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United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-253861

August 29, 1994

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

Dear Mr. Chairman:

In June 1994, we issued our opinions on the calendar year 1993 financial statements of the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and FSLIC Resolution Fund (FRF) and our opinion on the Federal Deposit Insurance Corporation's (FDIC) system of internal controls as of December 31, 1993, and reported on FDIC's compliance with applicable laws and regulations for the three funds for the year ended December 31, 1993 (GAO/AIMD-94-135, June 24, 1994).

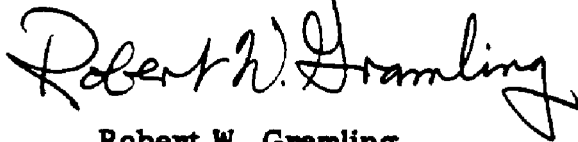
In conducting our 1993 audits, we found that FDIC made progress in addressing the accounting procedure and internal control matters identified in our management letter from our 1992 audits (GAO/AIMD-94-30ML, January 24, 1994). The purpose of this letter is to report to you other matters identified during our 1993 audits regarding accounting procedures and internal controls which could be improved and to make suggestions for improvement. While these matters are not considered material in relation to the financial statements of the three funds, we believe they warrant management's attention. We have broken these matters down into four areas: (1) corporate operations (enclosure I), (2) consolidated office operations (enclosure II), (3) serviced asset pool operations (enclosure III), and (4) electronic data processing (enclosure IV). The enclosures discuss these matters and include our suggestions for improvement. Also, one additional matter concerning electronic data processing security controls is being communicated to you in a separate correspondence.

We conducted our audits pursuant to the provisions of section 17(d) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1827(d)), and in accordance with generally accepted government auditing standards.

We would appreciate receiving your comments and a description of the corrective actions FDIC plans to take to address these matters within 30 days from the date of this letter. We acknowledge the cooperation and assistance provided by FDIC officials and staff during our 1993 audits.

If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-9406 or Steve Sebastian, Assistant Director, at (202) 512-9521.

Sincerely yours,



Robert W. Gramling
Director, Corporate Financial Audits

Enclosures

FDIC CORPORATE OPERATIONS

As part of our calendar year 1993 audits, we tested accounting and other controls necessary to ensure that the assets of the funds administered by FDIC were safeguarded against loss from unauthorized acquisition, use, or disposition and that transactions were executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. We interviewed FDIC officials, reviewed FDIC policy, procedures, and accounting manuals and documented our understanding of the processes and relevant internal controls. We then designed procedures to test relevant controls for proper authorization, execution, and accounting and reporting of transactions.

Our tests covered reconciliations of various general ledger accounts on FDIC's Financial Information System (FIS) to determine if the account balances or account activity were being reconciled on a timely basis to supporting subsidiary records and whether such reconciliations were approved by appropriate supervisory personnel. We also tested the validity, accuracy, and proper recording of transactions processed during the year and performed analytical procedures. Discussed below are the internal control weaknesses we identified while performing these tests.

ENTRANCE AND EXIT FEES FROM INSURED DEPOSIT TRANSFERS WERE NOT PROPERLY CALCULATED

Insured deposit transfers (IDTs) from SAIF member institutions in conservatorship with the Resolution Trust Corporation (RTC) to BIF member institutions are subject to entrance and exit fees. IDT entrance and exit fees are paid to BIF and SAIF, respectively, and in total cannot exceed the premium the acquiring institution pays for the right to enter into the IDT arrangement. During 1993, we found that FDIC did not properly calculate IDT entrance and exit fee amounts and as a result recorded incorrect amounts on FIS for both BIF and SAIF.

FDIC's existing rules and regulations require the BIF entrance fee rate to be based on BIF's reserve ratio and SAIF's exit fee to be set at a fixed rate. The rules and regulations also provide for how the premium is allocated to pay the entrance and exit fees. This allocation establishes a direct relationship between the BIF entrance fee and the SAIF exit fee. During 1993, the accounting unit responsible for calculating and recording the IDT transactions was unaware that BIF's entrance fee rate could change and therefore calculated and recorded the incorrect fee amounts for BIF and SAIF. While not material, this error affected the accuracy of amounts reported in BIF's and SAIF's financial statements.

We suggest that FDIC ensure that the accounting unit responsible for calculating and recording IDT transactions use the appropriate BIF entrance fee rate to properly calculate and accurately record BIF's and SAIF's entrance and exit fees, respectively.

TRANSACTIONS WERE NOT ALWAYS PROCESSED WITH PROPER WRITTEN AUTHORIZATION

A major objective of a system of internal controls is to provide reasonable assurance that all transactions are properly authorized to minimize the risk of waste, loss, unauthorized use, and misappropriation of assets. Additionally, FDIC's Regional Accounting Manual (RAM) requires that all manual entries to FIS be reviewed for accuracy, sufficiency of supporting documentation, and approval. The RAM further requires that the review and approval be documented. However, during our 1992 and 1993 audits, we found that transactions associated with failed financial institution resolution activity were not always processed with proper authorization. Specifically, 9 of 361 transactions we tested during our 1993 audits were not properly authorized. We found similar weaknesses during our 1992 audits. These transactions related to collections on receivership billings, advances to receiverships, disbursements to depositors, premiums received from acquiring institutions, and collections on subrogated claims.

Ineffective authorization controls increase the risk that (1) assets may not be safeguarded against loss from unauthorized use, (2) transactions may not be executed in accordance with management authority, and (3) transactions may not be properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with generally accepted accounting principles.

We suggest that FDIC ensure that all transactions are properly reviewed and authorized in accordance with management policy.

TREASURY CASH BALANCE WAS NOT RECONCILED OR CLEARED IN A TIMELY MANNER

FDIC requires that monthly reconciliations between its general treasury account balance on FIS and the U.S. Treasury Undisbursed Appropriations Accounts Ledger (TFS 6653) be performed and that all reconciling items be identified and promptly resolved. However, we found approximately $35 million of unreconciled differences between FIS and U.S. Treasury records existed at December 1993.

The $35 million consists of cumulative differences since 1990 between FDIC's payroll records and the National Finance Center (NFC) payroll

disbursement activity as reported to the U.S. Treasury. Through the end of our fieldwork, FDIC had determined that $8.8 million of the total difference dates to 1990 and relates to the Common Services Fund, which was established to allocate expenses among FDIC's funds. The remaining $26.6 million in differences between FDIC and NFC records since 1990 remained unresolved at the end of our fieldwork. Delays in resolving reconciling items increases the risk of errors or irregularities and limits FDIC's ability to ensure the accuracy of its cash balance.

We suggest that FDIC enforce its policy requiring monthly reconciliations between the general treasury account balance on FIS and the U.S. Treasury Undisbursed Appropriations Accounts Ledger and resolve reconciling items within 30 days after month-end.

INADEQUATE DATA USED TO ESTIMATE CORPORATE LITIGATION LOSSES

Generally accepted accounting principles require that an estimated loss be accrued when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. The methods used to establish the loss amount should be adequately documented and supported by evidential data. During our 1993 audits, we found that FDIC does not accumulate data necessary to accurately estimate litigation losses.

FDIC calculates litigation losses based on estimates of amounts a court or jury would award if a case went to trial. However, FDIC does not consider the fact that litigation is often settled without going to trial. Further, FDIC does not have a system to accumulate the actual litigation loss for each case, and therefore has no historical data to assist in determining the loss estimates. This limits FDIC's ability to reasonably estimate future litigation losses.

We suggest that FDIC accumulate actual litigation loss data from resolved cases and consider this historical data in estimating future litigation losses for financial statement purposes.

FRF'S LOSS RESERVE PROJECTIONS WERE NOT ADEQUATELY SUPPORTED AND REVIEWED

On a quarterly basis, FDIC's case managers prepare estimates of assistance agreement loss reserves. These loss reserves are reported as "Estimated Liabilities for Assistance Agreements" on FRF's Statement of Financial Position. The loss reserve projections must be supported by adequate evidential data and be reviewed and approved by appropriate management. FDIC's "General Guidelines/Methodology and Procedures [for] Preparation of Loss Reserves - Assistance Agreements" (General Guidelines) requires that the Unit Chief or

Assistant Regional Manager review and approve loss reserve projections.

We found that FRF's loss reserve projections contained numerous calculation errors and instances of insufficient supporting documentation. These errors and lack of supporting documentation were not detected or corrected in the review and approval process. Additionally, during 1993, FDIC consolidated and restructured the units responsible for overseeing FRF's assistance agreements but failed to update the General Guidelines to incorporate changes in responsibilities for reviewing and approving loss reserve projections. This resulted in a lack of clear responsibility for reviewing and approving the projections.

While the errors we noted during our audits were not material to FRF's 1993 financial statements, the numerous instances of these errors and the lack of supporting documentation indicate that loss reserve projections are not adequately reviewed. Additionally, failure to use or maintain adequate supporting documentation in preparing loss reserve projections restricts FDIC's ability to determine if these projections are properly prepared. Furthermore, lack of clear review and approval responsibility could result in reviews which are inadequate to detect and correct errors in the loss reserve projections. These deficiencies could affect the accuracy of FRF's financial statements.

We suggest that FDIC use and maintain sufficient documentation to prepare and support FRF's loss reserve projections. Additionally, we suggest that FDIC update its General Guidelines to incorporate operational changes to ensure that loss reserve projections are sufficiently reviewed. Future changes to the General Guidelines should be issued prior to, or concurrent with, any significant changes to the review and approval responsibilities for FRF's assistance agreements.

RESOLUTION OF EXCEPTIONS IDENTIFIED IN CALCULATING LOSS ALLOWANCES NOT ALWAYS DOCUMENTED

FDIC's Loan Loss Reserve Processing Procedures (LLR procedures) require resolution of all exceptions identified on the loan loss reserve anomaly reports. These anomaly reports identify failed institutions for both BIF and FRF with loan loss reserve data outside the parameters expected by FDIC. The LLR procedures require resolution of identified exceptions on the anomaly reports by either adjusting the loan loss reserve data or documenting that no adjustment is necessary. The LLR process calculates all of FRF's, and the majority of BIF's, allowance for losses on their respective balances of subrogated claims and investment in corporate-owned assets. However, we found that FDIC did not document the resolution for 9 of 86 exceptions identified

in the anomaly reports as of September 30, 1993. Additionally, while a supervisory review of the resolution of anomaly report exceptions is required, we found that this supervisory review was not always documented.

Failure to document the resolution of all exceptions limits FDIC's ability to ensure that all required adjustments are properly made and compromises the effectiveness of the anomaly reports as an important control in calculating BIF's and FRF's allowance for losses. Unresolved exceptions in the loan loss reserve data could affect the accuracy of BIF's and FRF's allowance for losses related to the balance of subrogated claims and investment in corporate-owned assets.

We suggest that FDIC document the resolution of all exceptions identified on the anomaly reports. In addition, we suggest that the supervisory review of the resolution of anomaly report exceptions be documented to ensure full compliance with FDIC's LLR procedures.

GROSS CASH RECOVERY ESTIMATES INCLUDE CONTINGENT GAINS

Generally accepted accounting principles require that contingent gains be excluded from income in order to avoid recognizing income prior to its realization. However, we found that FDIC's gross cash recovery estimates used in the allowance for loss calculations include contingent gains from pending litigation and professional liability claims. Including these contingent gains in estimating recoveries affects the accuracy of amounts reported in BIF's and FRF's financial statements.

Asset managers at FDIC's consolidated offices estimate recoveries from the management and liquidation of failed institution assets, including pending litigation and professional liability claims, in accordance with the Division of Depositor and Asset Services Credit Manual (Credit Manual). These estimated recoveries are used to calculate the allowance for losses on BIF's and FRF's balances of subrogated claims and investment in corporate-owned assets.

The allowance for loss calculation should include estimated recoveries from all failed institution assets to which receiverships have existing rights to the assets and their respective cash flows. However, receiverships do not have an existing right to potential recoveries from pending litigation and professional liability claims. The receivership's right to the potential recoveries is dependent upon the FDIC, in its receivership capacity, successfully adjudicating its claim. In contrast, for failed institution assets, such as loans or owned real estate, the event determining FDIC's right to the asset and the respective cash flows from the asset has occurred and the remaining question is the value of the right. While not material to the 1993 financial statements of

either BIF or FRF, including potential recoveries from pending litigation and professional liability claims overstated BIF's and FRF's balances of subrogated claims and investment in corporate-owned assets at December 31, 1993, by $120 million and $216 million, respectively.

We suggest that FDIC revise the Division of Depositor and Asset Services Credit Manual to exclude contingent gains arising from pending litigation and professional liability claims.

FINANCIAL STATEMENT TRANSACTIONS WERE MISCLASSIFIED

One important function of an effective accounting system and related internal controls is that they ensure that transactions are properly classified in financial reports. However, during our 1993 audits, we found misclassifications in the financial statements of all three funds administered by FDIC.

For example, FRF's Statement of Financial Position was misclassified as a result of an inappropriate $70 million reclassification from "Estimated Liabilities for Assistance Agreements" to another liability line item. While this and the other misclassifications we identified were not material, they did result in incorrect line item amounts in the financial statements. We believe that these misclassifications may indicate weaknesses in FDIC's recording and review of transactions flowing into the financial statements and weaknesses in FDIC's review of the financial statements. Inadequate recording and reviewing of transactions and financial statements could lead to more significant misstatements to future financial statements.

We suggest FDIC ensure that transactions are properly recorded and reviewed and that financial statements are properly reviewed for potential misclassifications.

CONSOLIDATED OFFICE OPERATIONS

During our 1993 audits, we visited 9 of 17 FDIC consolidated offices to review the internal controls over receipts and disbursements, and general ledger reconciliations. As part of our review, we tested reconciliations of various asset and liability accounts on FIS to determine if general ledger accounts were being reconciled on a timely basis to the appropriate subsidiary records, necessary adjustments to FIS or the subsidiary records were accurately recorded, and such reconciliations were approved by the appropriate supervisory personnel. In addition, we tested check receipt and disbursement transactions at the offices we visited to verify whether these transactions were valid and were recorded accurately in FIS and whether disbursements were properly authorized. During our review, we noted weaknesses in general ledger account reconciliation, check receipt, and disbursement processes. The internal control weaknesses noted in these areas are summarized below.

FDIC LACKED ADEQUATE PROCEDURES FOR THE MISCELLANEOUS RECEIVABLE ACCOUNT

FDIC calculates the allowance for losses on BIF's and FRF's balances of subrogated claims and investment in corporate-owned assets using estimated recoveries from the management and liquidation of failed institution assets. This calculation includes recoveries from miscellaneous receivables of the failed institution. However, we found weaknesses with regard to the validity, completeness, and valuation of transactions recorded in this account and deficiencies in the documentation supporting the activity recorded in this account.

We reviewed the Miscellaneous Receivable account for 27 receiverships and found numerous procedural weaknesses affecting the integrity of the recorded balances on this account. We found, for example, that working capital advances to property management companies were recorded as miscellaneous receivables rather than expensed and valid tax receivables were inappropriately charged-off. We also found that certain recorded receivables lacked adequate supporting documentation. In addition, FDIC does not review and assess the collectibility of receivables recorded in this account and adjust the recorded value of the receivable to reflect only the amounts deemed collectible. We believe these weaknesses are due to inadequate accounting policies and review procedures over miscellaneous receivables. The lack of adequate policies and procedures for recording miscellaneous receivables overstated the account balance recorded on FIS and the estimated recoveries used to calculate BIF's and FRF's allowance for losses on their respective balances of subrogated claims and investment in corporate-owned assets.

We suggest that FDIC establish specific accounting policies and review procedures governing the Miscellaneous Receivable account that effectively address the conditions identified during our review.

ACCOUNTING FOR SUBSIDIARIES COULD LEAD TO MISSTATED ACCOUNTS[1]

FDIC accounts for investments in subsidiaries using the equity method of accounting. Generally accepted accounting principles require the carrying amount of the investment be adjusted for the investor's share of earnings and losses, plus net advances, until the investment balance is reduced to zero. When the subsidiary has a negative net worth, the aggregate balance of FDIC's investment in the subsidiary should be reflected as zero unless FDIC is committed to provide further financial support. However, FDIC's current method of accounting for subsidiary transactions increases the risk of overstating its investment in subsidiary balance.

Currently, FDIC records the initial investment, results of operations, and dividends received in the Investment in Subsidiary account and records working capital advances in either the Commercial Loans or Miscellaneous Receivables accounts. However, if a subsidiary has a negative net worth, the aggregate of these three accounts overstates FDIC's investment balance. This occurs because FDIC applies the equity method of accounting only to the Investment in Subsidiary account and does not consider the balances in the Commercial Loans or Miscellaneous Receivables accounts. However, the transactions in these accounts are components of the subsidiary's net worth. Consequently, their impact on the net worth of the subsidiary has already been taken into consideration. Additionally, this accounting treatment complicates reconciling subsidiary financial statements to FIS because subsidiary transactions are not easily identifiable in the Commercial Loans and Miscellaneous Receivable accounts.

FDIC's accounting treatment for subsidiary transactions also increases the risk of overstating the recovery estimates used in calculating BIF's and FRF's allowance for losses on their respective balances of subrogated claims and corporate owned assets. FDIC's account officers specifically determine the recovery estimate for each investment in subsidiary, which represent total recoveries estimated from the

[1]This comment differs from the comment in Enclosure III titled "Servicers' Accounting for Subsidiary Assets Differs From FDIC" personnel at the consolidated offices failed to properly apply the equity method of accounting for subsidiary transactions. In contrast, FDIC's contracted asset servicers did not apply the equity method of accounting for subsidiary related transactions.

remaining investment balance as well as any outstanding advances. However, overstatements in the recovery estimates can occur because (1) there may be more than one asset on LAMIS to allocate the recovery, (2) LAMIS automatically calculates a separate recovery estimate for assets with book value under $250,000, and (3) recoveries for miscellaneous receivables are calculated at 100 percent of their outstanding balance. These conditions impair FDIC's ability to ensure asset balances are accurately reported.

We suggest that FDIC record all investment in subsidiary transactions in a single account on FIS and LAMIS.

LIMITATIONS WITH FIELD ACCOUNTS PAYABLE SYSTEM IMPAIR CONTROLS

FDIC's Regional Accounting Manual (RAM) requires that all disbursements be paid from original invoices. FDIC often incurs costs that require allocation of a single invoice to multiple receiverships or assets. However, FDIC's accounts payable system does not allow entering more than one receivership or asset number for each disbursement. Therefore, payment of a single invoice associated with more than one receivership or asset is made from photocopied invoices, not the original. FDIC personnel indicated that the accounts payable system identifies multiple payments to the same vendor. However, this does not function as an effective compensating control because there are no limits established on the number of acceptable payments from photocopied invoices and because there are no controls in place that compare the cumulative payments to the original invoice amount. This limits FDIC's ability to ensure that portions of invoices are not paid more than once or that invoices are paid in full.

We suggest that FDIC modify its accounts payable system to allow allocation of expenditures to multiple receiverships or assets from a single original invoice.

CASH COLLECTIONS-IN-PROCESS ACCOUNT NOT RECONCILED OR AGED PROPERLY

FDIC's RAM requires that all asset and liability general ledger accounts be supported by subsidiary records. Additionally, accounts that represent unapplied "in-process" transactions should be aged to ensure transactions are cleared in a timely manner. However, our 1992 and 1993 audits found that consolidated offices which use the Work-in-Process (WIP) subsidiary system to record Cash Collections-in-Process cannot reconcile the subsidiary ledger to the final month-end account balance on FIS. This condition continues to exist because FDIC's WIP system does not accept post dated transactions, which can be entered on FIS. While FDIC performs daily reconciliations of the general ledger

balances to subsidiary records, a reconciliation to the month-end aging reports is not performed. In addition, we found that aging reports at three consolidated offices only accounted for items outstanding in excess of 30 days.

As a result of these conditions, the final month-end balances of the Cash Collections-in-Process accounts on FIS were not supported by detailed subsidiary records. This limits the ability of FDIC and others to ensure the accuracy of the Collections-in-Process and other receivership account balances. In addition, not including all outstanding transactions on the aging reports limits FDIC's ability to reconcile the aging report to Cash Collections-in-Process accounts on FIS and ensure that all transactions are cleared in a timely manner.

We suggest that FDIC modify its subsidiary systems to allow reconciliation of month-end balances in Cash Collections-in-Process accounts to subsidiary records and to month-end aging reports which account for all outstanding items comprising the account balances.

RECEIPTS WERE NOT ADEQUATELY CONTROLLED OR PROMPTLY DEPOSITED

FDIC's RAM requires establishing control totals for each day's receipts at the initial point of entry. FDIC's Division of Finance personnel are then required to reconcile each day's receipts processed to the control totals. The RAM also requires that all checks received before the depository deadline be deposited that day.

Our 1992 audits found the controls over the receipt of checks at their initial point of entry and reconciliation of checks received to checks processed and deposited were not fully effective. Although progress has been made to address these weaknesses, we noted similar conditions during our 1993 audits. Specifically, at one consolidated office we found that checks processed in the Cashier's System were not reconciled to control totals for checks received at the point of entry. At two other consolidated offices, checks received after the mailroom's cutoff deadline were simply locked in a file cabinet until the next day without first establishing a control total for these unprocessed items. Also, two consolidated offices deposited checks 2 to 3 days after their receipt. Without adequate accounting and safeguarding controls for each day's check receipts, FDIC cannot ensure that all funds received are processed, recorded on FIS, and credited to the correct receivership.

We suggest that FDIC strictly enforce its procedures to establish control totals for each day's receipts, reconcile both the daily processed and unprocessed receipts to the control totals, and deposit checks within the time frames required by the RAM.

RECEIVERSHIP CLAIMS AND DIVIDENDS NOT RECONCILED ON A REGULAR BASIS

FDIC's RAM requires reconciliation of subsidiary records to recorded balances on FIS and resolution of reconciling items on a timely basis. However, at three consolidated offices visited, we found that FDIC did not reconcile the general ledger accounts used to record receivership dividends and claims for uninsured deposits and other creditors on a regular basis. FDIC personnel at two of these offices indicated that these reconciliations were only performed when a dividend was declared. However, adjustments are routinely made to balances on FIS which may or may not be made to the receivership claims and dividends records. At the third office, the most recent reconciliation was 4 months old at the time of our fieldwork. Lack of timely reconciliations increases the risk that errors may not be promptly detected and corrected, which could result in inaccurate financial records.

We suggest that FDIC establish procedures to reconcile receivership claims and dividends balances, at a minimum, on a quarterly basis.

DATA INTEGRITY REVIEWS DO NOT PRODUCE RELIABLE RESULTS

During 1993, FDIC implemented a certification program, using the Data Integrity Evaluation Reporting System (DIVERS), to ensure the reliability of data elements on LAMIS. One purpose of this program was to ensure that recovery estimates for FDIC's failed institution assets were calculated accurately. To work effectively, data elements critical to calculating the recovery estimates should be certified as to their accuracy and program results should be reported correctly. However, incomplete information and inadequate systems design in both LAMIS and DIVERS prevent updating and certifying critical data fields by account officers and have resulted in inaccurate certification results.

In calculating recovery estimates on assets, it is critical to consider the amount of prior liens, if any, and the delinquency status of loans. However, LAMIS does not maintain data fields necessary to record the amount of prior liens on assets. Further, LAMIS is not designed to allow input into the "paid to date" field for nonaccrual assets, which is critical in determining the delinquency status of assets. These conditions could misstate recovery estimates. In addition, we noted inadequate systems design in DIVERS. For example, DIVERS requires an affirmative or negative response to the accuracy of all LAMIS data fields it is programmed to verify. However, we found that not all data fields are applicable for certain assets and therefore should require no response. Requiring a positive or negative response when one is not applicable could lead to misinterpretation of certification results. In

addition, data input or edits to data by a reviewer for certain data fields are considered errors by the system regardless of the cause of the data input or edits. These conditions increase the risk that errors in recovery estimates may go undetected and decrease management's ability to rely on the certification results.

We suggest that FDIC modify LAMIS to account for prior lien amounts and to calculate delinquencies on nonaccrual assets. In addition, we suggest that FDIC correct the system design on DIVERS discussed above to produce reliable certification results.

ASSET WRITE-OFFS NOT PROPERLY CLASSIFIED

Generally accepted accounting principles require classification of financial statement balances and activity with similar characteristics. However, we found that FDIC uses various income, expense, and equity accounts to record write-offs for unreconciled asset and liability activity. Although FDIC's Chart of Accounts includes equity accounts to record asset or liability write-offs and an income statement account to recognize losses on asset dispositions, there are no specific income statement accounts to record write-offs for unreconciled asset and liability account activity. Not maintaining separate accounts to record write-offs resulting from asset disposition activity and from clearing unreconciled asset and liability account balances decreases management's ability to determine the effectiveness and performance of consolidated offices in safeguarding assets, maximizing collections, and reducing expenses. An income statement account for write-offs would have been particularly meaningful to management during 1993 when consolidated offices disposed of large differences between asset book values on FIS and LAMIS and large balances reported in the cash Collections-in-Process account that existed at December 31, 1992.

We suggest that FDIC amend the chart of accounts to include income and expense accounts to record write-offs for unreconciled asset and liability account activity.

SERVICED ASSET POOL OPERATIONS

FDIC has contracted with third-party entities to service and liquidate the assets, such as loans, owned real estate, subsidiaries, and other assets from numerous large failed financial institutions. In addition, FDIC also contracted the servicing and liquidation of performing residential and commercial loans to two other third-party entities. These serviced assets had an aggregate recorded book value on FIS of $8.8 billion and $2 billion, respectively, as of December 31, 1993. FDIC's Contractor Oversight and Monitoring Branch (COMB) is responsible for ensuring that these servicers properly manage, liquidate, and account for the assets within each serviced asset pool, and FDIC's Division of Finance (DOF) is responsible for ensuring that the transaction activity and asset balances are properly recorded on FIS.

As part of our 1993 audits, we reviewed FDIC's internal controls over its contracted asset servicers. Specifically, we reviewed FDIC's internal controls designed of ensure the validity of servicer billings to FDIC, proper application of collections to assets and remittance to FDIC, adequacy of the oversight committee approval for asset liquidation, gross cash recovery estimates submitted by the servicers, reconciliation of servicers' bank accounts, and reconciliations between the servicers' subsidiary and general ledgers and FDIC's FIS. We also reviewed servicers' internal audit functions to ensure adequate audit coverage of critical asset servicing activities. We identified the following internal control weaknesses in FDIC's serviced asset pool operations during our 1993 audits.

SERVICED ASSET BALANCES WERE NOT PROPERLY RECONCILED

Sound accounting practices require that entities maintain subsidiary records which support general ledger account balances and perform reconciliations between subsidiary records and general ledger account balances on a timely basis. However, we found that reconciliations of servicers' general ledger balances to subsidiary records were not performed properly. One servicer reconciled the preliminary balance of owned real estate, instead of the adjusted balance, to subsidiary records. Another servicer did not reconcile the investment in subsidiary account to the subsidiary financial statements for 30 entities. Not properly reconciling serviced asset balances to subsidiary records could misstate servicer records and result in incorrect balances being reported to FDIC. Additionally, this compromises FDIC's ability to adequately safeguard its inventories of failed institution assets.

We suggest that FDIC ensure that, through review of servicers reconciliations, (1) servicers reconcile adjusted general ledger balances to subsidiary records and other supporting documents on a monthly basis, (2) reconciliations are accurate, and (3) reconciling items are properly identified and resolved promptly.

TRANSACTIONS MISCLASSIFIED IN SERVICERS' FINANCIAL ACTIVITY REPORTS

To record servicers' asset pool activity on FIS and to evaluate servicers' performance in managing and liquidating serviced assets while maximizing recoveries, FDIC receives monthly reports from the contracted asset servicers which summarize asset pool transactions. Financial transactions on these reports must be properly classified to maintain the integrity of asset pool activity and balances recorded on FIS and to provide accurate and relevant information for use in making management decisions. However, we found that one servicer misclassified activity on these reports. Specifically, this servicer reported losses on asset sales as principal collections. FDIC identified the misclassification based on other information submitted by the servicer. However, this correction did not result from a routine verification process. Although FDIC corrected the information from the activity report before recording transactions to FIS, misclassifying asset pool activity on these monthly reports by the servicers increases the risk that FDIC could record incorrect transactions and inappropriately evaluate servicers' performance. Such misclassifications, if not corrected by FDIC, could also impair FDIC's ability to accurately account for, and properly safeguard, serviced assets.

We suggest that FDIC make certain servicers properly classify asset pool activity on the financial reports submitted to FDIC by reviewing these financial reports to ensure transactions are properly classified.

AUDIT OF LOAN SERVICER NOT PERFORMED PROMPTLY

To ensure that serviced asset pool balances are accurately reported and internal control systems over serviced assets are adequately structured, FDIC should closely supervise and monitor the activities of its primary mortgage loan servicer. An independent accounting firm audits and reports on the serviced asset pool balance of this servicer. FDIC personnel have indicated that these audits are a primary control in FDIC's oversight function of this servicer. However, these audits are not performed on a regular basis and do not cover all periods under the servicing contract. For example, one audit covered a 14-month period from July 30, 1990, through September 30, 1991, and another audit covered a 9-month period from June 30, 1992, through March 31,

1993. The period October 1, 1991, through June 29, 1992, was not audited. Allowing extensive time periods to elapse without adequate supervision and monitoring of the mortgage loan servicer increases the risk that internal control deficiencies could become more severe and result in loss of assets and misstate balances reported on FIS.

We suggest that FDIC require annual audits of the mortgage loan servicer and communicate the deficiencies identified, if any, and necessary actions required to correct them to the appropriate level of divisional management within 6 months after the audit period.

SERVICERS' ACCOUNTING FOR SUBSIDIARY ASSETS DIFFERS FROM FDIC

Serviced asset pool balances are required to be maintained on a basis of accounting consistent with FDIC policies for receiverships. FDIC's RAM requires that transactions associated with subsidiaries of failed institutions be accounted for under the equity method of accounting. Under this method, investors should adjust the carrying value of the investment to recognize their share of earnings or losses and should not provide for additional losses when the investment falls below zero unless the investors are committed to provide further financial support. This method of accounting is used to ensure accurate reporting of the legal balances[2] of FDIC's assets and liabilities for the investment in subsidiaries. Additionally, the asset servicing agreements between FDIC and the contracted asset servicers specifically require that the adjusted pool value for any pool asset should not be less than zero. However, differences in accounting methods for subsidiary assets exist between FDIC's consolidated offices and its contracted asset servicers.

During our 1992 audit, we reported that while FDIC's consolidated offices do not allow the investment in subsidiary balance to fall below zero, servicers recorded the negative equity balance for subsidiaries. FDIC personnel indicated that COMB allowed servicers to record the negative equity balances for subsidiaries. During 1993, we found similar inconsistencies for accounting for investment for subsidiaries between consolidated offices and servicers. Inconsistent accounting

[2]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. In this context, the legal balance of receivership assets represents all amounts legally due and owed by an obligor to FDIC. The legal balance of receivership liabilities represents all amounts legally due and owed by FDIC to others.

policies between FDIC and its contracted asset servicers could misstate the balance of investments in subsidiaries reported on FIS and limit FDIC's ability to adequately safeguard and accurately report its receivership assets. In addition, the accounting of negative operating results for subsidiaries gives the appearance that FDIC is liable for the operating losses of the subsidiaries.

We suggest that FDIC require the contracted asset servicers adopt accounting policies set forth in FDIC's RAM. Additionally, FDIC should monitor the servicers' implementation of these accounting policies.

CONTRACTED SERVICERS DID NOT OBTAIN AUDIT COVERAGE IN ALL CRITICAL AREAS

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 obtains assurance that serviced assets are adequately safeguarded and accurately reported to FDIC, servicing contract costs are valid, and collections are remitted to FDIC promptly. In our 1992 audits, we reported that certain audits critical to the effective oversight of the serviced asset pools were not performed and that the review and issuance of the audit reports was not timely.[3]

During 1993, FDIC made significant progress to address these weaknesses. However, our 1993 audits found that certain critical areas continued to be overlooked. For example, the internal audit department for two servicers did not perform audits on the pool activity and balances reported to DOF. Also, one of these servicers failed to audit the accounting for owned real estate assets and the other servicer failed to audit the asset recovery estimates reported to FDIC. This increases the risk that weaknesses in servicers' systems of internal controls or errors in reported pool balances are not identified and resolved in a timely manner.

We suggest that FDIC closely monitor the servicers' internal audit departments to ensure all critical audits are completed adequately and that corrective actions are taken promptly.

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[3]Financial Audit: Federal Deposit Insurance Corporation's 1992 and 1991 Financial Statements (GAO/AIMD-93-5, June 30, 1993).

ELECTRONIC DATA PROCESSING (EDP) CONTROLS

As part of our calendar year 1993 audits, we reviewed general controls[4] over FDIC's computerized information systems to ensure that data files, computer programs, and computer hardware were protected from unauthorized and/or inadvertent access and modification. We designed procedures to identify applicable general controls, determine how these controls function, and evaluated and tested the effectiveness of these controls. We conducted our review through interviews with FDIC management, analysis of system documentation, observation, and detail testing. During our review, we noted weaknesses in system development and change controls, security access controls, and service interruption controls. Discussed below are the internal control weaknesses we identified while performing our review.

FDIC'S CHANGE MANAGEMENT POLICY LACKS IMPLEMENTATION AND STANDARDIZATION

Management of program changes is critical for supporting data security and integrity. A centralized change control function allows an entity to enforce corporate-wide standards benefiting all program applications and users.

In August 1993, FDIC issued an interim change management policy and established a change management committee to establish a corporate-wide change management process and to serve as FDIC's focal point for approving all proposed change requests. However, through the completion of our fieldwork, FDIC, through the Division of Information Resources Management (DIRM), had yet to finalize the change management policy. Additionally, we found that four distinct change control processes exist within DIRM for program application changes. While we did not specifically review these four change control processes, each of the processes is unique, and some of them may be contrary to the DIRM data administration, security, and quality initiatives described in the interim change management policy.

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[4]General controls are the policies and procedures that apply to an entity's overall effectiveness and security of operations and create the environment in which application controls and certain user controls operate. General controls include the organizational structure, operating procedures, software security features, system development and change control, and physical safeguards designed to ensure that only authorized changes are made to computer programs, access to data is appropriately restricted, back-up and recovery plans are adequate to ensure the continuity of essential operations, and physical protection of facilities is provided.

We suggest that DIRM consolidate the four distinct change processes, finalize the corporate-wide change management policy, and enforce this policy.

FDIC SYSTEM DEVELOPMENT PROCESS LACKS ENFORCEMENT

A standard system development life cycle methodology is essential to provide control, quality assurance, and implementation of DIRM standards, and to maximize efficiency and effectiveness in developing new and significantly modified FDIC application systems. A system development life cycle methodology provides management with greater assurance that management's objectives are adequately addressed, including information integrity, security, disaster planning, and standardization at both the system and application levels.

In 1989, after detailed analysis, DIRM selected Arthur Andersen's system development life cycle methodology product. This methodology not only provides a structured development approach, but also integrates project management, analysis, design, and code generation components. However, our work disclosed that DIRM has not uniformly enforced the use of the system development life cycle methodology. For example, project management tools have been used inconsistently across different projects. Additionally, DIRM has not provided training on the system development life cycle methodology for project managers, system developers, and end-users.

Project management is an important element of a system development life cycle because it provides the project managers with defined tasks, phases, management checkpoints (for controls, quality, and user feedback), and deliverables. Without the use of project management tools, DIRM and system development senior management may not adequately respond to systems development demands on an ongoing basis.

We suggest that DIRM enforce the use of the system development life cycle methodology, and provide training on this methodology to project managers, selected system developers, and key end-user management.

CA-ACF2 MANAGEMENT NEEDS ENHANCING[5]

Password management and control protects critical system resources against unauthorized and/or inadvertent access and modification. This becomes even more important as FDIC moves towards "single sign-on" capabilities through CA-ACF2. Also, an essential ingredient in the separation of responsibilities within an organization is a limit on the information available to the user. Information is generally made available on a need-to-know basis.

Our work revealed that FDIC does not enforce the use of CA-ACF2 password syntax rules such as 1-character numeric and use of a restricted password list. Additionally, we noted excessive use of certain security privileges. For example, as many as 18 users have the READALL privilege. This is a powerful privilege, allowing users the ability to access and review the entire database and program directory. While these users may require limited access to review selected files such as payroll and the general ledger, no one individual should have the complete READALL privilege. Also, FDIC has not periodically reviewed the use of other significant security privileges. Normally, these privileges are only assigned to a limited number of systems software and security personnel. Those who have these privileges can override other security controls and management may not be able to detect them. Without sound security controls, computer resources are not protected against unauthorized access to data and software.

We suggest that FDIC enforce the use of CA-ACF2 password syntax, that system-wide READALL be eliminated, and that management review the use of all security privileges to ensure that these privileges are granted only to those individuals who have a valid need.

ACCESS TO CICS MASTER TERMINAL TRANSACTIONS IS EXCESSIVE

The integrity of FDIC's data depends on the proper security and handling of Customer Information Control System (CICS) transactions. CICS master terminal transaction allows the user to change the CICS operating environment and bypass system security. Normally, access should be provided only to operations supervisors and CICS software programmers. However, our work revealed that as many as 78 FDIC personnel have access to this sensitive master terminal transaction, of which only 14 are operations supervisors and CICS software

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[5]CA-ACF2 (Computer Associates - Access Control Facility 2) is an access control software package which provides system-level security over computer resources, such as computer usage, data, transactions, accounts, and programs.

programmers. This excessive access could undermine the integrity of the terminal's security and FDIC's data.

We suggest that FDIC review who has access to the CICS master terminal transaction and restrict the number of users to only the operations supervisors and CICS software programmers.

FDIC'S DISASTER RECOVERY PLAN NEEDS IMPROVEMENT

FDIC has a formal disaster recovery plan in place. This plan has a designated back-up data center off-site to assist in the restoration of critical processing in the event of a disruption to FDIC's computer center located in Arlington, Virginia. However, the plan does not identify specific critical applications to be recovered in the event of a disaster or the order in which the applications are to be restored. DIRM management stated this was not necessary because they expect to recover all 86 production applications shortly after an emergency. However, we found this is technically impossible since the off-site data center provides for only 50 percent of the total processing capacity and 33 percent of the total telecommunications capacity. If a service disruption occurs, users must know in advance what applications will be available for use and the restoration period for their application. A disruption of computer services for any appreciable length of time would have an unacceptable impact on many vital activities and, ultimately, FDIC's mission.

In addition, the plan includes procedures for sending data tapes to the back-up data center but lacks specific details necessary to ensure that it could be properly carried out in the event of a disaster. For example, the plan does not provide such detailed procedures as who will send the tapes, who will authorize the transfer, and who will verify the tapes have been forwarded.

We suggest that FDIC perform an analysis to identify the critical applications and their corresponding technology requirements and to develop procedures for users to follow to restore these applications. In addition, FDIC should assign specific responsibilities in the disaster recovery plan to ensure the restoration of critical applications promptly.

FDIC DOES NOT PERFORM UNANNOUNCED DISASTER RECOVERY TESTS

FDIC conducts disaster recovery tests in an effort to simulate, as realistically as possible, a disruptive event to determine how successfully critical applications and telecommunications can be restored. However, these tests have not been realistic simulations of an environment likely to be found in the event of a disaster. For example, past tests have been announced and rehearsed.

Additionally, we found that DIRM typically has relied heavily upon the same designated recovery personnel for each of the tests instead of rotating the responsibilities so that everyone has the opportunity to participate in a disaster recovery test. By not performing unannounced disaster recovery tests and rotating responsibilities among personnel, FDIC increases the risk that critical applications and telecommunications will not be restored promptly in the event of an actual disaster.

We suggest that DIRM conduct unannounced disaster recovery tests and include an annual unannounced rotation of their critical applications and recovery personnel defined in the disaster recovery plan.

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