FDIC cannot maintain accountability for these assets. These weaknesses in controls over LAMIS data integrity could result in future misstatements in both BIF’s and FFF’s financial statements if FDIC management does not take appropriate corrective action.

At December 31, 1992, LAMIS, as the subsidiary system for BIF’s and FFF’s inventory of failed institution assets, maintained detail information on the condition and estimated recoveries for approximately 270,000 BIF and FFF assets managed internally by DAS account officers. GCR estimates for assets maintained on LAMIS are either derived by formulas or calculated by account officers who manage the assets. Assets with book values below $250,000, except for judgments, claims, and restitutions, have GCR values derived by formulas. The formulas will generate GCR values between 0 and 100 percent of an asset’s book value depending on the asset type and its performance status. At December 31, 1992, these assets had an aggregate book value of about $4.3 billion and GCR value of about $2 billion.

For all assets with book values of $250,000 or more, and for all judgments, claims, and restitutions, LAMIS assigns a GCR value equal to 50 percent of the asset’s book value when FDIC initially enters the asset on the system. Account officers assigned to manage and dispose of the assets later revise the GCR after developing their own estimates of the recovery value of the assets. While those assets whose GCRs are specifically determined by account officers make up a relatively small percent of the total number of assets on LAMIS, they comprise approximately 85 percent of the total estimated recovery value for assets maintained on LAMIS. The reliability and reasonableness of the GCRs maintained on LAMIS that are estimated by the account officers depend on (1) account officers having current and complete collateral appraisals and financial information on borrowers or guarantors and (2) controls to ensure that account officers make timely and accurate updates to GCR information in LAMIS.

Recovery Estimates Were Not Always Supported by Asset Files

Estimates of recoveries on assets in liquidation maintained on LAMIS were not always supported by documentation in files maintained for each asset by DAS account officers. In many cases, the documentation in the files was outdated or incomplete. In others, more current information on the asset’s condition and potential for recovery was not reflected in the GCR prepared by the account officer and recorded in LAMIS. Additionally, procedures FDIC developed in June 1992 requiring account officers and their supervisors to certify the completeness and accuracy of information for each asset.
maintained on LAMIS were not implemented for all assets at FDIC's consolidated receivership sites at the time of our reviews. For those offices that had implemented the procedures, they did not consistently and effectively ensure data integrity.

We found that GCR values estimated by account officers and recorded in LAMIS were not accurate for 121 of 409 (30 percent) BIF assets and for 59 of 153 (39 percent) FRF assets selected for review. We discussed our findings with the appropriate account officers and they generally agreed with our conclusions. Based on the results of our review of the assets in our samples, we projected that the estimates of asset recovery values used in developing BIF's and FRF's December 31, 1992, allowance for losses on their respective balances of receivables from resolution activity and investments in corporate-owned assets were overstated by about $310 million and $150 million, respectively.

There are several reasons for the significant number of errors in the GCR values for the assets we reviewed. For 52 percent of the 180 cases with inaccurate GCRs, account officers had not promptly updated the GCR values in LAMIS with current available information, such as recent appraisals and settlement or sales agreements. Outdated appraisals were used in 14 percent of the cases for which the primary basis of the GCR estimate was the appraised value. In 23 percent of the 180 cases, account officers did not follow the FDIC Credit Manual procedures for estimating recovery values. In most of these cases, the noncompliance was attributable to account officers not following FDIC procedures regarding the exclusion of expenses and inclusion of interest and operating income for OREO.

Other factors also contributed to the GCR exceptions. For example, asset files did not contain adequate documentation, such as borrowers' financial statements and asset appraisals, to justify the account officer's basis for the GCR estimate. In addition, the asset data sheets which are required for each asset did not always provide enough information for an independent reviewer to determine how the estimate was developed.

FDIC's Credit Manual requires that account officers update GCRs for assets whenever more recent information becomes available or recent events result in significant changes in the potential recovery for the asset. FDIC also has procedures which call for the account officers and their supervisors to review the completeness and accuracy of GCRs semiannually. This review is to be supplemented by a monthly review and certification of certain data contained in LAMIS, including asset recovery
The semiannual review, which is required by the end of the second and fourth quarters of each calendar year, is FDIC's primary control to ensure the completeness and accuracy of GCRs. Although the semiannual reviews had been performed for 93 percent of the assets sampled, these reviews, as evidenced by the results of our work, were not effective in ensuring the validity of the GCRs reported at September 30, 1992, which were used in the year-end calculation of BIF's and FRF's allowance for losses, because they did not coincide with the GCR reporting date.

In response to recommendations in our 1991 audit report, FDIC issued a directive to regional and consolidated offices in June 1992 requiring the review and certification of certain data elements in LAMIS, including GCR values. Of the 562 assets we reviewed, we found that the review had been performed for 402 assets. For 68 assets, the reviews were not required because the assets were new or recently transferred either from other consolidated offices or other servicers. For the remaining 92 assets, the reviews were required, but we were unable to substantiate that they were performed due to a lack of documentation. Other than our review of the adequacy of the GCR estimates, we did not verify the accuracy of the specific data elements included in this review and certification. However, based on the high percentage of inaccurate and outdated GCRs found in our sample, this control was not effective throughout 1992.

Material unresolved differences in the reported book values of receivership assets existed between FDIC's general ledger control accounts and the subsidiary records maintained on LAMIS as of December 31, 1992, for both BIF and FRF. The lack of a uniform system for tracking differences between the subsidiary records and control accounts has exacerbated this problem. The inability to adequately resolve these differences on a timely basis and consider what impact, if any, they may have on the GCRs reported, reduces FDIC's ability to adequately safeguard receivership assets through the loss of accountability for these assets, and thus increases the potential for additional losses to the funds. In addition, it could result in misstating BIF's and FRF's estimates of recovery values on their inventories of failed institution assets.

As discussed previously, FDIC maintains on LAMIS the book value and the estimated GCR value for each individual asset of each receivership managed internally by FDIC personnel. The book values of all assets for each receivership are required by FDIC to be reconciled on a daily basis to
the respective receivership's general ledger control account totals on FIS to ensure proper accountability over the assets.

Despite FDIC's requirement that FIS and LAMIS be reconciled daily, we found significant differences between the aggregate book values of receivership assets reported by FIS and LAMIS for both BIF and FRF. At December 31, 1992, the aggregate book value of receivership assets maintained on LAMIS exceeded the amount recorded in the FIS general ledger control accounts by $1.7 billion for BIF and by $291 million for FRF. We found similar differences at September 30, 1992. At that time, the aggregate book value of receivership assets maintained on LAMIS for BIF was $2.5 billion less than the aggregate amount recorded on FIS, while the aggregate book value of the LAMIS assets exceeded the aggregate amount recorded on FIS by $484 million for FRF.

One of the reasons for these persistent differences is that FDIC has no uniform system for tracking the differences between FIS and LAMIS. The lack of a uniform management tracking system gives rise to inconsistencies in how the reconciliation process is performed by each office. At the consolidated offices we visited, we noted inconsistencies in how differences between FIS and LAMIS receivership asset book values were reported. One office did not have a system which specifically tracked or aged differences between FIS and LAMIS. Another two offices tracked differences only after they were 30 days old, but did not age the differences. By not including all differences in reconciliation reports, the magnitude of all differences between FIS and LAMIS could not be assessed. Finally, two other offices did not age differences as of September 30, 1992, but did prepare aging reports on differences between FIS and LAMIS by December 31, 1992.

Most of the FIS/LAMIS reconciliation reports prepared by the consolidated offices simply identified the amount of the differences, with some including a brief description of how each individual difference occurred, and the identity of the party responsible for its resolution. However, none of the reports summarized the amount of differences by their cause and none tracked the disposition of the differences by correcting entries needed to FIS and LAMIS.
Lack of Automated Reconciliations Exposed Funds to Potential Losses and Financial Reporting Errors

FDIC experienced significant delays during 1992 in reconciling asset balances between FIS and its primary contracted servicer for performing commercial and residential loans acquired from failed financial institutions. As of the completion of our fieldwork, approximately half of the total $2.8 billion in book value of assets serviced by this contractor had not been reconciled through November 1992. As reconciliations become more delinquent, the ability to successfully resolve reconciling items may become more difficult. The lack of reconciliations of these serviced assets and timely follow-up of differences between the servicer's and FDIC's records adversely affected FDIC's ability to adequately safeguard these assets and exposed both BIF and FRF to additional losses and errors in financial reporting.

FDIC has contracted with an outside entity to service the performing commercial and residential loans of approximately 500 BIF and FRF receiverships. Control totals are maintained on FIS and LAMIS for the assets serviced by this entity at the receivership level. This servicer estimates GCR values for the assets it services and provides these estimates to DAS, along with asset book values. DAS then uses the GCR information it receives from the servicer to update recovery values on LAMIS. Reconciliations are to be performed monthly, by receivership, between the asset book values on the servicer's records and the control totals for the asset book values in LAMIS and in the general ledger control account totals on FIS.

We found that the reconciliations of asset book values between the servicer's records and the control totals in LAMIS, and in the general ledger control account totals on FIS, were significantly behind. As of March 1993, reconciliations of receivership asset book values through November 1992 had not been performed between FIS, LAMIS, and the servicer's loan system for 85 receiverships. The aggregate book value of assets associated with these receiverships was approximately $1.3 billion, or 46 percent of the total $2.8 billion pool. Of these 85 receiverships, 71, with aggregate book values of $734 million (27 percent), had not been reconciled since June 1992.

The primary reason these reconciliations were not completed in a timely manner is that the reconciliation process is manual and thus extremely labor intensive. FDIC's and the servicer's systems are not electronically linked to allow for automated reconciliations. Consequently, FDIC must manually reconcile each receivership's balances and investigate and resolve the differences.
Weaknesses in Time and Attendance Processes Could Affect Expense Allocations Among Funds

FDIC was not consistently adhering to its policies and procedures over its time and attendance reporting process. We first reported this condition in our report on the results of our 1991 audit of SAIF’s financial statements. In addition, certain responsibilities within the time and attendance reporting process were not segregated to provide assurance that errors can be detected and corrected in a timely manner. FDIC’s time and attendance reporting is its primary means for allocating payroll and other overhead expenses among the three funds it administers. Given the relative sizes of the three funds, improper allocation of employee time and associated costs are more likely to result in material misstatements of SAIF’s financial statements and could inappropriately decrease the fund’s limited resources. SAIF’s fund balance at December 31, 1992, was $279 million, making its ratio of reserves to insured deposits negligible.

In our 1991 audit, we selected a statistically valid random sample of time cards and reviewed them for required signatures and agreement with various payroll reports. We also reviewed the time cards and related payroll reports for conformance with FDIC’s “Time and Attendance Reporting Directive.” Our 1991 audit disclosed numerous instances in which (1) time cards and related payroll reports were missing required supervisor and/or timekeeper signatures, (2) timekeepers made changes to time card data without required approval from the employee or the employee’s supervisor, (3) payroll reports were not reconciled to the time cards as required in order to verify that the data on the time cards were properly recorded in the system, and (4) employees were not provided a copy of their processed time card data as required, which would allow them to review the accuracy of their attendance data.

For our 1992 audit, we judgmentally selected a sample of employee time cards to determine if the conditions we identified during our 1991 audit still existed at December 31, 1992. We found similar conditions to those identified in 1991, indicating that there were still significant weaknesses regarding the completion and review of employees’ time cards and related payroll reports. Our work in 1992 further disclosed a number of instances in which (1) time cards were missing required employee signatures, (2) payroll reports did not agree with the time card data with regard to fund charged, hours worked, or leave balances, and (3) the fund to be charged was omitted from the time card, requiring the timekeeper to judgmentally determine what fund or activity the employee should have charged.

FDIC's Office of Inspector General conducted a review of internal controls over FDIC's time and attendance reporting between March 1992 and December 1992. This review identified many of the same problems we identified in our audit, as well as additional concerns. The inspector general found that employees did not always have a reasonable basis to charge their time to a particular fund. This was mainly because employees were not required to formally track and document what fund or activity they spent their time on in a given day. As a result, employees estimated their time usage when completing their time cards, often resulting in unreasonable payroll charges to a particular fund and an insupportable basis for determining percentages to use in allocating other overhead expenses among the funds.

The inspector general also found instances in which the fund charged on the time card was not accurately recorded in the general ledger and instances in which the timekeeper incorrectly changed the fund code that an employee specified on his or her time card. These two conditions resulted from the lack of reconciliations between payroll reports and time cards and the lack of segregation of duties between the timekeeper and the data entry functions, both of which were not addressed by existing FDIC policy. As a result, payroll expenses were not always charged to the proper fund.

In our report on the results of our audit of SAIF's 1991 financial statements, we recommended that FDIC enforce the policies and procedures documented in FDIC's "Time and Attendance Reporting Directive" to ensure that employees' time charges are valid and that payroll expenses are charged to the correct fund. In our briefings with FDIC officials during our 1992 audits and in correspondence, we reiterated the need for FDIC to take corrective action in response to this recommendation. In addition, we recommended that FDIC revise its directive to separate the timekeeping, data input, and reconciliation functions to help ensure that data entry errors or irregularities are detected.

In response to our recommendations, FDIC has taken steps to address the conditions noted during our 1991 and 1992 audits. In July 1993, FDIC issued a revised "Time and Attendance Reporting Directive" which specifically requires the separation of the timekeeping, data input, and reconciliation functions over time and attendance reporting activity. FDIC issued further guidance in August, September, and October 1993 regarding the importance of charging time to the proper fund; situations warranting the use of the common services fund code to record time charges; and the
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review of biweekly time and attendance reports. These procedures and guidance, if adhered to, should reduce the likelihood of significant misallocations of payroll and other overhead expenses among the three funds.

Conclusions

The internal accounting control weaknesses in FDIC’s asset management activities adversely affected FDIC’s ability to manage, liquidate, and report on the large volume of failed institution assets for which it was responsible. These weaknesses affected FDIC’s ability to accurately report transactions associated with BIF’s and FRF’s resolution and liquidation activity and increased the risk of misappropriation of assets, possibly adding to the losses on receivership assets being incurred by BIF and FRF. This is a matter of particular concern because FDIC is scheduled to assume responsibility for managing and disposing of receivership assets currently under the control of the Resolution Trust Corporation (RTC) when it terminates its asset disposition operations on December 31, 1995. Unless FDIC acts to correct these internal control weaknesses, it will be hindered in effectively managing and liquidating the additional assets likely to be transferred to its failed institution asset inventory.

The weaknesses in FDIC’s controls over its time and attendance processes continued to expose SAIF to improper and significant allocations of payroll and other overhead expenses, and thus could further decrease its available resources at a time when the fund is not well-capitalized. However, FDIC’s recent actions designed to address these weaknesses should assist in strengthening controls over its time and attendance processes and reduce the likelihood of significant misallocations of expenses in the future if its revised procedures are effectively implemented.

Recommendations

To address the weaknesses identified in the oversight of asset servicing entities, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the heads of the Division of Finance and the Division of Depositor and Asset Services to

- reconcile asset pools promptly and routinely among the servicing entities’ records and the general ledger control accounts maintained on FIS,
- obtain adequate and timely audit coverage of all critical areas of serviced asset pool operations through the efforts of asset servicing entities’ internal audit departments and FDIC’s visitation groups,
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- expand review procedures when excessive error rates in GCRS are detected and perform follow-up procedures on those assets where errors were detected to ensure the accuracy of the GCRS being used in BIF's allowance for losses calculation,
- require asset servicing entities to update GCRS when the liquidation strategy affecting an asset has changed,
- require GCRS for both internally managed assets and assets serviced by outside entities to be determined based on consistent methodologies using consistent cutoff dates, and
- develop written policies and procedures that require more standardization in the frequency and structure of audits conducted by servicing entities' internal audit departments to ensure that audit findings are completed and communicated to oversight committees in a timely manner and that the audit procedures address areas critical to ensuring the accuracy of financial reporting and safeguarding of receivership assets.

To address the weaknesses in LAMIS data integrity, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the heads of the Division of Depositor and Asset Services and the Division of Finance to:

- perform asset data integrity reviews and certifications in a manner that ensures a review of the data elements critical to accurately determine GCRS for assets in liquidation,
- modify the timing of the semiannual reviews to coincide with the September 30 GCR report date to ensure accurate reporting of GCRS submitted to the Division of Finance,
- direct account officers and managing liquidators to perform timely updates of asset recovery estimates to reflect the most current information available,
- promptly investigate and resolve differences in receivership asset information between FIS and LAMIS and adjust the balances in each system accordingly, and
- implement a uniform system for tracking and aging all differences between FIS and LAMIS that identifies all differences by asset type and responsibility center and enables management to determine whether the differences have a direct impact on the financial reporting process.

To address the weaknesses in reconciliations between FDIC and its principal performing loan servicer, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the heads
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of the Division of Finance and the Division of Depositor and Asset
Services to

- monitor reconciliation activity between the servicer's loan system and
LAMIS and FIS to ensure that delinquent reconciliations are promptly
completed and any adjustments to the receivership asset balances are
promptly made and
- automate the reconciliation process between the servicer's loan system
and LAMIS and FIS to assist in the timely and accurate preparation of
reconciliations of receivership asset balances.

Agency Comments and Our Evaluation

FDIC concurred that its system of internal controls can be improved. However, it disagreed with our characterization of certain internal control weaknesses as material. FDIC stated that we failed to recognize compensating controls put in place by FDIC management that, it contended, alleviate the potential for material reporting errors and loss of assets.

FDIC agreed that improvements are needed in internal controls relating to the liquidation of receivership assets by outside servicing entities. In fact, FDIC cited numerous actions it is taking or intends to take to address many of our findings and recommendations over the contracted asset servicing activity. However, FDIC disagreed that material weaknesses existed in this area. FDIC stated that existing oversight committee reviews, visitations, and internal audits of servicer activity provide sufficient controls over the servicer asset recovery estimation process. Similarly, FDIC disagreed that the audit oversight process for servicer internal audit departments is materially weak, and cited servicer internal audits as being just one of several controls which, taken as a whole, provide effective audit coverage of critical aspects of servicer operations. FDIC also disagreed with our recommendation that more standardization is needed in the frequency and structure of audits conducted by servicer internal audit departments, and stressed the need for each servicer to analyze the risk factors inherent in its own operations and design audit procedures commensurate with this risk.

Some of the weaknesses in controls we identified in the asset servicing function are not necessarily, in and of themselves, material weaknesses. However, taken together, we believe they significantly increase the risk that material errors in reported asset book values and recovery estimates may occur and not be promptly detected, and that receivership assets are not properly safeguarded. The compensating controls over this activity
FDIC referred to are not operating consistently or effectively. For example, this chapter notes that the oversight committee reviews of assets were not sufficient to ensure the integrity of the recovery estimates developed by servicers. While some visitation groups did review recovery estimates, the reviews were not consistent among the servicers, and follow-up procedures and expansion of the reviews were not performed when the visitation teams noted numerous inconsistencies.

Furthermore, FDIC’s own policies with regard to servicer-prepared asset recovery estimates as documented in the asset servicing agreements were inconsistent with the policies governing such estimates for internally managed assets. Finally, while we agree that certain asset pools and servicers have their own different areas of risk that may call for unique audit approaches to address this risk, consistent audit coverage of critical control areas, such as inception balances of pool assets, general ledger reconciliations, cash receipts, cash disbursements, and asset recovery estimates, are fundamental to the effectiveness of these audits as a reliable control over FDIC’s contracted asset servicing operations.

With regard to data integrity problems over LAMIS, FDIC acknowledged that improvements can and will be made to enhance the accuracy of the data maintained in this system. However, FDIC stated that we had not demonstrated that the weaknesses we identified in LAMIS have resulted, or could result, in errors in asset recovery estimates that are considered material to the financial statements of BIF or FRF. FDIC stated that reviews and analyses of asset recovery estimates performed quarterly mitigate the potential for significant misstatements in the financial statements. FDIC also stated that we did not adequately demonstrate that material differences existed in asset book values reported by FIS and LAMIS, and that receivership assets were not properly safeguarded. FDIC contended that we used inappropriate data in determining the differences in FIS and LAMIS reported asset book values, and that we did not expand our work to review common explanations for “out-of-balance” conditions.

Our review of a statistical sample of assets in LAMIS found a range of errors that go to the very heart of the integrity of data on asset recovery estimates. While our projected level of misstatement on BIF’s and FRF’s 1992 financial statements fell just below an amount that would have been considered material in relation to the respective financial statements of the two funds, the examples of outdated, inconsistent, and nonexistent support for asset recovery estimates clearly demonstrate the potential for material misstatements if corrective action is not taken. While quarterly
reviews are performed at a macro level by the Division of Finance, these procedures (1) only identify potential errors in recovery estimates if the aggregate asset recovery estimates for a given receivership exceed the outstanding balance of the claim FDIC has on the receivership and (2) do not provide for more detailed reviews of the aggregate asset recovery estimates for a given receivership if they do not change from quarter to quarter. Such review procedures, we believe, do not mitigate the potential for material errors in recovery estimates.

With regard to the differences in reported asset book values between FIS and LAMIS, the information we used for our comparison was provided to us by FDIC. As of the date of this report, FDIC has not provided us a more appropriate comparison of the two systems' asset balances. Additionally, it is FDIC's responsibility to establish and maintain a system of internal controls that includes consistent, routine reconciliations of the two systems, with clear explanations as to the nature and ultimate resolution of reconciling items in the aggregate. Had such routine reconciliations been performed, the magnitude, nature, and potential reporting consequences of any differences in reported book values between FIS and LAMIS in the aggregate would have been apparent.

With regard to the lack of timely reconciliations between FDIC's records and those of its primary servicer for performing commercial and residential loans of receiverships and corporate-owned assets, FDIC disagreed that the delays in completing these reconciliations have exposed BIF and FRF to additional losses. FDIC stated that the reconciliation process was extremely labor intensive but that, as of June 25, 1993, 94 percent of the March 1993 book value of the loan portfolio with this servicer had been reconciled, with reconciling items substantially cleared. FDIC also noted that, despite the reconciliation delays, no write-offs had been taken on the portfolio and, consequently, BIF and FRF did not suffer any losses due to the reconciliation delays.

We do not believe that the writing off of assets should be the only measure of the impact of reconciliation differences. Current, routine reconciliations between control accounts and subsidiary detail, particularly where such detail resides with the servicing entity, are critical to ensure the integrity of reported information as well as the safeguarding of assets. In addition, one of the primary reasons we believe reconciliations between FDIC's and the servicer's records should be automated is that the current process is so cumbersome and labor intensive.
As discussed previously, FDIC has issued a revised directive on time and attendance reporting and other guidance that (1) provides direction for completing all time sheets, (2) separates the timekeeping, data entry, and reconciliation functions, (3) specifies that financial institution numbers and other codes should be entered properly on the time sheets, (4) specifies the number of employees that each timekeeper and data entry staff should process, (5) requires employees to complete their own time sheets and supervisors to review and approve employee time sheets, (6) requires supervisors to maintain tracking procedures, such as logs, to ensure that employee time sheets are properly reported and approved, and (7) requires employees involved in the time and attendance reporting process to receive proper training. These procedures and guidance, if properly followed, should address the weaknesses we noted in FDIC's time and attendance processes during our audits.
This chapter discusses reportable conditions that existed in FDIC’s system of internal accounting controls during 1992 that warrant FDIC management’s attention. These conditions hindered the ability of FDIC’s system of internal accounting controls to ensure accurate reporting of financial transactions and proper safeguarding of assets. Weaknesses in FDIC’s general controls over its information systems exposed these systems to unauthorized access and use. The absence of adequate controls over cash receipts at some FDIC consolidated receivership sites throughout most of 1992 precluded FDIC from having reasonable assurance that all collections from the servicing and disposition of failed institution assets managed internally were adequately safeguarded and were completely and accurately recorded for BIF and FRF.

Additionally, internal accounting controls did not provide for consistency in the accounting methods used for contracted asset servicing activity. Internal controls were also not effective in ensuring that assessment revenue due to SAIF was properly recorded in the Fund’s financial records, and that all exit fee transactions arising from financial institutions changing their insurance coverage from SAIF to BIF were properly recorded. Finally, formal procedures did not exist during 1992 to ensure proper authorization of all adjustments to the financial statements of the three funds.

General controls over FDIC’s computerized information systems did not provide adequate assurance that data files, computer programs, and computer hardware were being protected from unauthorized access and modification. FDIC uses its computerized systems extensively, both in its daily operations and in processing and reporting financial information. Therefore, general controls over the systems are critical to FDIC’s ability to produce accurate and reliable financial statements.

General controls are the policies and procedures that apply to an entity’s overall effectiveness and security of operations and that create the environment in which application controls and certain user controls operate. General controls include the organizational structure, operating procedures, software security features, and physical protections designed

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1Application controls provide reasonable assurance that data are complete, accurate, and properly authorized.

2User controls are designed to provide independent control over the submission and acceptance of input, system processing procedures, and the reconciliation of the results of electronic data processing (EDP).
to ensure that only authorized changes are made to computer programs, that access to data is appropriately restricted, that back-up and recovery plans are adequate to ensure the continuity of essential operations, and that physical protection of facilities is provided. The effectiveness of general controls is a significant factor in ensuring the integrity and reliability of financial data.

During our 1992 audit, we assessed FDIC's general controls over its information systems. Additionally, in 1992, FDIC's Office of the Inspector General reviewed security over FDIC's telecommunications network and data center, and an independent contractor performed a review of FDIC's mainframe operating system and security access software. These reviews indicated that FDIC did not have adequate security controls in place to ensure that computer programs and hardware were protected against unauthorized access. Without these controls, the opportunity for unauthorized modifications to data files and programs, as well as misuse of computer hardware, is greatly increased.

Weak Controls Over Systems Access

FDIC utilizes an access control software package (ACF2) to provide security over its computer resources. When properly installed and used, this package helps ensure system and data integrity and protects the confidentiality of sensitive information. ACF2 accomplishes this by requiring the use of passwords and user identification codes before granting access to the mainframe operating systems, application programs, and data files, and by providing the capability for audit trails of security violations. However, FDIC has not properly regulated access to the system, or provided policies and procedures governing investigations of unauthorized access attempts or security violations.

As part of its general controls, an entity should establish procedures regulating who may access a system, and what information they may access. However, FDIC had not adopted such rigorous standards. Instead, FDIC assigned system access identification codes to all FDIC employees regardless of job responsibility or position. More importantly, some

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1An operating system is a series of programs that manage computer resources and that serve as an interface between application programs and system hardware. These programs manage and control the execution of application programs and provide the services these programs require. These services may include job scheduling, disk and tape management, job accounting, program compiling, testing, and debugging.


3Computer resources include computer usage, data, transactions, accounts, and programs.
employees were given greater access authority than they needed for their job functions.

FDIC also did not regulate its system access rules, thus allowing too many users access to systems data that they should not normally have had the authority to obtain. These broad access rules could allow an individual to override the normal restrictions and security features of the system. For example, 56 users had been given bypass label processing (BLP) privileges, which permit a user to access data stored on tape. Although the use of BLP is logged under ACF2, FDIC personnel were not required to review this report to oversee use of BLP.

Compounding these problems was FDIC's lack of policies or procedures governing the investigation of unauthorized access attempts. Without this guidance, FDIC personnel did not review or follow up on security violations, such as unauthorized access attempts to FDIC's mainframe computers, which are recorded on an audit trail by ACF2.

The significance of these weak controls was illustrated by the inspector general's security review of FDIC's telecommunications network. Inspector general personnel were able to use a mainframe subsystem to bypass access controls and eventually penetrate other sensitive subsystems. FDIC has four mainframe subsystems that were not subject to ACF2 protection, relying instead on internal security features within each subsystem. However, FDIC allowed password access to these subsystems to be optional. In addition, access capability restrictions, such as "read-only," were not used or were easily bypassed. Consequently, inspector general personnel were able to access the subsystems and then perform most subsystem functions, such as viewing and duplicating information and user profiles. Access to the user profiles allowed inspector general personnel to gain ACF2 user identification codes and passwords belonging to FDIC management personnel. With these codes and passwords, the personnel were then able to access other mainframe subsystems disguised as management personnel.

Weak Monitoring of FDIC's Operating System

Because operating systems manage and oversee both application software and access and security software, it is important that FDIC have controls in place to monitor the operating system. Without such monitoring, individuals can access and override features built into the system, as well as manipulate the audit trail that the system normally provides. FDIC had...
Inadequate Controls Over Data Center Physical Security

In addition to protecting data files and programs, general controls also include the physical security of computer resources. FDIC’s data center is located in the L. William Seidman Center in Arlington, Virginia. The data center supports the majority of FDIC’s data processing requirements. The data center’s main entrance was monitored by an automated physical access control system. However, FDIC had not established adequate operating practices for administering the automated system used for building and data center physical security. For example, access was granted to the data center without written authorization, and established access lists were not reviewed to ensure that they were correct and appropriate. Additionally, FDIC employees responsible for administering the access control system had not undergone formal system training and, consequently, were unable to explain, demonstrate, or perform basic system functions. Finally, FDIC did not have written procedures to address activity and violation reports and the monitoring of access profiles to ensure their appropriateness.

Both the inspector general and the independent contractor recommended a number of actions FDIC management should take to correct these weaknesses in general controls. FDIC management is aware of these general control problems and is in the process of addressing the Inspector General’s and independent contractor’s recommendations. We concur with these recommendations and will follow up on management’s actions during our 1993 audit.

Weaknesses in Cash Receipts Processing Controls

FDIC did not have adequate controls over cash receipt processes at four consolidated receivership sites during most of 1992 to provide reasonable assurance that all collections from the servicing and liquidation of failed institution assets managed internally by FDIC personnel were adequately safeguarded and completely and accurately recorded for BIF and FRF. As a
result, BIF and FRF may not have deposited and recorded all proceeds from collections and sales of assets in liquidation during 1992.

Controls over cash receipt processes should include procedures to establish accountability for all receipts received on a daily basis. At a minimum, control procedures should include the existence and maintenance of receipt control logs or some other mechanism to account for and track all receipts received at their point of entry.

Prior to September 1992, FDIC had not established uniform procedures to ensure the accountability of all receipts received in its consolidated offices. Due to the lack of specific guidance, procedures did not exist for most of 1992 that would ensure adequate control over checks received at 4 of the 11 consolidated offices for which we performed testing of receipt processing controls. These offices had been processing checks into FDIC’s cashier system without initially establishing a control total or a control log for checks received at various entry points at the sites.

FDIC revised its Regional Accounting Manual in September 1992 to adopt uniform procedures for ensuring that all receipts received at the consolidated offices were properly accounted for on a daily basis. The revised manual requires DOF personnel at the consolidated offices to establish control totals for each initial point of receipt, including post office boxes and mail rooms. The manual requires DOF personnel to reconcile the total of each day’s receipts processed through the cashier system back to the sum of these control totals. According to FDIC, these procedures were implemented in November 1992 by three of the consolidated offices where such controls did not previously exist and in December 1992 by the fourth office. We concur with these revised procedures and believe that, if effectively implemented, they should help establish accountability for, and ensure safeguarding of, all receipts received.

Weak Controls Over Accounting for Servicer Collections

The accounting method used in applying collections for two of the seven large serviced asset pools did not comply with the requirements of receivership accounting. This resulted in servicer reported balances of receivership assets being compromised and the need for significant adjustments to the receivership general ledgers for these asset pools. Additionally, FDIC’s method of accounting for servicer collections and remittances on FIS varied between the two FDIC regional offices responsible for recording such activity. This inconsistency was further complicated by
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the regional offices' improper use of standard receivership accounts on FIS. As a result, FDIC personnel did not have accurate information on the composition of receivership accounts, which is necessary to adequately safeguard receivership assets. A clear understanding of the nature of recorded transactions is essential to ensure accurate accounting and reporting of asset management and liquidation activity and to maintain accountability for the failed institution asset inventory.

Lack of Compliance With Receivership Accounting Resulted in Adjustments to Asset Pool Balances

Serviced asset pools are required to be maintained on a basis of accounting consistent with FDIC policies for receiverships. Under receivership accounting, collections on an asset are applied among principal, interest, and other income so that the legal balance7 of loans can be maintained. Because FDIC does not maintain a subsidiary record of each asset's legal balance for those assets included in servicer pools, it is critical that the integrity of the aggregate pool balance for each asset pool be maintained accurately on FIS.

For two of the contracted asset servicers, we found that the asset servicing agreements, which outline the servicers' basic responsibilities, did not require that receivership accounting be used. Instead, the agreements outlined different procedures for applying collections on assets in the pools. The pool accounting under these agreements required that all collections be treated as a principal reduction to the book value of an asset until the book value reached zero. Although not specifically stated in the agreements, FDIC confirmed that cumulative collections which exceeded an asset's book value were to be recorded as interest income. Under this basis of accounting, a legal asset could still exist even though the servicers' pool records would reflect a zero balance. The two servicers accounted for the assets they serviced in a manner consistent with the asset servicing agreements and did not allocate collections among principal, interest, and other income until June 1992 and July 1992, respectively. Consequently, the balances in the FIS general ledger control accounts for the assets serviced by these entities were misstated until correcting entries were made in December 1992 and January 1993, respectively. Thus, controls to ensure adequate safeguarding of, and accountability for, all assets with a positive legal balance were compromised.

7The legal balance represents the amount of indebtedness or liability legally due and owed by an obligor, including principal and accrued and unpaid interest, late fees, attorneys' fees and expenses, taxes, insurance premiums, and similar charges, if any.
For one of the servicers, collections received prior to June 1992 were recorded on FIS in a “cash collections-in-process” account. A total of $102 million, representing collections on the pool assets from August 1991 through May 1992, were recorded in this account before FDIC required this servicer to convert to a receivership basis of accounting. During December 1992, a correcting entry of $19.1 million was made to transfer amounts out of the cash collections-in-process account and appropriately record them in the “principal collections” and “interest income” accounts. An additional $66.9 million was reclassified in January 1993. The remaining $16 million had not been reclassified at the time of our field work.

For the other servicer, all collections received from its inception date, June 1991, to July 1992 had been recorded on FIS in a “principal collections” account in accordance with the accounting guidance contained in the asset servicing agreement. In December 1992, an adjusting entry was made to reclassify $308.5 million in interest income that had been incorrectly recorded as principal collections.

FDIC was aware of the weaknesses in accounting guidance for servicers during 1992 and took corrective action that allowed the above adjusting entries to be recorded to the servicers’ pool records and to the proper FIS accounts so that legal balances could be restored. Additionally, FDIC took steps to ensure that the language in subsequent asset servicing agreements complied with receivership accounting policies.

Standard Receivership Collection Accounts Were Used Inconsistently

DOF personnel at FDIC’s New York regional office were responsible for maintaining the FIS accounting records for six of seven serviced asset pools, while DOF personnel at the Dallas regional office were responsible for the FIS accounting records for the remaining pool. We found inconsistencies in how the two regions accounted for servicer collections on FIS. The New York region recorded servicer collections on FIS after they were remitted to FDIC. In contrast, the Dallas region recorded both the remitted and unremitted servicer collections on FIS.

Accounting for the unremitted collections significantly increases the amount of assets (cash) and liabilities (cash collections in process) reflected within a receivership on FIS. An additional $14.3 million was reflected in FIS records for the serviced asset pool accounted for by the Dallas region at September 30, 1992. Additionally, because FIS does not have an account specifically designated for the recording of unremitted
collections, the Dallas region utilized the "cash collections-in-process" account to record unapplied and unremitted collections, and used the "accounts payable" account to record unapplied remittances. In contrast, the New York region used just one account, "cash collections-in-process," to record unapplied collections that had been remitted by the servicers.

The inconsistent accounting procedures followed by the two regions was primarily due to the absence of standard policies and guidance by headquarters DOF officials for accounting for servicer activity on FIS. Generally accepted accounting principles require consistent application of accounting practices for transactions of a similar nature. Inconsistency in the accounting practices followed by the two regions distorted the integrity of the reported FIS balances, and resulted in inaccurate data on the nature of the transactions recorded in the accounts.

FDIC did not have effective controls in place to ensure that assessment income due SAIF was properly recorded in the Fund's financial records. Errors in the calculation of assessments submitted to FDIC by banks with both BIF- and SAIF-insured deposits were not detected through verification procedures recently implemented by FDIC in time to prevent misstatements to the Fund's financial statements. As a result, SAIF's assessment revenue has been understated since 1990, and significant adjustments were required to SAIF's current and prior years' financial statements to correct these errors.

From SAIF's inception with the enactment of FIRREA on August 9, 1989, until December 31, 1992, all of SAIF's assessment income came from banks whose deposit base included deposits acquired from thrift institutions. FDIC relies on each of these banks to calculate their insurance assessments and requires them to submit a completed and signed certified statement with a check for the assessment amount by January 31 and July 31 of each calendar year. Prior to July 1992, FDIC did not have procedures in place to verify that these banks were accurately completing their certified statements.

In July 1992, FDIC began performing a detailed review of all insured banks' certified statements received from SAIF's inception through July 1992 to determine if the banks properly calculated their insurance assessments. Based on these reviews, FDIC determined that adjustments to SAIF's 1992

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8Pursuant to section 5(d)(3) of the Federal Deposit Insurance Act, banks can acquire deposits of thrift institutions without changing insurance coverage for these acquired deposits. Accordingly, acquired thrift deposits continued to be insured by SAIF and assessed at SAIF's assessment rate.
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and 1991 financial statements totaling $11.6 million and $5.6 million, respectively, were necessary as of December 31, 1992, to reflect previously unrecorded assessments. Additionally, FDIC determined that an adjustment of $1.2 million was necessary to reflect previously unrecorded assessment revenue in SAIF's opening 1991 fund balance. These adjustments were needed to account for assessments due SAIF that were recorded in BIF's general ledger and additional assessments owed SAIF by banks with thrift-acquired deposits. As a result of errors in these institutions' calculations of assessment premiums owed SAIF and FDIC's lack of verification procedures over SAIF's assessment income prior to July 1992, SAIF's assessment income had been understated by $18.4 million over the life of the Fund prior to the adjustments recorded as of December 31, 1992.

In 1993, FDIC began receiving insurance assessments from all SAIF-member depository institutions, except those amounts required by the Financing Corporation (FICO) for the payment of interest and custodial costs on bonds it previously issued to recapitalize FSLIC. The increase in assessment income makes it critical that appropriate controls such as the internal reviews of certified statements be in place and maintained to ensure that SAIF receives all assessment income to which it is rightfully due and to ensure that SAIF's assessment income is properly recorded in the period earned.

Weak Controls Over Recording SAIF's Exit Fees Resulted in Audit Adjustments

FDIC did not establish procedures to ensure that all exit fee income from financial institutions that changed their insurance coverage from SAIF to BIF were properly recorded in SAIF's financial records. Reconciliations between general ledger control accounts used to record exit fee income and detailed entrance and exit fee activity reports were not performed, and significant levels of adjustments arising from other verification procedures were not recorded in the general ledger for SAIF. As a result, significant adjustments were required to SAIF's financial records to properly reflect all income from exit fees.

FIRREA directs that insured depository institutions converting from SAIF to BIF must pay an appropriate fee to each fund. A financial institution electing to exit SAIF and enter BIF calculates its own fee on an entrance and exit fee certified statement and submits the completed statement to FDIC. FDIC sends the institution a bill for the fee and establishes a receivable for the fee in SAIF's general ledger until it receives payment in full. Because FDIC relies on each institution to accurately calculate its own exit fee, it
performs review procedures to verify the accuracy of the exit fee certified statements submitted by the institutions. Based upon the results of these reviews, adjustments to the fees are sometimes required.

We found weaknesses in FDIC's internal accounting controls over the recording of exit fees during 1992 that led to errors in SAIF's general ledger accounts used to record exit fee transactions. For example, we found that general ledger balances used to account for exit fee income were not reconciled to supporting exit fee activity reports to ensure that all appropriate transactions had been recorded. As a result, $2.3 million in exit fee income was earned but not recorded in SAIF's general ledger accounts in 1992. Also, we found that adjustments that arose from the internal verification procedures FDIC performs on the certified statements were not always recorded in the general ledger. Of 45 institutions we selected at random that had adjustments made to their fees as a result of FDIC's verification procedures, we found that the adjustments for 33 institutions (73 percent) had not been recorded in SAIF's general ledger.

FDIC's failure to reconcile the general ledger control accounts used for exit fees to supporting activity reports increased the risk of errors in accounting for exit fee activity. Similarly, FDIC's failure to ensure that adjustments arising from its internal verification procedures are recorded in the general ledger defeats the purpose of this important control, and significantly increases the risk that exit fees could become materially misstated in the future.

Written Procedures for Financial Reporting Adjustments Were Lacking

FDIC did not have written procedures to ensure that adjustments to the financial statements of the three funds were properly authorized. In addition, there were no written procedures to ensure that all transactions that should be recorded through adjustments were properly considered in preparing the financial statements. The lack of such written procedures could result in misstatements to the financial statements of the three funds.

Although the financial statements of the three funds encompass the effects of transactions through December 31 of each calendar year, the general ledgers maintained on FIS for each of the three funds are not officially closed until several weeks after the end of the reporting period to permit the recording of transactions which originated in the reporting period. In addition, transactions that have not been entered into FIS before the general ledgers are officially closed, but whose effects should be reflected
in the reporting period covered by the financial statements, are recorded manually as post-closing adjustments.

We examined 49 post-closing adjustments to the December 31, 1992, financial statements for the three funds, whose aggregate dollar impact on the three funds totaled $6.4 billion. Of these, we found that seven adjustments, whose aggregate dollar impact on the three funds totaled $320 million, were missing supervisory approval. While supporting documentation we reviewed indicated that the adjustments were appropriate for purposes of presentation in each fund’s financial statements, the lack of supervisory approval and written procedures to ensure that all post-closing adjustments are appropriately considered could allow inappropriate adjustments to be made to the funds’ financial statements. Also, the lack of such controls could result in needed adjustments not being made to the financial statements.

**Conclusions**

The weaknesses that existed in FDIC’s system of internal accounting controls during 1992 resulted in adjustments to BIF’s receivership accounts, SAIF’s general ledger control accounts, and SAIF’s financial statements. These adjustments illustrate the impact that the internal control weaknesses had on FDIC’s ability to ensure that transactions were properly recorded and summarized. Additionally, the weaknesses in FDIC’s general controls over its information systems precluded it from having reasonable assurance that systems hardware and applications were not accessed without appropriate authorization and, consequently, that assets were safeguarded from unauthorized use. The lack of adequate cash receipts processing controls at several of its consolidated receivership sites throughout much of 1992 precluded FDIC from having reasonable assurance that all collections were appropriately deposited and accurately recorded in BIF’s and FRF’s receivership accounts.

FDIC took action during 1992 to address the weaknesses in its cash receipts processing procedures, which should provide reasonable assurance concerning the completeness of consolidated office collections. Additionally, the changes FDIC made in the standard language of asset servicing agreements regarding the appropriate method of accounting for serviced asset pools by servicers should result in more consistent and appropriate accounting of collections to ensure that the integrity of the legal balances of the asset pools are maintained.
Chapter 3  
Other Reportable Conditions Could Affect  
Financial Reporting and Safeguarding of  
Fund Assets

Recommendations

To address the weaknesses identified in general controls over its computerized information systems, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the head of the Division of Information Resources Management to

- implement the recommendations of the inspector general and the independent contractor, particularly with respect to (1) regulating access to the systems and establishing policies and procedures to investigate unauthorized access attempts and security violations, (2) fully monitoring programmer changes and addressing system exposures, and (3) improving existing practices for administering the automated building and data center physical security system.

To address the inconsistencies in the use of standard receivership collection accounts, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the head of the Division of Finance to

- establish (1) centralized leadership within DOF to provide accounting guidance to the regional offices tasked with the responsibility of accounting for transactions associated with the serviced asset pools, and (2) a standard accounting policy manual to assist in the application of consistent accounting procedures for these pools.

To address weaknesses in controls over recording SAIF’s assessment income, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the head of the Division of Finance to

- routinely perform detailed reviews of all insured institutions’ certified statements to ensure that these institutions properly calculate their insurance assessments and record any adjustments resulting from these reviews in SAIF’s financial statements in the period in which the assessments were earned.

To address weaknesses in controls over recording SAIF’s exit fees, we recommend that the Acting Chairman of the Federal Deposit Insurance Corporation direct the head of the Division of Finance to

- routinely reconcile the general ledger control accounts used for exit fees to supporting activity reports and
- promptly and accurately record all adjustments resulting from internal verification procedures in the general ledger.
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To address weaknesses in controls over financial reporting adjustments,
we recommend that the Acting Chairman of the Federal Deposit Insurance
Corporation direct the head of the Division of Finance to

- establish written procedures for approving post-closing adjustments to the
  financial statements which would include guidance regarding the
  appropriate level of supervisory approval required for adjustments.

Agency Comments
and Our Evaluation

FDIC concurred with some of the reportable conditions we identified, but
disagreed with others either because it disagreed with our findings or
because it disagreed that such findings constituted reportable conditions.

FDIC concurred with the reportable condition regarding weaknesses in
general controls over its information systems, but pointed out that these
weaknesses were largely identified by an independent contractor hired by
FDIC to review its mainframe operating system and security access
software. As stated in chapter 1 of this report, we reviewed the work of the
independent contractor as well as the inspector general's work on FDIC's
telecommunications network and data center, and concurred with their
findings.

FDIC disagreed with our finding of weaknesses in cash receipts processing
at its consolidated receivership sites. FDIC pointed out a number of internal
control procedures developed over the last 6 years to ensure adequate
controls over this activity. FDIC also noted that additional internal control
procedures were incorporated into its Regional Accounting Manual in
September 1992 to ensure that all receipts from various sources were
properly accounted for on a daily basis. However, FDIC itself noted that
four consolidated offices did not already have such procedures in place.
We concur that these additional control procedures should ensure
appropriate accountability for all receipts received at these offices in the
future. However, this control was not in place during most of 1992 for
these four offices and, therefore, FDIC did not have assurance that all
checks received at these four offices during 1992 were deposited,
recorded, and applied to the proper accounting period.

FDIC concurred that there was a lack of compliance and consistency in the
use of receivership accounting and standard receivership accounts, but
did not believe that this should be characterized as a reportable condition.
FDIC acknowledged that there were inconsistencies in accounting for
serviced asset pools, but stated that it recently began to include in all subsequent asset servicing agreements the requirement that servicers adhere to receivership accounting. FDIC also noted that the inconsistency regarding the accounting for remittances in one serviced asset pool did not cause any material misstatement in the financial statements. FDIC agreed that some inconsistencies resulted from the usage of certain general ledger liquidation accounts based on differing collection reporting methodologies and stated that the establishment of a Contractor Accounting Oversight Group within the Division of Finance, created to provide overall accounting for the serviced asset pools, should assist in providing adequate control over, and timely financial reporting of, assets serviced by third parties.

As stated in this chapter, the modified language that FDIC adopted for new asset servicing agreements to require servicers to account for the serviced asset pools under receivership accounting should help ensure that the servicers account for their serviced pools in an appropriate and consistent manner in the future. However, the lack of such clarifying language in the earlier servicing agreements resulted in inconsistencies and improper methods of accounting for two serviced asset pools, the effects of which were not fully corrected until January 1993. We also concur that the inconsistency in accounting for remittances did not cause a material misstatement to the financial statements. It does, however, make it difficult to understand the nature of the transactions recorded in the accounts, and could result in comparing incompatible information on collections. In addition, a deficiency in the design or operation of internal controls does not require a demonstrated effect of a misstatement to be deemed a reportable condition. Rather, the deficiency or weakness need only have the potential for causing a misstatement for it to be considered a reportable condition.

With regard to weaknesses we identified in FDIC's process for recording SAIF's assessment income, FDIC intends to continue the process it established in July 1992 for routine audits of assessment fees. Further, FDIC stated that it intends to reflect any adjustments arising from these audits in the period in which the audits were completed as opposed to the period in which the fees were earned. We believe FDIC should consider the materiality of these adjustments relative to SAIF's financial statements in determining which period to reflect the impact of these adjustments. To do otherwise would not be in accordance with generally accepted accounting principles and could result in material misstatements to SAIF's financial statements.
FDIC took exception to our finding of weak controls over the recording of SAIF's exit fees. FDIC stated that procedures were established to ensure that both exit and entrance fee transactions were recorded in SAIF's financial records. FDIC noted that reconciliations are performed on a monthly basis between the general ledger and detailed entrance and exit fee reports, and that any adjustments needed are made at the time the reconciliations are completed. As discussed in this chapter, however, contrary to FDIC's assertions, we found that such reconciliations were not performed during 1992 and that, as a result, $2.3 million in exit fee income was earned but not recorded in SAIF's general ledger. We also found that adjustments arising from the internal review procedures on certified statements were not always recorded in the general ledger. Consequently, we believe FDIC should ensure that general ledger control accounts used for exit fee activity are routinely reconciled to the detailed activity reports, and that all adjustments arising from the internal review procedures are promptly and accurately recorded in SAIF's general ledger.

With regard to our finding that FDIC lacks formal procedures to ensure the proper authorization and appropriate consideration of adjustments to BIF's, SAIF's, and FRF's financial statements, FDIC stated that, while not formally documented, it does have such control procedures. We believe the results of our work clearly show the risk of not formally documenting procedures. We believe that formalizing procedures for approving adjustments to the financial statements will institute more discipline in the process and will provide better assurance to FDIC that all necessary adjustments are appropriately considered and approved by responsible parties. FDIC has agreed to document its policies and procedures over the post-closing adjustment process.
June 25, 1993

Mr. Robert W. Gramling
Director, Corporate Financial Audits
U.S. General Accounting Office
441 G Street NW, Room 6112
Washington, DC 20548

Dear Mr. Gramling:

This is in response to your letter of June 22, 1993 concerning the internal control weaknesses noted during the 1992 financial statement audits. We agree that FDIC's internal control systems can be improved upon. FDIC management has, in accordance with the Chief Financial Officers Act, developed an ongoing management process to continuously evaluate internal control systems throughout the Corporation, report weaknesses identified and develop plans to correct these weaknesses. This is an essential management activity given the environment within which FDIC operates and critical nature and complexity of its operations. The GAO's observations on our internal control systems, as part of the financial statement audit, can contribute to our efforts to regularly review and enhance controls. We are concerned, however, that GAO has not developed their findings and presented sufficient evidence to support conclusions of material weaknesses in some FDIC systems of internal controls as of December 31, 1992.

While some of the weaknesses cited by GAO relate to various management systems, the findings of material weaknesses fail to recognize compensating controls that management has put in place to protect against the very problems cited in your audit. Hence, we strongly object to the characterization of the conditions as material. We are supportive of GAO's attempts to encourage improved controls and procedures and would hence appreciate your providing FDIC with specific evidence for the findings so that corrective actions may be taken where appropriate.

The material below responds to the individual findings and recommendations raised in your letter. GAO's audit findings are quoted in italics below with FDIC's response shown in regular type.

Material Weaknesses Cited

Weaknesses in Asset Servicer Oversight. Our work disclosed that weaknesses exist in FDIC's internal accounting controls over contractors engaged to service and liquidate over $11 billion in receivership assets from failed banks resolved by BIF. We found that three of 7 serviced asset pools, with assets totaling about $7 billion at December 31, 1992, had not been reconciled to the asset balances recorded in FDIC's financial information system promptly or completely.

FDIC's Response: We concur that improvements are needed in internal controls relating to the liquidation of receivership assets by contractors. However, we do not agree that a material weakness...
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exists. The responsibility for different aspects of accounting and reporting resides with the Divisions of Finance (DOF) and Liquidation (DOL).

DOF is charged with the responsibility of providing receivership accounting requirements to servicers and to account for serviced asset pools in the FDIC’s accounting system. The Division of Liquidation’s Contract Oversight Monitoring Branch (DOL/COMB) is responsible for the oversight of various functions (including accounting) carried out by Serviced Asset Pool (SAP) contractors. As a result of the increased coordination between DOF and DOL/COMB many of GAO’s concerns are being addressed.

DOF and DOL/COMB work together with servicers to achieve consistency in accounting for serviced asset pools. Issues include development of consistent reconciliation procedures, reporting formats and accounting requirements for servicing agreements. To achieve this consistency:

1. Additional resources have been assigned to Consolidated Field Offices.
2. The reporting and reconciliation process is being reviewed to reduce the existing timing differences.
3. Reconciling items identified in the reconciliation process are followed up and resolved.
4. Two field offices have been established that are dedicated to serviced asset pool related issues.
5. A Washington unit to govern the accounting for serviced asset pools has been established to serve as a liaison between the field offices and other Divisions at headquarters (DOR and DOL).

Additionally, we found that controls were not sufficient to ensure that the methodology used by servicers for calculating asset recovery estimates was consistent with the methodology FDIC used on assets managed internally, and that servicers prepared complete and accurate asset recovery estimates.

FDIC’s Response: FDIC disagrees with the GAO’s contention that controls over the GCR process are not sufficient. While making certain changes (some of which have been suggested by the GAO) would improve the process and make it more efficient, we do not believe they would materially impact the FDIC’s loss reserve or the FDIC’s internal controls. We believe that due to the extraordinarily large dollar volume coverage obtained through existing reviews, visitations, audits etc. the effect of these improvements either individually or in the aggregate, would not be material, even had they been in place in 1991 and 1992.

While individual agreements had provided for various methods of computations of GCRs, the method prescribed by DOL was adopted as policy for contractors in the latter part of 1992. Contractors were then instructed that they must conform to new standards of preparation for all GCR submissions no later than those required subsequent to December 1992.
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The planned changes for 1993, in addition to those addressed above, are: (1) the implementation of servicer-generated quarterly GCR reports; (2) certain service agreement amendments to conform the semi-annual GCR full update to March 31 and September 30; (3) the review of the sampling procedures utilized by the visitation teams to make sure that all assets are included in the universe sampled; (4) improving servicer cut-off procedures for the timely updating of GCRs between reporting periods, and improving consistency of information on a servicer to servicer basis; (5) all servicers will implement a "GCR audit", and the procedures currently being performed in other audit programs will be incorporated and conformed servicer to servicer, and (6) the establishment of a procedure whereby the servicer's internal audit department routinely follows up on FDIC visitation exception findings.

We also found that the servicer's internal audits, which FDIC relied on, were not consistently conducted to ensure coverage of critical control areas such as inception review of asset pools, general ledger reconciliations, and asset recovery estimates. Significant findings from internal audits of servicer pool operations were not always communicated to the servicers' oversight committee in a timely manner. We believe these weaknesses in the oversight of contracted asset servicing entities expose BIF to errors in the process used to determine the Fund's estimated losses on bank resolution activity and prevent FDIC from adequately safeguarding receiver assets.

FDIC's Response: FDIC disagrees with the GAO's determination that the Audit Oversight process represents a material weakness in the overall oversight of the pool, and respectfully asks that you reconsider this conclusion. The audit oversight of the servicer's internal audit department is one of several reviews, visitations, audit procedures, etc., which, taken as a whole, give FDIC an appropriate level of comfort with respect to the private sector involvement in the serviced asset pools. We believe the GAO failed to consider all of the audit-related activities being conducted in their conclusion that the audit oversight process is materially weak. Furthermore, in discussions with the GAO, it was revealed that despite the fact that most of their audit-related concerns were addressed by the internal audits conducted by the servicers, they found the process materially weak in part because the audit programs were not identical for each serviced asset pool. DOL believes that the current requirement that each pool analyze its own risk factors, and develop audit plans and programs accordingly, is an appropriate methodology in the circumstances. The programs utilized by the servicers were, for the most part, originally designed by "Big Six" accounting firms, and are reviewed continually by FDIC Audit Oversight staff. The use of "cookbook" programs is not believed to be an effective way to audit the separate asset pools due to their individual, unique composition and characteristics.

We do agree with the GAO's recommendation regarding the timeliness of reporting to the Oversight Committee. FDIC is presently revising its "Servicer's Audit Guide" to include requirements that draft audit reports be issued to management and Audit Oversight staff within 15 days of completion of field work, and that no later than 30 days from issuance of the draft, management respond to the draft. The final report is to be presented to the Oversight Committee at the end of those forty-five days. This will be monitored by Audit Oversight staff assigned to the various Pools, with monthly reporting by the Servicer for all audits not meeting that time frame. Significant delays will thereby be reported to the Oversight Committee as soon as they are recognized, as well as any significant audit findings. Also included in the revision will be a requirement for a standard reporting format that would result in uniform reporting and disclosure of audit results across all pools. Other proforma reports will also be included, increasing reporting requirements substantially.

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Related GAO Recommendations:

- timely and routinely reconcile asset pools between asset servicing entities' records and the general ledger control accounts maintained on FIS;

FDIC Response: FDIC has been aware of this situation and has been working with the servicers to implement procedures requiring monthly reconciliations which are designed to eliminate the concerns expressed by the GAO. A project is underway to bring all delinquent reconciliations to a current status.

- coordinate the efforts of asset servicing entities' internal audit departments and FDIC's visitation teams to obtain adequate and timely coverage of all serviced asset pools;

FDIC Response: In connection with the next revision of the COMB "Servicer's Audit Guide", the servicer will be provided a copy of the Semi-Annual Visitation Report at its completion. In addition, any agreed-upon corrective actions will be listed in the audit action tickler report provided to Audit Oversight monthly. Through this document, the Internal Audit Department will track completion of the actions, with any delays being reported back to the Oversight Committee. The Oversight Committee will remain as the focal point for contact with the servicers as to any delays.

- expand review procedures when excessive error rates in GCR estimates are detected and perform follow-up procedures on those assets where errors were detected to ensure the accuracy of GCRs being used in BIP's allowance for losses calculation;

FDIC Response: DOL's policy requires that the 25 largest asset relationships for loans and ORE be reviewed by the Oversight Committee each quarter. This is an in-depth review, on an asset-by-asset basis, with the appropriate account officers. DOL believes this quarterly concentration on the "large" asset relationships, which accounts for a large percentage of dollar coverage, coupled with the site visitation coverage of the "small" and "medium" asset/relationships, together provides a representative and materially sufficient sample of the pool.

For future visitation reports, more information will be included regarding the methodology employed to select assets, and the impact of exceptions or errors noted on any conclusions regarding the entire portfolio. Where "excessive" error rates in GCR estimates are detected, the scope of review will be expanded, with appropriate follow-up procedures documenting the ultimate resolution of the exceptions.

- require asset servicing entities to update GCRs when an asset's liquidation strategy has changed;

FDIC Response: Servicers, as part of asset management, review expected collections results when changing strategy. These changes are reflected in internal management systems. However, for loan loss purposes semi-annual reviews will continue to be necessary.

- require GCRs for both internally managed assets and assets serviced by outside entities to be determined based on consistent methodologies;
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FDIC Response: We agree.

provide more standardization in the frequency and structure of audits conducted by servicing entities' internal audit departments to ensure that audit findings are completed and communicated to oversight committees in a timely manner and that the audit procedures address areas critical to ensuring the accuracy of financial reporting and safeguarding of receivership assets;

FDIC Response: DOL disagrees that the present methodology utilized by the servicers to plan, develop and execute internal audits represents a material weakness. Areas of risk differ at each separate pool, depending on the composition of its assets, and terms of the individual asset liquidation agreement. For example, one of the existing serviced asset pools is primarily comprised of very large non-performing, real estate mortgages, construction loans and other real estate. Another pool will shortly be comprised entirely of performing one-to-four family mortgages. DOL believes it is inappropriate to impose identical, standard audit programs on servicers as diverse as these. Further, we believe following this course would be counterproductive to the DOL audit oversight objective of mitigating risk in the serviced asset pools, and thereby increase the risk of loss for the FDIC. Standard audit programs would not adequately replace the current requirement that each servicer analyze its own risk factors, and develop audit plans and programs accordingly. The use of "cookbook" audit programs has been abandoned by all "Big Six" accounting firms in favor of a systems evaluation approach. Due to the unique characteristics of each Pool, and the fact that each service agreement is different, DOL believes this continues to be the most efficient method of approaching the risk elements present in the administration of the pools. Nevertheless, as part of our continuous review of policies and procedures we will reexamine the adequacy of the current "Servicer Audit Guide."

FDIC Response: We agree.

modify the timing of the semiannual reviews to coincide with the September 30 GCR report date to ensure accurate reporting of GCRs submitted to the Division of Finance;

FDIC Response: We agree.

Weaknesses in LAMIS Data Integrity. Our work disclosed that controls to ensure the integrity of data in FDIC's liquidation asset management information system (LAMIS) are not working effectively. The lack of consistent maintenance and updating of data files within the system to reflect current information impacting the condition and potential recoveries on assets in liquidation, and inconsistencies in how estimated recoveries are derived, has resulted in significant errors in system generated information on asset recovery estimates.

Related GAO Recommendations:

perform asset data integrity reviews and certifications in a manner that ensures a review of the data elements critical to accurately determine GCRs for assets in liquidation;

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FDIC Response: FDIC has recognized that improvements can be made in LAMIS data integrity. Accordingly, as part of its efforts to enhance the accuracy of the data in FDIC’s liquidation asset systems, DOL has in place an ongoing data integrity review and certification effort, as established in the DOL “Certification of Data Integrity” Directive issued in mid-1992. The above-noted recommendations on ensuring accuracy of asset recovery estimates are covered by this Directive.

However, GAO has not demonstrated that, because of data integrity weaknesses, significant errors in system generated asset recoveries have or could result, such that the Corporation’s financial statements could be significantly misstated. Reviews and analyses of asset recovery estimates are performed quarterly to mitigate the potential for significant misstatements in FDIC’s financial statements. Therefore, we cannot agree with GAO’s conclusion.

In addition, material differences in receivership asset book values existed at December 31, 1992, between receivership general ledger control accounts on FIS and subsidiary records maintained on LAMIS for both BIF and FRF. The lack of a uniform system for tracking differences between the subsidiary records and control accounts has exacerbated this problem.

We believe the weaknesses in the integrity of data maintained in LAMIS could result in future misstatements to both BIF’s and FRF’s financial statements if action is not taken to correct these weaknesses. We also believe that unresolved differences in receivership asset balances between FIS and LAMIS reduce FDIC’s ability to adequately safeguard receivership assets and could also result in misstating BIF’s and FRF’s asset recovery estimates.

Related GAO Recommendations:

- promptly investigate and resolve current and future differences in receivership asset information between FIS and LAMIS and adjust the balances in each system accordingly;

- implement a uniform system for tracking and aging all differences between FIS and LAMIS, that identifies all differences by asset type and responsibility center. The disposition of significant differences between the two systems should be tracked to enable management to determine whether the differences have a direct impact on the financial reporting process.

FDIC Response: FDIC does not believe that the GAO has successfully supported this finding. The GAO, in its comparison of FIS and LAMIS book values, used a FIS balance net of participations and a LAMIS balance gross of participations. This one example of the incomparability of data renders GAO’s assertion of material differences inappropriate, especially since LAMIS participations for all assets in liquidation at 12/31/92 equaled $1.9 billion.

In addition, GAO did not support its assertion that receivership assets are not properly safeguarded. We were provided no documentation that GAO expanded its audit work to review common reasons for out-of-balance conditions such that the perception of lack of control would be mitigated. Such reasons would include timing differences of transaction processing and assets with interim servicers not being converted to LAMIS.
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Finally, one of GAO's primary concerns as communicated to us seemed to be the age of some outstanding reconciling differences. GAO did provide us with copies of several reconciliation tracking schedules obtained from the field offices during its audit. However, in reviewing these schedules, it appears that the largest portion of older outstanding items relates to the transfer of assets to and from Bowest. That being the case, this concern duplicates a separate GAO-identified material weakness related to Bowest reconciliations. While this separate weakness has been represented by GAO as being more narrow in scope (i.e., only focusing on Asset Type 51 Bowest outages), it seems that identified control weaknesses related to the entire Bowest asset transfer process constitutes only one finding and not two. GAO should not duplicate the weakness to create two separate material weaknesses.

FDIC agrees that differences between FIS and LAMIS need to be promptly investigated and resolved and has existing procedures in place to direct a daily balancing of the two systems and timely follow-up of exceptions. We also agree that enhancements can be made to the overall reconciliation format and process. Accordingly, for 1993, we plan to form a joint DOL/DOF task force to evaluate current LAMIS/FIS reconciliation procedures and determine necessary changes to procedures or enhancements to systems. This task force will consider GAO's recommendations for standardizing the tracking system nationwide and including, among other things, fields to help categorize the causes of identified outages.

Weaknesses in Reconciliation Process Between Bowest and FDIC. Our work disclosed that FDIC experienced significant delays in reconciling asset pool balances between FIS and the records of Bowest Corporation, the primary servicer of its performing commercial and residential loans of receivables and corporate-owned assets. We found that the November 30, 1992, balances for over half of the $2.3 billion in assets serviced by this contractor had not been reconciled as of March 1993. Of this amount, assets with September 30, 1992, reported book values of approximately $759 million had not been reconciled since June 1992.

We believe the lack of complete and up-to-date reconciliations between Bowest's and FDIC's records adversely affects FDIC's ability to adequately safeguard these assets, and exposes both BIF and FRF to additional losses and errors in financial reporting.

Related GAO Recommendation:

- automate the reconciliation process between Bowest Corporation's loan system and LAMIS and FIS to assist in the timely and accurate preparation of reconciliations of receivables and assets balances.

FDIC Response: As GAO has acknowledged on several occasions, DOL has significantly reduced its reconciliation delays and has made great strides in bringing reconciliations current. We believe this should be reflected in GAO's report.

In addition, FDIC disagrees that the delays in reconciliations have exposed BIF and FRF to additional losses. At the time of this response, 99.8 percent of the book value of the portfolio is reconciled for November and 94 percent of the book value of the portfolio is reconciled for March with reconciling...
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items substantially cleared. The remaining items require information from ITT RCC. Although the reconciliation process is extremely labor intensive, no write-offs have been taken on the portfolio. The Corporation has suffered no losses due to the reconciliation delay.

Weaknesses in Time and Attendance Processes. Our work disclosed that FDIC is not consistently adhering to its policies and procedures over the time and attendance reporting process. Additionally, certain responsibilities within the time and attendance reporting process, such as timekeeping and data entry, are not segregated to provide assurance that errors can be detected and corrected in a timely manner.

Time and attendance reporting is FDIC's primary means for allocating payroll and other overhead expenses between the three funds it administers. Given the significance of employee and overhead costs required to administer and manage the assets of the funds, and the significance of BIF's and FID's assets relative to those of SAIF, improper allocation of employee time and associated costs to SAIF could result in significant costs attributable to the other funds and in material misstatements in SAIF's financial statements.

Related GAO Recommendations:

--- revise the Time and Attendance Reporting Directive to separate the timekeeping, data input, and reconciliation functions to help ensure that data entry errors are detected;

--- provide better enforcement of the policies and procedures documented in FDIC's Time and Attendance Reporting Directive to ensure that employee's time charging is valid and that payroll expenses are charged to the correct fund.

FDIC Response: A revised directive on time and attendance will be issued and will specifically address the following:

1. Provides direction for completing all time sheets and separates timekeeping and data entry responsibility.

2. Specifies that Financial Institution Numbers (FIN) and others codes should be entered properly on the time sheets.

3. Specifies the number of employees that each timekeeper and data entry staff should process (150).

4. Requires that employees complete their own time sheets and that supervisors review and approve those time sheets. Also requires that supervisors maintain tracking procedures (logs) to ensure that employee T&A is properly reported and approved.

5. Require that employees involved in the T&A process receive proper training.
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Reportable Conditions Cited

Weaknesses in General Controls Over FDIC's Information Systems. General controls over FDIC's computerized information systems did not provide adequate assurance that data files, computer programs, and computer hardware were protected from unauthorized access and modification. The effectiveness of general controls is a significant factor in ensuring the integrity and reliability of financial data. Without the mitigating controls FDIC had in place during 1992, such as manual comparisons, the weaknesses in general controls would raise concerns over the integrity of information obtained from FDIC's systems.

FDIC's Response: We find this reportable condition to be accurate; however, GAO's report does not state that this condition was identified by FDIC as a direct result of a Division of Information Resources Management (DIRM) internal review performed by Computer Associates in 1992. The DIRM internal review was completed prior to GAO's involvement or discovery of the condition. Computer Associates identified a number of weaknesses in DIRM's administration of ACF2, our mainframe security package. A DIRM Action Plan resulted from the review and was also implemented prior to GAO's involvement. As of this date we have resolved approximately 98% of all issues raised.

Weaknesses in Cash Receipts Processing at Consolidated Receivership Sites. FDIC did not have adequate controls over cash receipts processes at 4 of the 11 consolidated receivership sites during 1992 for which we performed testing of receipt processing controls to provide reasonable assurance that all collections from the internal servicing and liquidation of failed institution assets were completely and accurately recorded for BIF and FRF. As a result, BIF and FRF may not have deposited and recorded all proceeds received from collections and sales of assets in liquidation during 1992.

FDIC Response: We strongly disagree with the finding on weaknesses in cash receipts processing at consolidated office sites.

We have employed a number of internal controls over the cashiering process since the existing cashier system was implemented approximately six years ago at the consolidated offices. These internal control procedures include:

1. Serial stamping of all receipts,
2. Separation of duties within the cashier unit,
3. Rotation of cashier tasks,
4. Unscheduled internal reviews, and
5. Reconciliation of the general ledger accounts to the cashier subsidiary ledger(s).

FDIC's Response to GAO's Audit Findings
In September of 1992, as noted by the auditor, the Regional Accounting Manual (RAM) officially incorporated additional control procedures to ensure that all receipts from various sources are properly accounted for on a daily basis. The RAM requires daily control totals be established for each initial point of receipt such as mail room, DOF P.O. Box, wire transfers, over the counter, lock box, etc. The total of each day's receipts processed through the Cashier system is reconciled back to the sum of the initial control totals. Even prior to the inclusion of these procedures in RAM, all except four (4) consolidated offices during the entire year of 1992 already ran adding machine tapes or maintained logs when checks were received to establish a control total for reconciliation to the Cashier system. Currently, all the consolidated offices are in compliance with these procedures.

Furthermore, in order to provide assurance to the management that the consolidated offices properly follow all current accounting policies and procedures, DOF has implemented a site visitation program.

The procedures explained above are fully operational and we do not contemplate further action regarding this issue.

**Lack of Compliance and Consistency with Receivership Accounting.** The method of accounting used by several of the entities contracted by FDIC to service and liquidate a significant level of BIF's failed bank asset inventory did not comply with the requirements of receivership accounting for applying collections. This resulted in incorrect reported balances of receivership assets and the need for significant adjustments to the receivership general ledgers for the applicable serviced asset pools.

**FDIC Response:** The statement is factually correct but incomplete. This issue was recognized and corrective actions implemented prior to GAO's involvement. As a result of the increased coordination between DOF and DOL, many of GAO's concerns have been addressed. DOF and DOL are currently working together with servicers to address some of the issues that are crucial to achieving consistency in accounting for serviced asset pools. These issues include development of consistent reconciliation procedures, reporting formats and accounting requirements for servicing agreements. Also, the formation of the new Contractor Accounting Oversight Groups, which has an overall responsibility for the accounting for serviced asset pools, will provide the standardized policies and procedures addressed by GAO's review comments.

Beginning in the latter part of 1991, FDIC has included the specific requirement of receivership accounting in all Asset Liquidation Agreements awarded; hence, we do not believe that this is a reportable condition.

Additionally, FDIC's method of accounting for servicer collections and remittances varied between regional offices. This inconsistency was further complicated by improper use of standard receivership accounts by FDIC. The results of these conditions were a reduced degree of understanding of the composition of receivership accounts shown on FDIC's financial information system and, consequently, a reduction in the ability of FDIC to properly monitor and safeguard the pool assets.

**FDIC Response:** There are 2 separate issues addressed in this comment:

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1) FDIC's method of accounting for servicer collections and remittances has varied among pools.

Although an inconsistency does exist regarding the accounting for servicer remittances in one serviced asset pool, we do not believe this one inconsistency makes the process incorrect. We disagree that this one specific inconsistency causes any material misstatement in FDIC's financial statements, it merely reduces an existing timing difference in one of the pools. DOF is currently reviewing this recordation procedure.

2) Improper use of standard receivership accounts by FDIC.

Some inconsistency did occur in the usage of the Work In Process and the Adjustment to Liabilities accounts based on the differing collection reporting methodologies. The Contractor Accounting Oversight Groups established by DOF will be responsible for the overall accounting for serviced asset pools. This group is currently reviewing the account structure needed for serviced asset pool accounting.

We feel that a major first step has been taken during the past few quarters toward the goal of assuring adequate control over, and timely financial reporting of, FDIC assets serviced by third parties. The establishment of a separate serviced asset pool organization within DOF and the continuing efforts on the part of DOF and DOL to work together will result in achievement of the above stated goals.

Weaknesses in Process for Recording SAIF's Assessment Income. FDIC did not have effective controls in place to ensure that assessment revenue due SAIF was properly recorded in the fund's financial records. Errors in assessment information submitted to FDIC by banks with SAIF-insured deposits were not detected on a timely basis through FDIC verification procedures. As a result, SAIF's assessment revenue has been understated since the fund's inception, and significant audit adjustments totaling $18.5 million had to be made to SAIF's current and prior years' financial statements to correct these errors.

FDIC Response: FDIC has an established systematic ongoing process for auditing assessment fees for both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). This is a strong internal control to ensure that FDIC receives all of our assessment revenue and that it is appropriately applied to the specific fund. Assessment fee calculation by the financial statements can be complicated, especially related to SAIF and errors do occur.

The purpose of the audits is to ensure that the errors are corrected. It is FDIC policy to reflect the audit adjustments in the period of audit completion instead of the period when the fees were earned. We believe this to be proper accounting policy and to do otherwise would require restatements to the financials every year. FDIC agreed to restatement of SAIF revenue for 1991 at the request of GAO. However, we plan to follow our existing policy for future periods.

Weak Controls Over Recording of Entrance and Exit Fees. FDIC did not establish procedures to ensure that all entrance and exit fee transactions recorded in SAIF's financial records when financial
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Institutions changed their insurance coverage from SAIF to BIF. Reconciliations between general ledger control accounts used to record entrance and exit fee income and detailed entrance and exit fee activity reports were not performed. Furthermore, a number of significant adjustments arising from other verification procedures were not recorded in the general ledger for SAIF. As a result, significant audit adjustments were required to SAIF's financial statements to properly reflect all entrance and exit fee activity.

FDIC's Response: It is not an appropriate statement to say "FDIC did not establish procedures..." Procedures were established between the Assessment Audit Unit, the Fiscal Unit and the SAIF Fund Accounting Unit to ensure exit and entrance fee transactions are recorded in the SAIF's financial records. These procedures continue to be modified as new issues arise.

The SAIF Fund Accounting Unit does perform a reconciliation of the general ledger to the detailed Entrance and Exit (E&E) records provided by the Fiscal Unit. The reconciliation between the general ledger and the detailed E&E reports are done on a monthly basis after month end close. The E&E receivable accounts and the unamortized discounts account are reconciled to the Receivables Report and the Amortization Report. The collection accounts are reconciled to the Collections Reports. Any adjustments needed are made at the time the reconciliations are completed.

Lack of Formal Procedures for Financial Reporting Adjustments. FDIC does not have formal procedures to ensure that adjustments to the financial statements of the three funds were properly authorized. In addition, there are no formal procedures to ensure that all transactions that should be recorded through adjustments are properly considered in preparing the financial statements. The lack of adequate approval procedures to ensure all necessary adjustments are considered could result in material misstatements to the financial statements of the three funds.

FDIC's Response: The key word in GAO's reportable condition is "formal." FDIC did have, and does have, procedures to ensure the proper authorization of adjustments and to ensure that all adjustments are properly considered.

For example, to ensure that all adjustments are properly authorized, adjustments originating outside the Reporting Section are signed by the unit or section chief proposing the adjustment. All adjustments, whether originated inside or outside the Reporting Section, are then listed in a recap and reviewed by the Chiefs of the Reporting Unit and Reporting Section as well as the Assistant and Associate Director.

To ensure that all adjustments are properly considered, FDIC has several procedures including: reviewing possible adjustments developed during month-end account reconciliation work; reviewing the inventory of missing standard or recurring journal entries; and an analysis of documentation received after month-end close which may affect cash allocation. This process occurs each month and any items discovered to have been omitted or incorrectly entered into the Financial Information System (FIS) are communicated to the Reporting Section for adjustment. In addition, the Reporting Section also performs a reasonableness check for items that can be forecast and contacts Corporate Accounting for an explanation if the FIS accounts appear out of line. Given the lack of activity for SAIF and the size of BIF, it is unlikely that material adjustments would be overlooked.

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Our procedures are currently not written; therefore, GAO has characterized them as lacking formality. However, a lack of formality is not equivalent to a lack of procedures. GAO's use of the phrase "lack of adequate approval procedures" is inaccurate, and we disagree with that characterization. To allay GAO's concerns over a lack of formality, FDIC shall document existing procedures through a statement in the form of a memorandum or other written guide.

We believe the information provided above provides sufficient basis for you to delete or reduce the classification of weaknesses you presented. We respectfully request that you incorporate our response in such a manner that our views are fairly presented in any and all reports issued by GAO.

Finally we wish to thank you and your staff for the assistance they have given us over the years in improving our financial operations. The FDIC remains committed to being an effective, well-managed financial organization and looks forward to working with GAO to achieve our common goals.

Sincerely yours,

Steven A. Seatig

cc: Chairman Hove

FDIC's Response to GAO's Audit Findings
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