Office of Inspector General

March 28, 2003
Audit Report No. 03-026

Internal Control Over Receivables from Failed Insured Depository Institutions

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Federal Deposit Insurance Corporation
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Office of Audits
Office of Inspector General

DATE: March 28, 2003

TO: Fred S. Selby, Director
Division of Finance

Mitchell L. Glassman, Director
Division of Resolutions and Receiverships

FROM: Russell A. Rau
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SUBJECT: *Internal Control Over Receivables from Failed Insured Depository Institutions* (Audit Report No. 03-026)

This report presents the results of our audit of the Federal Deposit Insurance Corporation's (FDIC) internal control over financial reporting of receivables from failed financial institutions. The objective of the audit was to determine whether the FDIC has implemented effective internal controls to ensure the accurate financial reporting of corporate receivables from failed insured depository institutions.[1] Our work was conducted to assist the U.S. General Accounting Office (GAO) with its audit of the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and Federal Savings and Loan Insurance Corporation Resolution Fund (FRF) financial statements for the years ended December 31, 2002 and 2001.[2] Additional details on the audit's objective, scope, and methodology, including the controls tested, are included in Appendix I.

BACKGROUND

A receivership is a temporary entity that is established when the primary state or federal regulatory authority closes an insured depository institution and appoints the FDIC as receiver to manage the business affairs of the failed institution. The FDIC, as receiver, maintains separate accounting and financial reporting from FDIC corporate activities while the receivership is in existence. In the role of receiver, the FDIC is required to dispose of the assets and liabilities of a

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[1] Insured depository institutions include banks and savings and loan institutions.

[2] The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), P.L. 101-73, created the BIF, SAIF, and FRF. The BIF and SAIF are insurance funds responsible for protecting insured bank and thrift depositors from loss due to institution failures. The FRF is a resolution fund responsible for winding up the affairs of the former Federal Savings and Loan Insurance Corporation and liquidating the assets and liabilities transferred from the former Resolution Trust Corporation.

failed financial institution in an orderly manner and distribute available funds according to a prescribed priority of payment.[3] The FDIC works to terminate receiverships promptly. The assets of the failed institution generally represent the main source of repayment of the FDIC's receivership expenses.

The FDIC in its corporate capacity[4] is the insurer of deposits for banks and savings institutions.[5] When an institution fails, the FDIC, in its corporate capacity, records a receivable for payments made to cover insured deposit obligations incurred on behalf of the failed insured depository institution. The FDIC, in its corporate capacity,[6] then has the right to recover, from the receivership that is managing the closed financial institution, the amount the insured depositor would have recovered from the failed institution. Receivables from receiverships on the FDIC's corporate books primarily consist of claims arising from corporate payments to insured depositors of closed insured financial institutions.

In addition, when conducting its normal operations, an institution in receivership may encounter funding needs. If a receivership is unable to meet its funding needs through cash on hand and asset liquidation, it can request funds from the FDIC in the form of a corporate advance[7] or loan. The Federal Deposit Insurance (FDI) Act, Section 13(c)(1), codified to 12 U.S.C. 1823, authorizes the FDIC to make loans to any insured depository institution. These advances/loans are recorded as receivables in the FDIC's corporate books and as a liability for the receivership.

The FDIC receives cash and non-cash dividends[8] on all claims from the receivership for closed financial institutions. Cash dividends are declared and paid to the Corporation by the receivers out of funds available from the liquidation of the failed financial institution's assets, after payment of liquidation expenses, and after payment of prior corporate advances to the receivership.

The FDI Act, Sections 11(a)(4)(A) and 11A(a)(1), codified to 12 U.S.C. 1821 and 1821a, requires the FDIC to separately maintain and not commingle the BIF, SAIF, and FRF.

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[3] The National Depositor Preference Amendment sets forth the priority that claims against the receivership would be paid. The priority is as follows: (1) administrative expenses incurred by the receiver; (2) any deposit liability of the institution, including both insured and uninsured depositors; (3) other general or senior liabilities of the institution such as claims from vendors, suppliers, contractors, and claims arising from employee obligations and unpaid taxes; (4) subordinated obligations; and (5) shareholder claims.

[4] The FDIC performs several functions. In its capacity as insurer, the FDIC maintains, manages, and controls risks to two deposit insurance funds (corporate capacity). Whenever a federally insured depository fails, the FDIC pays off insured deposits or, more frequently, it arranges for the transfer of accounts from the failed institution to a healthy one. In addition, the FDIC acts as receiver or liquidating agent for failed federally insured depository institutions (receivership capacity).

[5]The Federal Deposit Insurance Act Section 11, codified to 12 U.S.C. 1821, establishes statutory limits on the amount of insured deposits due to any depositor of a failed depository institution.

[6] A failed institution's creditors include the FDIC (in its corporate capacity), which essentially stands in the place of the failed financial institution's customers with insured deposits.

[7] Advances are funds provided by the FDIC, in its corporate capacity, to receiverships for specific operating purposes. These funds are actually receivership borrowings from the FDIC corporate accounts.

[8] A dividend is the distribution of receivership cash or assets to proven claimants of a failed institution. FDIC (corporate) as subrogee for insured deposit claims is entitled to receivership dividends.

Accordingly, the assets held by receivership entities and the claims against them are accounted for separately in the BIF, SAIF, and FRF. The FDIC's *Field Finance Office Accounting Manual* governs the processing of transactions related to receivables from failed insured depository institutions. The manual includes the policy and procedures for processing claims, dividends, advances, and termination transactions.

At December 31, 2002, the gross receivables balance reported by the FDIC for BIF was $6.1 billion, $721.6 million for SAIF, and $27.6 billion for FRF. Specific internal control activities of the Divisions of Finance (DOF) and Resolutions and Receiverships (DRR) are designed to ensure that these corporate receivables are accurately recorded and not commingled in the accounting records of the Corporation and FDIC receiverships. Within the FDIC's Financial Information Management System (FIMS), certain general ledger[9] transactions automatically generate or "route" additional entries to interrelated accounts. Thus, journal entries related to corporate disbursements generate router entries to corresponding receivership accounts.

RESULTS OF AUDIT

The FDIC has effectively implemented selected internal controls to ensure the accurate financial reporting of corporate receivables from failed insured depository institutions. We identified the following controls, including those related to entries that impact both the corporate and receivership accounts, that were in place and operating:

- The FDIC has issued policies and procedures pertaining to transactions affecting the receivables from failed institutions.

- Transactions were adequately supported and properly approved.

- Proper segregation of duties was maintained between recording corporate receivables and receivership accounting activities.

- Proper separation of cash disbursement and receipts duties from corporate and receivership cash accountability duties, such as recording cash transactions and performing reconciliations, was maintained within the corporate and receivership accounting functions.

- An accounting system exists that automatically routes entries to the proper corresponding corporate or receivership accounts.

- DRR and DOF accountants reconcile corporate accounts with the corresponding receivership accounts to identify and correct any incorrect journal entries.

[9] A general ledger is a collection of all asset, liability, equity, revenue, and expense accounts.

- Supervisory accountants review and approve all journal entries prepared by both DRR and DOF accountants for adequate support and to ensure that the appropriate accounts and amounts are posted to the general ledger.

These control activities safeguard assets from loss due to unauthorized use or disposition and ensure appropriate processing, recording, and summarizing of transactions to permit the preparation of reliable financial statements.

We provided the results of our audit to the GAO for its consideration in evaluating the Corporation's internal control over financial reporting and compliance with applicable laws and regulations.

CORPORATION COMMENTS AND OIG EVALUATION

Our report does not include recommendations for corrective actions. However, we provided our draft report to the Director, DOF and the Director, DRR. These divisions responded that they had no comments.

APPENDIX I

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of this audit was to determine whether the FDIC has implemented effective internal control to ensure the accurate financial reporting of corporate receivables from failed insured depository institutions. Our work was not intended to express, and we do not express, opinions on the fair presentation of the balances for corporate receivables for 2002 or 2001, or related internal control over financial reporting or compliance with laws and regulations. Such opinions, if expressed, are the responsibility of the GAO as the principal auditor for the FDIC's corporate financial statements.

Scope and Methodology

To achieve our objective, we followed the financial auditing methodology outlined in the GAO/President's Council on Integrity and Efficiency *Financial Audit Manual*. We selected dollar (monetary) unit samples[10] from separate BIF and FRF transactions recorded during the period January 1, 2002 through October 31, 2002 in specific general ledger accounts.[11] The balances of these accounts represent the gross corporate receivables from resolutions amounts disclosed in the BIF and FRF financial statement footnotes. At December 31, 2002, the gross receivables balance reported by the FDIC for BIF was $6.1 billion, $721.6 million for SAIF, and $27.6 billion for FRF. Our testing of corporate receivables did not include tests related to certain allowance for loss accounts, used to determine the "net" receivables from resolutions for each fund's financial statements as of December 31, 2002. The GAO tests these accounts. Our review focused on the gross corporate receivables and included tests of the corresponding entries in the receivership accounts only to the extent that the same documentation supported the entire transaction.

The BIF dollar unit sample consisted of 40 transactions, totaling $193.1 million. For the FRF, we selected 150 transactions totaling $581.2 million. For the SAIF, we did not use dollar unit sampling but instead selected a sample of 6 major transactions totaling $1.09 billion that occurred during the period January 1, 2002 through December 31, 2002. Additionally, we tested other selected transactions from the BIF, FRF, and SAIF. Our testing included, but was not limited to, the following types of transactions: dividends, terminations, advances, and claims.

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[10] Dollar (monetary) unit sampling is a type of statistical sampling in which the monetary unit is the sample item and is then subjected to random sampling. The auditor performs the test not on the individual monetary unit but on the account balance that includes the monetary unit selected. This method of sampling is most suitable when the expected total dollar amount of the misstatement is expected to be very low.

[11] These accounts include accounts in the following series: 019XXX, 034XXX, 035XXX, 051XXX, 057XXX, 061XXX, 062XXX, 063XXX, 064XXX, 068XXX and 162101.

Receivership Dividends Paid to the FDIC in its Corporate Capacity

We tested dividend payments to the FDIC in its corporate capacity. Dividends paid included the traditional and final dividend payments. For those controls related to dividends, we verified that:

- sampled transactions were adequately supported and proper journal entries were recorded;
- dividend calculations per the Dividend Processing System (DPS) were reviewed and approved, and transactions were correctly posted to both receivership and corporate accounts;
- DRR accountants reconciled the receivership subrogated claim and receivership repayment balances per DPS to the same balances recorded in FIMS; and
- Receivership Wire Authorization Vouchers, authorizing wires to corporate bank accounts, were properly approved.

Inactivation/Termination of Receiverships[12]

For those controls related to inactivation/termination of receiverships, we verified that:

- the receivership termination case was approved by the proper level of delegated authority;
- the proper documentation to inactivate the receivership was prepared; and
- no subsequent transactions were recorded for the inactivated receiverships.

Corporate Advances

For those controls related to corporate advances, we verified that:

- sampled transactions were adequately supported and
- journal entries were recorded properly.

Claims

For those controls related to claims, we verified that:

- sampled transactions were adequately supported;
- transactions were approved by the proper level of delegated authority; and
- journal entries were recorded properly.

[12] A terminating receivership is inactivated on the Corporation's financial systems to preclude further activity after the signing of the Certificate of Termination.

Computer-Processed Data

To achieve the audit objective, we relied on computer-processed data contained in FIMS and DPS. We conducted sufficient tests of the data by accessing DOF's Financial Data Warehouse to independently verify that the account balances recorded on DPS Dividend Reports were accurate, as of the time the DPS system computed the dividend amounts payable. In addition, we traced transactions back to source documentation to verify that the data were valid and adequately supported. As a result of the tests and assessments, we concluded that the computer-processed data are sufficiently reliable to be used in meeting the objective of the audit.

Performance Measures

The FDIC has not established performance measures specifically related to internal control over financial reporting of receivables from failed insured depository institutions. Therefore, our audit did not address the FDIC's compliance with performance measures.

Compliance with Laws and Regulations

We found no instances of non-compliance with significant provisions of applicable laws and regulations as they relate to the receivables from bank and thrift resolutions line items of the BIF, SAIF, and FRF financial statements as of December 31, 2002. The applicable laws identified were: FDI Act Sections 11(a)(4)(A) and 11A(a)(1), codified to 12 U.S.C. 1821 and 1821a, which require the FDIC to separately maintain and not commingle the BIF, SAIF, and FRF and section 13(c)(1), codified to 12 U.S.C. 1823, which authorizes the FDIC to make loans to any insured depository institution.

Our audit work was performed in accordance with generally accepted government auditing standards from October 2002 through February 2003.