



U.S. Department of Agriculture

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Office of Inspector General  
Financial & IT Operations

## **Audit Report**

### **Federal Crop Insurance Corporation Risk Management Agency's Financial Statements for Fiscal Years 2004 and 2003**

Report No. 05401-13-FM  
November 2004

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UNITED STATES DEPARTMENT OF AGRICULTURE  
OFFICE OF INSPECTOR GENERAL  
Washington D.C. 20250



DATE: NOV 12 2004

REPLY TO  
ATTN OF: 05401-13-FM

SUBJECT: Federal Crop Insurance Corporation/Risk Management Agency's  
Financial Statements for Fiscal Years 2004 and 2003

TO: Ross J. Davidson, Jr.  
Administrator  
Risk Management Agency

ATTN: Michael Hand  
Deputy Administrator  
Risk Compliance  
Risk Management Agency

This report presents the auditors' opinion on the Federal Crop Insurance Corporation/Risk Management Agency (FCIC/RMA) principal financial statements for the fiscal years ending September 30, 2004 and 2003. Reports on FCIC/RMA's internal control structure and compliance with laws and regulations are also provided.

Deloitte & Touche LLP (Deloitte), an independent certified public accounting firm, conducted the audits. Deloitte is responsible for the auditors' report, dated November 4, 2004. We monitored the progress of the audit at all key points, reviewed Deloitte's report and selected working papers and performed other procedures, as we deemed necessary. Our review, as differentiated from an audit in accordance with the Government Auditing Standards, was not intended to enable us to express, and we do not express, an opinion on FCIC/RMA's financial statements, conclusions about the effectiveness of internal controls, conclusions on whether FCIC/RMA's financial management systems substantially complied with the three requirements of the Federal Financial Management Improvement Act of 1996, or conclusions on compliance with laws and regulations. Our review disclosed no instances where Deloitte did not comply, in all material respects, with the Government Auditing Standards.

It is the opinion of Deloitte, that the financial statements present fairly, in all material respects, FCIC/RMA's financial position as of September 30, 2004, and 2003; and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with generally accepted accounting principles. The report on

FCIC/RMA's internal control structure over financial reporting identified four reportable conditions. Specifically, Deloitte identified weaknesses in FCIC/RMA's:

- Information technology security controls;
- application program and database change controls;
- preparation of the Statement of Budgetary Resources and Statement of Financing; and
- loss reserve estimates.

The first three reportable conditions were considered to be material weaknesses. The report on compliance with laws and regulations disclosed two instances of noncompliance with the Federal Financial Management Improvement Act of 1996.

As discussed in Note 16 to the financial statements, FCIC/RMA restated its fiscal year 2003 financial statements as a result of an error in its budgetary accounting records and as a result of a change in accounting policy, relating to accounting and reporting on cash held outside of Treasury.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective actions taken or planned, including the timeframes to address the reports' recommendations. Please note the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance.

/s/

ROBERT W. YOUNG  
Assistant Inspector General  
for Audit

## INDEPENDENT AUDITORS' REPORT

The Inspector General  
U.S. Department of Agriculture and the  
Board of Directors of the Federal Crop Insurance Corporation

We have audited the accompanying consolidated balance sheets of the Federal Crop Insurance Corporation/Risk Management Agency ("FCIC") as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statements of budgetary resources (collectively referred to as the "consolidated financial statements") for the years then ended. The consolidated financial statements are the responsibility of FCIC management. Our responsibility is to express an opinion on the consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance that the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of FCIC as of September 30, 2004 and 2003, and its net costs, change in net position, reconciliation of net costs to budgetary obligations, and budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

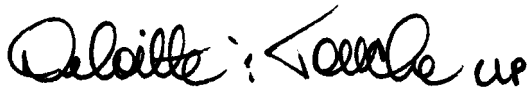
As discussed in Note 16 to the consolidated financial statements, the accompanying consolidated statements of financing and the combined statements of budgetary resources have been restated.

As discussed in Notes 1 and 12 to the consolidated financial statements, FCIC's ultimate losses on insurance claims may differ significantly from the recorded estimate due to differences between expected and actual yields, weather patterns and economic conditions.

Our audit was conducted for the purpose of forming an opinion on FCIC's basic consolidated financial statements taken as a whole. The information in the Management's Discussion and Analysis, Supplementary Stewardship Information, and Required Supplementary Information sections is presented for the purpose of additional analysis and is not a required part of the basic consolidated financial

statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. This supplementary information is the responsibility of FCIC management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit such information, and we do not express an opinion on them.

In accordance with *Government Auditing Standards*, we have also issued reports, dated November 4, 2004, on our consideration of FCIC's internal control over financial reporting and on compliance and other matters. The purpose of those reports is to describe the scope of our testing, and not to provide an opinion on the internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with *Government Auditing Standards*, and should be read in conjunction with this report in considering the results of our audits.

Deloitte : Touche up

November 4, 2004

## INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Inspector General  
U.S. Department of Agriculture and the  
Board of Directors of the Federal Crop Insurance Corporation

We have audited the consolidated balance sheets of the Federal Crop Insurance Corporation/Risk Management Agency ("FCIC") as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statement of budgetary resources (collectively referred to as the "consolidated financial statements") for the year then ended, and have issued our report thereon dated November 4, 2004 (which report expresses an unqualified opinion and includes explanatory paragraphs referring to the restatement of the consolidated financial statements and an emphasis of a matter). We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing our audit, we considered FCIC's internal control over financial reporting by obtaining an understanding of FCIC's internal control, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control over financial reporting.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FCIC's ability to record, process, summarize and report financial data consistent with the assertions of management in the consolidated financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected in a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements due to error or fraud may occur and not be detected.

We noted certain matters, described in Exhibit I, involving the internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that three of the reportable conditions are material weaknesses.

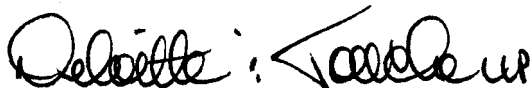
#### **ADDITIONAL REQUIRED PROCEDURES**

In addition, we considered FCIC's internal control over Required Supplementary Stewardship Information by obtaining an understanding of FCIC's internal control, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information, and accordingly, we do not provide an opinion on such controls.

With respect to internal control related to performance measures reported in the Management's Discussion and Analysis section of the consolidated financial statements, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 01-02. Our procedures were not designed to provide assurance on internal control over reported performance measures, and accordingly, we do not provide an opinion on such controls.

We also noted other matters involving internal control and its operation that we have reported to management of FCIC in a separate letter dated November 4, 2004.

This report is intended solely for the information and use of FCIC management, the Department of Agriculture's Office of the Inspector General, OMB and Congress, and is not intended to be and should not be used by anyone other than these specified parties.



November 4, 2004

**FEDERAL CROP INSURANCE/RISK MANAGEMENT AGENCY  
MATERIAL WEAKNESSES IN INTERNAL CONTROL**

**Finding No. 1 - Information Technology Security Controls**

The security of FCIC's financial data is considered to be at risk due to weaknesses related to its control and oversight over access to its information systems. These security weaknesses subject the agency to the risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction of data, which may occur without detection. The weaknesses noted below in information technology security controls were identified and reported as material weaknesses in our prior year's report.

Our testing of key controls over security administration noted security related control weaknesses in the areas of (1) inappropriate UNIX file and directory permissions, (2) ineffective user access administration controls over the computing environment, (3) inconsistent user authentication controls, (4) inappropriate use of generic account IDs, (5) excessive super user access privileges and (6) inadequate control of physical security to the data center.

In addition, control weaknesses related to information technology security were noted at the NFC in the areas of (1) inadequate review of access controls and violation monitoring, (2) inadequate security policies and plans, and (3) lack of certification and accreditation of general support systems.

**Recommendation No. 1 - We recommend the following actions to FCIC management:**

- a. Perform a regular and periodic comprehensive review of file, directory and user permissions in the UNIX environment. At a minimum, management should review the inappropriate use of duplicate User ID's, Switch User ID permissions, Switch Group ID permissions and group and world writeable permissions of sensitive files and directories.
- b. Define and adhere to strict access administration controls. Increased controls should be implemented for contractor accounts. In addition to administration controls, security procedures should include a regular scheduled review of user IDs and access levels to monitor the effectiveness of existing controls.
- c. Consistently apply user authentication controls across the various computing environments and applications. Password parameters, including but not limited to, requiring a password, minimum password length, password expiration interval and storing passwords in encrypted format should consistently adhere to agency requirements.
- d. Continue to increase efforts to eliminate generic and/or shared user IDs. Generic and shared user IDs do not provide appropriate accountability. Management has implemented procedures to request, approve and document user IDs with super user and domain administrator access rights. These procedures should prohibit the use of super user IDs with shared passwords. In cases requiring generic IDs, additional controls should be implemented to mitigate the risk involved.
- e. Re-evaluate agreements with the Farm Services Administration ("FSA") regarding access to the data center. Contracts should include FSA controls to restrict physical access to the data center and the FCIC/RMA verification of such controls.



## **Finding No. 2 - Application Program and Database Change Controls**

Weaknesses were noted in application program and database change controls which support specific application systems. These weaknesses include: (1) inadequate procedures for testing database structure and/or data changes (2) inadequate test environments that are not separate of production systems; and (3) inadequate segregation of duties for approving, performing, testing and documenting application program changes. These weaknesses may cause unauthorized or invalid program and operating system changes to be placed into production.

The OIG performed a review of the internal control structure of the NFC and identified control weaknesses related to (1) system software change controls, (2) inadequate controls to test system software changes, and (3) inadequate configuration controls for the mainframe environment.

These weaknesses were identified and reported as material weaknesses in our prior year's report.

### **Recommendation No. 2 - We recommend the following actions to FCIC management:**

- a. Apply enterprise-wide application change management procedures to supporting databases. Management has recognized the need for and invested considerable time and money to implement controls around application changes. Management should continue their efforts and apply a similar control structure to the databases supporting these application systems. These databases house data critical to the business operations.
- b. Application change management procedures and controls supported by Synergy should be applied to the RAS application system. Management has plans to apply the new application change management structure to the RAS application; however, this was not in place during the majority of the fiscal year. Controls and procedures, at a minimum, should provide for appropriate segregation of duties, stricter version control procedures, a test environment separate of production, and should further restrict developers' access to production.

## **Finding No. 3 – Preparation of Statement of Budgetary Resources and Statement of Financing**

FCIC made unsupported adjustments to its Statements of Financing (SOF) for the fiscal years ending September 30, 2004 and 2003. These adjustments were made in order to reconcile the SOF with FCIC's Statement of Net Cost. These adjustments were necessary because FCIC has not developed policies and procedures to adequately research and identify all reconciling items that support the compilation of the SOF. In addition, FCIC has not developed a formal crosswalk to support the compilation of the SOF from supporting transactions and account balances in the general ledger. Unsupported adjustments raise concern about the accuracy of the SOF compilation process and the lack of controls that assure proper entries to general ledger accounts.

OMB Circular A-123, Management Accountability and Control, requires that transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions and other significant events must be clear and readily available for examination.

Statement of Federal Financial Accounting Standard (SFFAS) No. 7, requires a SOF to explain how budgetary resources obligated during the period relate to the net cost of operations for the reporting entity. According to SFFAS No. 7, paragraph 95, the SOF should be presented in a way that clarifies the relationship between the obligation basis of budgetary accounting and the accrual basis of financial (i.e. proprietary) accounting. By explaining this relationship through a reconciliation, the SOF provides

information necessary to understand how the budgetary (and some nonbudgetary) resources finance the cost of operations and affect the assets and liabilities of the reporting entity.

To address our concerns over the unsupported adjustments, FCIC performed additional research after the SOF was initially presented to us for audit. As a result of this research and our additional inquiries, FCIC identified and corrected errors totaling \$1.9 billion (absolute value) in its SOF's for the fiscal years ending September 30, 2004 and 2003. FCIC identified one error where it had incorrectly recorded 2002 estimated losses on insurance claims as budgetary obligations in its combined statement of budgetary resources for the fiscal year ending September 30, 2002. By overstating its budgetary obligations in fiscal year 2002, FCIC effectively understated its budgetary obligations in its combined statement of budgetary resources for the fiscal year ending September 30, 2003. The resulting error amounting to over \$1 billion, went undetected because FCIC made the unsupported adjustment to its statement of financing in lieu of performing research and taking corrective action.

**Recommendation No. 3 – We recommend the following actions to FCIC management:**

We recommend that FCIC management prepare supporting documentation for any required manual adjustments to the SOF. The SOF compilation should be supported by transactions and account balances that are traceable to the general ledger.

We recommend that FCIC personnel involved in financial statement preparation obtain additional training on the relationship of the statement of financing to the statements of budgetary resources and net cost.

We recommend that management assess the overall process used to compile the statement of financing in order to identify approaches and techniques that provide for a more efficient, accurate and consistent compilation process. The compilation should be subjected to a secondary review by a trained member of management who is independent of the financial statement preparation process. In addition to reviewing specific support to the compilation, the review should also include an analytical analysis of the relationships among balances.

**REPORTABLE CONDITION IN INTERNAL CONTROL**

**Finding No. 4 - Loss Reserve Estimates are subject to a large degree of risk and uncertainty.**

FCIC's actuarial reserves are subject to a significant degree of risk and uncertainty. There are uncertainties associated with the estimation of crop losses which can result in actual losses which are materially different than the amounts recorded in the financial statements. These risks are primarily due to the nature and timing of crop losses. As of September 30, the financial statement date, the majority of crops insured under federal programs have not been harvested. The majority of losses from crop insurance are based on the amount of harvested crops and, for a large portion of insureds, on a harvest price for each crop. Since the amount of harvested crops and the harvest price are not known at the financial statement date, FCIC's liabilities for crop insurance losses from the current crop year are estimated based on certain data related to crop insurance losses and a statistical estimation model.

Data for the past thirteen years indicates that FCIC's estimation model and procedures have tended to be reasonable over the long term average, but large variances in individual years have been significant. For the fiscal year ended September 30, 2003, the estimated losses exceeded the actual crop losses by approximately \$725 million (22%) as of March 31, 2004. Large variances, in excess of 10% of the estimated losses, occurred in five out of the past thirteen years.

The potential amount of variance due to uncertainty in the estimated losses for 2004 is heightened due to several factors. Florida and the southeastern U.S. experienced hurricanes and excessive moisture, and the north central U.S. experienced early autumn freezes which are responsible for late season crop damage. Consequently, the loss estimates are subject to potentially large variances due to: (1) the very short time between the events and the collection of the latest data used for estimating losses; (2) the unusually high yields can impact the commodity prices and affect the estimated losses for revenue insurance products; and (3) the impact of extremely low or high yields for 2004 in certain major areas where the methods used to estimate losses are dependent on a very limited number of historical data points with similar low or high yields.

**Recommendation No. 4 - We recommend the following actions to FCIC management:**

We recommend that FCIC management provide documentation, supported by an independent review and opinion of a qualified actuary, of the feasibility and usefulness of the following actions related to determining if revisions to the model could materially improve the reliability of the outcome of its actuarial loss estimation model.

Continue to improve the statistical model to better predict losses, possibly using other variables in addition to the NASS estimates. Such improvements, while not all inclusive, may consist of the following:

- Build more detailed models for the largest crops and states, or other breakdowns for crop losses that seem to be particularly hard to predict.
- Investigate past years with large variances, for the largest crops and states, to look for underlying factors or variables that caused or were strongly related to mis-estimating losses.
- Explore indicators of possible large variances in loss predictions. For example, conditions, trends, weather events, etc. that would trigger when the model prediction might be particularly vulnerable to mis-estimating losses.
- Develop an approach to profiling the business in terms of areas that may need to be monitored due to unusual risk or problems in the predictability of losses. For example, if the insureds are buying higher coverage levels in particular areas or crops, growth in certain pilot programs and sensitivity on certain revenue products to commodity price uncertainty.

## INDEPENDENT AUDITORS' REPORT ON COMPLIANCE AND OTHER MATTERS

The Inspector General  
U.S. Department of Agriculture and the  
Board of Directors of the Federal Crop Insurance Corporation

We have audited the consolidated balance sheet of the Federal Crop Insurance Corporation/Risk Management Agency ("FCIC") as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statement of budgetary resources (collectively referred to as the "consolidated financial statements") for the year then ended, and have issued our report thereon dated November 4, 2004 (which report expresses an unqualified opinion and includes explanatory paragraphs referring to the restatement of the consolidated financial statements and an emphasis of a matter). We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget ("OMB") Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The management of FCIC is responsible for complying with laws and regulations applicable to the agency. As part of obtaining reasonable assurance about whether FCIC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 01-02, including the requirements referred to in the *Federal Financial Management Improvement Act of 1996* ("FFMIA"). We limited our tests of compliance to provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to FCIC.

The results of our tests of compliance disclosed no instances of noncompliance with the laws and regulations described in the preceding paragraph, exclusive of FFMIA, which disclosed instances of noncompliance as described in Exhibit II, that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02.

Under FFMIA, we are required to report whether FCIC's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

The results of our tests disclosed instances, described in Exhibit II, where FCIC's financial management systems did not substantially comply with Federal financial management systems requirements. The results of our tests disclosed, no instances in which FCIC's financial management systems did not comply with Federal accounting standards or the United States Government Standard General Ledger at the transaction level.

This report is intended solely for the information and use of FCIC's management, the Department of Agriculture's Office of Inspector General, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

*Deloitte* : *Carroll*

November 4, 2004

**FEDERAL CROP INSURANCE/RISK MANAGEMENT AGENCY  
NONCOMPLIANCE WITH LAWS AND REGULATIONS****Finding No. 5 – Noncompliance with Federal financial management system requirements**

The Federal Information Security Management Act (“FISMA”) requires that significant deficiencies in policies, procedures or practice, if relating to financial management systems, are instances of a lack of substantial compliance with FFMIA. The material weaknesses noted in Finding No. 1 and Finding No. 2 represent significant deficiencies in the financial management systems and consequently indicate a lack of substantial compliance with FFMIA.

**Recommendation No. 5** – See the recommendations following Finding No. 1 and Finding No. 2.

**Finding No. 6 – Establishment of a Continuous Monitoring System over Financial Management Systems**

The FFMIA establishes a statutory requirement for agency-heads to assess, on an annual basis, whether their financial management systems comply with the three requirements of FFMIA. If they do not comply, agencies are required to develop remediation plans and file them with OMB. In addition, OMB’s Revised Implementation Guidance for the FFMIA, dated January 4, 2001 recognizes OMB circular A-127, *Financial Management Systems*, as a reference document for government-wide financial management systems. Reviews of financial management systems performed in accordance with OMB Circular A-127 provide the basis for agency management’s annual assurance statements for Section 4 of the Federal Managers’ Financial Integrity Act (“FMFIA”) and the FFMIA.

OMB Circular A-127, Section 7, paragraph G provides that agency financial management systems shall conform to existing applicable functional requirements as defined in the Federal financial management systems requirements issued by the Joint Financial Management Information Program (“JFMIP”). Section 9, paragraph A3 of OMB Circular A-127 provides that each agency shall ensure appropriate reviews are conducted of its financial management systems and these reviews must determine whether agency financial management systems comply with the Federal financial management systems required by the JFMIP.

FCIC management has not fully implemented a continuous monitoring effort to ensure that its financial management systems comply with the Federal financial management system’s requirements in support of its annual assurance statement made under Section 4 of the FMFIA. As a result, FCIC management cannot provide reasonable assurance that its financial management systems comply with Federal financial management system requirements as required by the FMFIA. Examples of deficiencies in this process include the following:

- FCIC management reviewed its financial management systems during FY 2004 using checklists issued by the Government Accountability Office (GAO). These GAO checklists assist agencies in implementing and monitoring their systems and assist agency management in reviewing agency systems to determine if they substantially comply with FFMIA. However, we noted the GAO checklist used by FCIC management had not been updated with the most current systems requirements issued by the JFMIP in 2001 and 2004.
- The checklists completed by FCIC management had noted instances of noncompliance with specific requirements of JFMIP and FFMIA. The checklists also indicated the planned remediation by FCIC management. However, there is no formalized documentation by FCIC

management as to whether the individual instances of noncompliance, or the aggregate of those instances, represent substantial noncompliance with FFMLA.

**Recommendation No. 6** – We recommend that management develop policies and procedures to ensure the most current systems requirements are used in the FFMLA assessment process. The current FFMLA assessment process should be revised to ensure that formalized documentation is created to document management’s decisions as a result of the completion of its review of the core financial systems for compliance with FFMLA.



NOV 10 2004

United States  
Department of  
Agriculture

Deloitte & Touche LLP  
Kansas City, MO

Risk  
Management  
Agency

RE: OIG Audit Report 05401-13-FM, Federal Crop Insurance Corporation/Risk  
Management Agency's Financial Statements for Fiscal Years 2004  
and 2003

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Outlined below is the Federal Crop Insurance Corporation's (FCIC) response to the material weaknesses and reportable condition in internal controls cited in the subject report.

## **MATERIAL WEAKNESSES IN INTERNAL CONTROL**

### **Finding No. 1 - Information Technology Security Controls**

The security of FCIC's financial data is considered to be at risk due to weaknesses related to its control and oversight over access to its information systems. These security weaknesses subject the agency to the risk of inadvertent or deliberate misuse, fraudulent use, improper disclosure, or destruction of data, which may occur without detection. The weaknesses noted below in information technology security controls were identified and reported as material weaknesses in our prior year's letter.

Our testing of key controls over security administration noted security related control weaknesses in the areas of (1) inappropriate UNIX file and directory permissions, (2) ineffective user access administration controls over the computing environment, (3) inconsistent user authentication controls, (4) inappropriate use of generic account IDs, (5) excessive super user access privileges and (6) inadequate control of physical security to the data center.

In addition, control weaknesses related to IT security were noted at NFC in the areas of (1) inadequate review of access controls and violation monitoring, (2) inadequate security policies and plans and (3) lack of certification and accreditation of general support systems.

### **Recommendation No. 1- We recommend the following actions to FCIC management:**

- a. Perform a regular and periodic comprehensive review of file, directory and user permissions in the UNIX environment. At a minimum, management should review the inappropriate use of duplicate User ID's, Switch User ID permissions, Switch Group ID permissions and group and world writeable permissions of sensitive files and directories.



The Risk Management Agency Administers  
And Oversees All Programs Authorized Under  
The Federal Crop Insurance Corporation

An Equal Opportunity Employer



## FCIC CONCURS:

Duplicate user ID's, SUID's, and switch group ID's were corrected by July 2004.

Directory and file permissions were analyzed, reviewed, and remediated in September 2004. A shell script monitoring duplicate ID's was placed on the scheduler in September 2004. The process will run daily and a member of the Security Team will review and retain the results.

Once reasonable SUID's and switch group ID's are established (September 2004), Tripwire will be utilized to monitor changes (October 2004). Again, a member of the Security Team will review output from each cycle and retain the information (and any actions) in the Security Team's files.

- b. Define and adhere to strict access administration controls. Increased controls should be implemented for contractor accounts. In addition to administration controls, security procedures should include a regular scheduled review of user IDs and access levels to monitor the effectiveness of existing controls.

## FCIC CONCURS:

A new resource was moved to the Security Team in July 2004 and was tasked with reviewing all current ID's and passwords. That effort was completed in September 2004, along with the implementation of a schedule for the manual reviews. Results of manual reviews will be documented and retained indefinitely in the Security Team's files. Bindview and Tripwire are being installed in the Agency's environment for automated review of ID's and access, however, manual reviews will continue until Tripwire is tuned to the agency's environment.

- c. Consistently apply user authentication controls across the various computing environments and applications. Password parameters, including but not limited to, requiring a password, minimum password length, password expiration interval and storing passwords in encrypted format should consistently adhere to agency requirements.

## FCIC CONCURS:

All such conditions were corrected by April 2003. However, one security team member who has been removed from the position allowed additional incidents to occur. The responsible agency's CIO was notified of the situation and a new member of the security team was appointed and is correcting these and other anomalies.

A new resource was moved to the Security Team in July 2004 and was tasked with reviewing all current ID's and passwords. That effort was completed in September 2004, along with the implementation of a schedule for the manual reviews. Results of manual reviews will be documented and retained indefinitely in the Security Team's files. A shell script has been developed to check for and report on password violations (not requiring a password, password length, etc.). The process will be run daily from the scheduler beginning in September 2004. The output will be reviewed and logged by a member of the Security Team each day.

Bindview and Tripwire are being installed in the Agency's environment for automated review of ID's and access, however, manual reviews will continue until Tripwire is tuned to the agency's environment.

- d. Continue to increase efforts to eliminate generic and/or shared user IDs. Generic and shared user IDs do not provide appropriate accountability. Management has implemented procedures to request, approve and document user IDs with super user and domain administrator access rights. These procedures should prohibit the use of super user IDs with shared passwords. In cases requiring generic IDs additional controls should be implemented to mitigate the risk involved.

#### FCIC CONCURS:

The majority of shared/generic accounts were eliminated by April 2003. The last two-shared accounts were eliminated in June 2004. The two accounts in question (ACTDBA and OPER01) were shared among small teams of trusted personnel, many of whom have had the same level of permission on some platform or another for over a decade. When individual accounts were created (ACTDBA01, ACTDBA02, etc.) they were given the same level of permission as the original shared account.

However, there were mitigating controls in place over these shared accounts. If one of the personnel with ACTDBA or OPER01 permissions had "compromised" a database, application or script the following controls would have caught any unauthorized changes:

- The mini-40 process provides companies with a weekly-summarized file of data the FCIC has booked in its systems. The file shows record counts as well as dollar amounts. Companies can compare this data against their records.
- The Summary of Business (SOB) reports are used for basic reconciliation of most accounting and ad hoc reporting processes. The SOB provides views by company, by reinsurance year, by insurance plan, by crop, etc. For years, senior Agency officials have used the SOB as a general barometer of the health of the program. They have a high degree of familiarity with the reports and can readily identify anomalies or skewed data.

- Within the Escrow system, indemnity amounts are compared between flat files, the escrow database, and the policy database each week. This automated process notifies operators and accountants of out-of-balance conditions.
- The RECON system reconciles raw incoming data with data accepted.
- YEA, the year-end audit process reconciles acreage, losses, interest, etc. for the entire fiscal year.

These processes are all operated and maintained by developers and DBA's other than those sharing the ACTDBA ID. They confirm and reconcile data within the ACTDBA databases against alternate sources. Deliberately creating, deleting or otherwise manipulating data housed in these databases would require the collusion of operators, developers, DBA's and business personnel in other areas to go undetected.

- e. Re-evaluate agreements with the Farm Services Agency ("FSA") regarding access to the data center. Contracts should include FSA controls to restrict physical access to the data center and the FCIC/RMA verification of such controls.

#### FCIC CONCURS:

Condition was corrected. The FCIC has made substantial improvements to physical security since the OIG Security Audit (05099-18-KC). These improvements eliminate or mitigate any risk to FCIC data and systems:

- The Security Team now holds and secures all server rack keys. Keys are checked out to system administrators and the event logged. (February 2004).
- The primary FCIC router rack was upgraded to a front/back locking rack with keys. (March 2004).
- The FCIC has mitigated its risk by installing Netbotz systems (beginning in November 2002-January 2003) in its Kansas City computer room, the Egan Hotsite and the field offices to monitor access to equipment and the environment in the server room. Netbotz provides an "electronic eyeball" that detects motion within its "view". The motion detector is activated from 6:00 p.m. to 6:00 a.m. and weekends. It has successfully identified several occasions when FSA personnel appear to be in the FCIC space inappropriately. In July 2004, the KC Netbotz was upgraded to color. Current upgrades (to be completed from September 2004-October 2004) include moving to a color monitor for the Egan Hotsite and additional camera pods to receive two angles on the camera. This feature will be installed in the Kansas City and Egan site.
- After many discussions with the Office of the Chief Information Officer and FSA facilities management (May 2003-June 2004), approval of the separation of FCIC/FSA computer facilities was rejected as an option. Under advice from Deloitte and Touché, the FCIC entered into a Memorandum of Understanding

(MOU) with FSA. Under the MOU, each Agency reviews access to the computer room for their agency. Wherever possible they remove individuals that do not require access and then certify this review process to the other agency. The FCIC reviews its access list, reduces it accordingly, and (in writing) certifies to FSA that it has done so. FSA does the same. The MOU was signed in August 2004 and has already resulted in a reducing access to the computer room by over 100 people.

### **Finding No. 2 - Application Program and Database Change Controls**

Weaknesses were noted in application program and database change controls, which support specific application systems. These weaknesses include: (1) inadequate procedures for testing database structure and/or data changes (2) inadequate test environments that are not separate of production systems; and (3) inadequate segregation of duties for approving, performing, testing and documenting application program changes. These weaknesses may cause unauthorized or invalid program and operating system changes to be placed into production. These weaknesses were identified and reported as material weaknesses in our prior year's letter.

The OIG performed a review of the internal control structure of the NFC and identified control weaknesses related to (1) system software change controls (2) inadequate controls to test system software changes; and (3) inadequate configuration controls for the mainframe environment.

### **Recommendation No. 2 – We recommend the following actions to FCIC management:**

- a. Apply enterprise-wide application change management procedures to supporting databases. Management has recognized the need for and invested considerable time and money to implement controls around application changes. Management should continue their efforts and apply a similar control structure to the databases supporting these application systems. These databases house data critical to the business operations.

FCIC CONCURS:

Database change management procedures will be implemented by January 2005. However, the FCIC had several mitigating controls in place at the time of the audit that assured unauthorized database changes will not go undetected:

- In April 2002, the Actuarial Chief created a position (Database Coordinator) to act as a central clearinghouse for all database changes. Acting on management's behalf, the coordinator assures that changes are appropriate for the FCIC's processing and systems. This role was formalized by Directive 04-01 on September 20, 2004.
- There are weekly Database meetings between System Administration DBA's and development DBA's to discuss and coordinate upcoming changes.

- The Mini 40 process that provides weekly totals accepted into the FCIC systems to the companies. If the FCIC inadvertently added or failed to load data, it would be reflected in the counts and dollar amounts in the Mini 40.
- Manual adjustments usually occur during the weekends when heavy load processing occurs. These are documented to appropriate personnel (such as the DB Coordinator) via email. Failure to communicate these changes would be caught via other processes such as Recon or Escrow.
- The Summary of Business (SOB) reports are used for basic reconciliation of most accounting and ad hoc reporting processes. The SOB provides views by company, by reinsurance year, by insurance plan, by crop, etc. For years, senior Agency officials have used the SOB as a general barometer of the health of the program. They have a high degree of familiarity with the reports and can readily identify anomalies or skewed data.
- Within the Escrow system, indemnity amounts are compared between flat files, the escrow database, and the policy database each week. This automated process notifies operators and accountants of out-of-balance conditions.
- The RECON system reconciles raw incoming data with data accepted.
- YEA, the year-end audit process reconciles acreage, losses, interest, etc. for the entire fiscal year.

These processes are all operated and maintained by an assortment of developers and DBA's across the Agency. They confirm and reconcile data across multiple databases and file systems against alternate sources as part of normal diligent business processing. Deliberately creating, deleting or otherwise manipulating data housed in any of the Agency databases would require the collusion of operators, developers, DBA's and business personnel in other areas to go undetected.

- b. Application change management procedures and controls supported by Synergy should be applied to the RAS application system. Management has plans to apply the new application change management structure to the RAS application; however, this was not in place during the majority of the fiscal year. Controls and procedures, at a minimum, should provide for appropriate segregation of duties, stricter version control procedures, a test environment separate of production, and should further restrict developers' access to production.

**FCIC CONCURS:**

RAS change management was moved to Synergy in August 2004. However, prior to that, RAS changes were always requested, documented, and approved via the PTS process. Further, while the developer did act as operator and migratory until June 2004, the updates to the databases were always performed in a separate process under a different development area. Reconciliation of the RAS reports was conducted by

accountants with the Fiscal Operations and Systems Division using reports and screens from other systems not developed or controlled by the RAS developer. Operations and change control (migration of code) was moved to other individuals in June 2004 and operations and change management permissions revoked for the RAS developer.

There were multiple mitigating controls in place to assure the accuracy of data reported in the RAS system. Accountants review and reconcile figures from RAS against other systems in order to certify accuracy and release the reports to the companies:

- The mini-40 process provides companies with a weekly-summarized file of data the FCIC has booked in its systems. The file shows record counts as well as dollar amounts. Companies can compare this data against their records.
- Within the Escrow system, indemnity amounts are compared between flat files, the escrow database, and the policy database each week. This automated process notifies operators and accountants of out-of-balance conditions.
- The Summary of Business (SOB) reports are used for basic reconciliation of most accounting and ad hoc reporting processes. The SOB provides views by company, by reinsurance year, by insurance plan, by crop, etc. For years, senior Agency officials have used the SOB as a general barometer of the health of the program. They have a high degree of familiarity with the reports and can readily identify anomalies or skewed data.
- The RECON system reconciles raw incoming data with data accepted.
- YEA, the year-end audit process reconciles acreage, losses, interest, etc. for the year.

### **Finding No. 3 – Preparation of Statement of Budgetary Resources and Statement of Financing**

FCIC made unsupported adjustments to its Statements of Financing (SOF) for the fiscal years ending September 30, 2004 and 2003. These adjustments were made in order to reconcile the SOF with FCIC's Statement of Net Cost. These adjustments were necessary because FCIC has not developed policies and procedures to adequately research and identify all reconciling items that support the compilation of the SOF. In addition, FCIC has not developed a formal crosswalk to support the compilation of the SOF from supporting transactions and account balances in the general ledger. Unsupported adjustments raise concern about the accuracy of the SOF compilation process and the lack of controls that assure proper entries to general ledger accounts.

OMB Circular A-123, Management Accountability and Control, requires that transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports. The documentation for transactions and other significant events must be clear and readily available for examination.

Statement of Federal Financial Accounting Standard (SFFAS) No. 7, requires a SOF to explain how budgetary resources obligated during the period relate to the net cost of operations for the reporting entity. According to SFFAS No. 7, paragraph 95, the SOF should be presented in a way that clarifies the relationship between the obligation basis of budgetary accounting and the accrual basis of financial (i.e. proprietary) accounting. By explaining this relationship through a reconciliation, the SOF provides information necessary to understand how the budgetary (and some nonbudgetary) resources finance the cost of operations and affect the assets and liabilities of the reporting entity.

To address our concerns over the unsupported adjustments, FCIC performed additional research after the SOF was initially presented to us for audit. As a result of this research and our additional inquiries, FCIC identified and corrected errors totaling \$1.9 billion (absolute value) in its SOF's for the fiscal years ending September 30, 2004 and 2003. FCIC identified one error where it had incorrectly recorded 2002 estimated losses on insurance claims as budgetary obligations in its combined statement of budgetary resources for the fiscal year ending September 30, 2002. By overstating its budgetary obligations in fiscal year 2002, FCIC effectively understated its budgetary obligations in its combined statement of budgetary resources for the fiscal year ending September 30, 2003. The resulting error amounting to over \$1 billion, went undetected because FCIC made the unsupported adjustment to its statement of financing in lieu of performing research and taking corrective action.

**Recommendation No. 3 – We recommend the following actions to FCIC management:**

We recommend that FCIC management prepare supporting documentation for any required manual adjustments to the SOF. The SOF compilation should be supported by transactions and account balances that are traceable to the general ledger.

We recommend that FCIC personnel involved in financial statement preparation obtain additional training on the relationship of the statement of financing to the statements of budgetary resources and net cost.

We recommend that management assess the overall process used to compile the statement of financing in order to identify approaches and techniques that provide for a more efficient, accurate and consistent compilation process. The compilation should be subjected to a secondary review by a trained member of management who is independent of the financial statement preparation process. In addition to reviewing specific support to the compilation, the review should also include an analytical analysis of the relationships among balances.

**FCIC CONCURS:**

The FCIC determined that it had incorrectly recorded certain estimated losses on insurance claims as obligations incurred on its fiscal year 2002 combined statement of budgetary resources. Consequently, the FCIC incorrectly reported beginning obligated and unobligated budgetary resources and obligations incurred in its 2003 financial statements. The 2003 combined statement of budgetary resources and consolidated statement of financing have been restated from the amounts previously recorded to correct for this error.

This error occurred as part of a one-time event and was not part of the on-going financial process. As such, the FCIC does not view this as a recurring problem. Subsequent to this event, the FCIC filled two key positions, a senior staff accountant position and the Chief Financial Officer, which helped provide support to the Accounting Officer and another level in the financial statement preparation review process. The CFO and Accounting Officer will take additional action to ensure that an error of this nature does not occur again. Specific actions will include the following: prepare supporting documentation for any required manual adjustments to the SOF; provide additional training on budgetary accounting and the related statements; review the financial statement preparation process; incorporate analytical analysis of the relationships among balances into the review process; and have the compilation reviewed by a trained member of management who is independent of the financial statement preparation process.

**REPORTABLE CONDITION IN INTERNAL CONTROL****Finding No. 4 – Loss Reserve Estimates are subject to a large degree of risk and uncertainty.**

FCIC's actuarial reserves are subject to a significant degree of risk and uncertainty. There are uncertainties associated with the estimation of crop losses which can result in actual losses which are materially different than the amounts recorded in the financial statements. These risks are primarily due to the nature and timing of crop losses. As of September 30, the financial statement date, the majority of crops insured under federal programs have not been harvested. The majority of losses from crop insurance are based on the amount of harvested crops and, for a large portion of insureds, on a harvest price for each crop. Since the amount of harvested crops and the harvest price are not known at the financial statement date, FCIC's liabilities for crop insurance losses from the current crop year are estimated based on certain data related to crop insurance losses and a statistical estimation model.

Data for the past thirteen years indicates that FCIC's estimation model and procedures have tended to be reasonable over the long term average, but large variances in individual years have been significant. For the fiscal year ended September 30, 2003, the estimated losses exceeded the actual crop losses by approximately \$600 million (20%) as of March 31, 2004. Large variances, in excess of 10% of the estimated losses, occurred in five out of the past thirteen years.



**Recommendation No. 4 – We recommend the following actions to FCIC management:**

We recommend that FCIC management provide documentation, supported by an independent review and opinion of a qualified actuary, of the feasibility and usefulness of the following actions related to determining if revisions to the model could materially improve the reliability of the outcome of its actuarial loss estimation model.

Continue to improve the statistical model to better predict losses, possibly using other variables in addition to the NASS estimates. Such improvements, while not all inclusive, may consist of the following:

- Build more detailed models for the largest crops and states, or other breakdowns for crop losses that seem to be particularly hard to predict.
- Investigate past years with large variances, for the largest crops and states, to look for underlying factors or variables that caused or were strongly related to mis-estimating losses.
- Explore indicators of possible large variances in loss predictions. For example, conditions, trends, weather events, etc. that would trigger when the model prediction might be particularly vulnerable to mis-estimating losses.
- Develop an approach to profiling the business in terms of areas that may need to be monitored due to unusual risks or problems in the predictability of losses. For example, if the insureds are buying higher coverage levels in particular areas or crops, growth in certain pilot programs and sensitivity on certain revenue products to commodity price uncertainty.

**FCIC CONDITIONALLY CONCURS:**

The current model has produced predictions that are, on average, within ten percent of the actual value. Although the variance is high, the estimates do not show strong evidence of a long-term bias (the difference is not statistically different from zero).

The FCIC believes that most of the variance in the estimates is due to factors that cannot be avoided; regardless of what estimation model is used. These factors include *ex post* weather events and commodity price changes (including international events and market impacts) as well as the limited amount of information available on potential crop yields so early in the harvest season. The FCIC believes the potential to improve the FCIC indemnity estimates to any significant degree is limited at best; and to do so, would require improved estimation of the weather, plant growth, and the commodities market.

To address the issues or questions raised above, the FCIC will review and document existing research on the prediction model variables, and engage USDA or private sector economists, actuaries or other appropriate personnel it determines prudent to review and comment on the feasibility of the recommended actions to ascertain if the model can be improved. This work will be supervised by the FCIC's actuary to ensure actuarial

standards are maintained. Depending upon the results of this effort, the FCIC will review the need for a study to be conducted by an independent actuary to review the feasibility of the actions listed above.

## **NONCOMPLIANCE WITH LAWS AND REGULATIONS**

### **Finding No. 5 – Noncompliance with Federal financial management system requirements**

The Federal Information Security Management Act (“FISMA”) requires that significant deficiencies in policies, procedures or practice, if relating to financial management systems, are instances of a lack of substantial compliance with FFMIA. The material weaknesses noted in Finding No. 1 and Finding No. 2 represent significant deficiencies in the financial management systems and consequently indicate a lack of substantial compliance with FFMIA.

**Recommendation No. 5** – See the recommendations following Finding No. 1 and Finding No. 2.

FCIC CONCURS:

See response to Finding No. 1 and Finding No. 2.

### **Finding No. 6 – Establishment of a Continuous Monitoring System over Financial Management Systems**

The FFMIA establishes a statutory requirement for agency-heads to assess, on an annual basis, whether their financial management systems comply with the three requirements of FFMIA. If they do not comply, agencies are required to develop remediation plans and file them with OMB. In addition, OMB’s Revised Implementation Guidance for the FFMIA, dated January 4, 2001 recognizes OMB circular A-127, *Financial Management Systems*, as a reference document for government-wide financial management systems. Reviews of financial management systems performed in accordance with OMB Circular A-127 provide the basis for agency management’s annual assurance statements for Section 4 of the Federal Managers’ Financial Integrity Act (“FMFIA”) and the FFMIA.

OMB Circular A-127, Section 7, paragraph G provides that agency financial management systems shall conform to existing applicable functional requirements as defined in the Federal financial management systems requirements issued by the Joint Financial Management Information Program (“JFMIP”). Section 9, paragraph A3 of OMB Circular A-127 provides that each agency shall ensure appropriate reviews are conducted of its financial management systems and these reviews must determine whether agency financial management systems comply with the Federal financial management systems required by the JFMIP.

FCIC management has not fully implemented a continuous monitoring effort to ensure that its financial management systems comply with the Federal financial management system’s

requirements in support of its annual assurance statement made under Section 4 of the FMFIA. As a result, FCIC management cannot provide reasonable assurance that its financial management systems comply with Federal financial management system requirements as required by the FMFIA. Examples of deficiencies in this process include the following:

- FCIC management reviewed its financial management systems during FY 2004 using checklists issued by the Government Accountability Office (GAO). These GAO checklists assist agencies in implementing and monitoring their systems and assist agency management in reviewing agency systems to determine if they substantially comply with FFMIA. However, we noted the GAO checklist used by FCIC management had not been updated with the most current systems requirements issued by the JFMIP in 2001 and 2004.
- The checklists completed by FCIC management had noted instances of noncompliance with specific requirements of JFMIP and FFMIA. The checklists also indicated the planned remediation by FCIC management. However, there is no formalized documentation by FCIC management as to whether the individual instances of noncompliance, or the aggregate of those instances, represent substantial noncompliance with FFMIA.

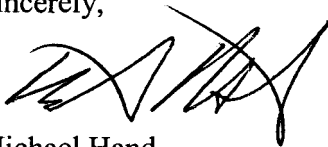
**Recommendation No. 6** – We recommend that management develop policies and procedures to ensure the most current systems requirements are used in the FFMIA assessment process. The current FFMIA assessment process should be revised to ensure that formalized documentation is created to document management’s decisions as a result of the completion of its review of the core financial systems for compliance with FFMIA.

FCIC CONCURS:

The FCIC will update the review process for the current year to use any updated financial management systems guidance issued by the JFMIP. In addition, the FCIC will require that the formalized documentation also include an overall management decision as to whether individual instances of noncompliance, or the aggregate of those instances, represent substantial noncompliance with the FFMIA.

If you or a member of your staff have any questions or require additional information concerning this response, please contact Alan Sneeringer at (202) 720-8813.

Sincerely,



Michael Hand  
Audit Liaison Official

FEDERAL CROP INSURANCE CORPORATION  
RISK MANAGEMENT AGENCY  
CONSOLIDATED FINANCIAL STATEMENTS  
AS OF SEPTEMBER 30, 2004 and 2003

## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

### **Mission and Organizational Structure**

#### **Organizational Structure**

The Federal Crop Insurance Corporation (FCIC) is a wholly-owned government corporation created February 16, 1938 (7 U.S.C. 1501). The program was amended by Public Law (P.L.) 96-365, dated September 26, 1980, to provide for nationwide expansion of a comprehensive crop insurance program.

The Risk Management Agency (RMA) was established under provisions of the Federal Agriculture Improvement and Reform Act of 1996 (1996 Act), P.L. 104-127, signed April 4, 1996. The 1996 Act amended the Department of Agriculture Reorganization Act of 1994 (1994 Act), P.L. 103-354, Title II, by requiring the Secretary of Agriculture (the Secretary) to establish within the U.S. Department of Agriculture (USDA) an independent office responsible for supervision of the FCIC, administration and oversight of programs authorized under the Federal Crop Insurance Act, such as any pilot insurance plans or other programs involving revenue insurance, risk management education, risk management savings accounts, or the use of the futures markets to manage risk and support farm income that may be established under the Federal Crop Insurance Act or other law; and any other programs the Secretary considers appropriate. The Federal Crop Insurance Act as amended through 2002, is hereafter referred to as the Act.

#### **Mission**

The purpose of the FCIC and RMA, (hereafter the combined entities will be referred to as the FCIC), is to promote, support, and regulate sound risk management solutions to strengthen and preserve the economic stability of American agricultural producers.

#### **Regulatory Acts Impacting the FCIC**

The Farm Security and Rural Investment Act of 2002 (2002 Farm Bill) was signed into law on May 13, 2002. Major provisions of this new legislation included: Authorization for sweet potato insurance to extend beyond the time the crop is in the field (as in the case of tobacco and potatoes) and expansion of the Adjusted Gross Revenue Insurance pilot program into additional counties in California and Pennsylvania.

The President signed the Agricultural Risk Protection Act of 2000 (ARPA) into law on June 20, 2000. Major provisions of this new legislation included: expanded use of contracts and partnerships for the research and development of policies and other risk management tools; revised Catastrophic Risk Protection (CAT) administrative fees and loss adjustment expense reimbursements; significantly revised premium subsidies; livestock coverage authorization; reimbursement of research, development, and maintenance costs for products submitted to the FCIC; expanded risk management education and assistance; funds to address under-served areas, States, and commodities; an expert review panel and procedures for reviewing policies, plans of insurance, and related material or modifications; improved program compliance and integrity provisions;

acceptance of electronic information; limitations of multiple insurance benefits on the same acreage in the same crop year; prevented planting; substitution of yields in a producer's actual production history; provisions specifying that good farming practices include scientifically sound sustainable and organic farming practices; a reconsideration process regarding good farming practice determinations; and others not included herein.

On June 30, 2000, FCIC published an Interim Rule in the Federal Register to amend the regulations for the Common Crop Insurance Policy and Group Risk Plan of Insurance Basic Provisions and the CAT Endorsement, effective for the 2001 crop year, to implement the changes in the administrative fees and subsidies and the substitution of yields in the producer's actual production history mandated by ARPA. These changes were also made in the crop insurance policies for other plans of insurance, such as Crop Revenue Coverage (CRC), Revenue Assurance (RA), and Income Protection (IP).

On September 18, 2002, FCIC published a Proposed Rule followed by a Final Rule published in the Federal Register on June 25, 2003, effective for the 2004 crop year for all crops with a contract change date on or after June 30, 2003. The Final Rule amended the Common Crop Insurance Policy and Group Risk Plan of Insurance Basic Provisions to implement the remaining policy changes required by ARPA. These changes included limitations of multiple insurance benefits on the same acreage in the same crop year, prevented planting, good farming practices including organic and sustainable farming practices, and a reconsideration process regarding good farming practice determinations. These changes were incorporated in the crop insurance policies for other plans of insurance, such as CRC, RA, and IP. Additional changes have been made in these policies, effective for the 2005 crop year for crops with contract change dates after August 30, 2004, to improve program integrity. These changes included: requiring additional levels of Social Security Number (SSN) reporting to help avoid providing benefits for ineligible persons, adjustments to APH yields when based on small acreages that are not representative of the unit to be insured, or if farming practices are changed, and the addition of provisions to encourage accurate reporting of key crop insurance information.

### **Business Overview**

Federal crop insurance is available to producers through private insurance companies that market and service policies upon which those companies also share in the risk. The amount of risk they share is defined by reinsurance agreements with the FCIC. Under these agreements, reinsured companies agree to deliver risk management insurance products to eligible entities under certain terms and conditions. Reinsured companies are responsible for all aspects of customer service and guarantee payment of premium to FCIC. In return, FCIC reinsures the policies and provides a subsidy for administrative and operating expenses associated with delivering the insurance products and/or programs. FCIC also provides a subsidy for producer's premium. This constitutes a joint effort between the Government and the private insurance industry for program delivery.

Approximately 1.3 million policies were written in crop years 2004 and 2003 with an

estimated \$1.72 billion and \$ 1.40 billion in farmer paid premium for crop years 2004 and 2003 and an estimated \$2.49 billion and \$2.09 billion in estimated premium subsidies for crop years 2004 and 2003. For the 2004 and 2003 crop years, an estimated \$3.5 billion and \$4.0 billion were to be paid in indemnities. For the 2004 crop year it is estimated that there are sufficient premiums to pay the 2004 crop year indemnities. For the 2003 crop year, there were \$ .2 billion of premiums in excess of indemnities. Crop insurance was available for 88 different commodities (approximately 600 commodities as enumerated for disaster assistance purposes) for crop year 2004 and crop year 2003. Crop year 2004 and 2003 coverage was available in over 3,000 counties covering all 50 states and Puerto Rico.

The FCIC maintains two separate funds, one for administrative and operating purposes (A&O Fund), and one for the crop insurance and livestock program (Insurance Fund). The A&O Fund is used to pay salaries and other administrative expenses. The Insurance Fund is used to pay for crop and livestock losses specified in the policies. The Insurance Fund also pays for the reinsured companies administrative expenses associated with marketing and fully servicing the crop insurance policies written. Operating expenses of the reinsured companies are reimbursed by the FCIC. The premium costs of insured persons are also subsidized. The FCIC encourages future crop insurance participation by offering premium discounts to purchasers of crop insurance.

The reinsured companies process insurance documents, bill and collect premiums, and pay losses according to stipulations within the insurance policy and reinsurance agreement with the FCIC. The reinsured companies electronically transmit to the FCIC, at least monthly, all data required under the reinsurance agreement in order to receive their contracted reimbursements. R&D divisions assist in processing all insurance data, record detailed accounting and statistical data, prepare the required accounting, statistical, and management reports for business from all sources, and collect all crop and accounting data needed for policy determinations, underwriting decisions, and financial management.

Ten regional offices formulate and recommend policies specific to the needs of the region for which each is responsible. They provide customer service, problem identification, resolution and/or referral, as well as assistance to delivery system partners regarding program issues related to underwriting and claims administration.

Six regional compliance offices provide assurance of program integrity by conducting program reviews and audits to assure mandates, policies and procedures are effective and are followed by persons involved in delivering crop insurance. The six field offices also conduct investigations into complaints alleging fraud or abuse of existing insurance programs. This ensures fair and equitable treatment of the farmer, taxpayer, and the FCIC.

## **Federal Crop Insurance Program - Activities**

The Federal crop insurance program comprises the following major activities:

- (1) Program Management includes the FCIC Board of Directors, the RMA Administrator's office and staff offices that report directly to the RMA Administrator.
- (2) Research and Development (R&D) involves the design and development of crop insurance programs, policies and standards, and the establishment and maintenance of rates and coverages for crops in each county. This activity also includes: 1) analysis of insurance experience and risk; 2) evaluation and establishment of setting crop insurance price elections; 3) production and dissemination of actuarial data, documents, and files; 4) the evaluation of current crop insurance plans and policies; and 5) development of strategies for increasing participation in the crop insurance program. This function handles products submitted under section 508(h) of the Act that must be reviewed and evaluated and if enacted, must be deployed and maintained like other risk management products. With the passage of the Agricultural Risk Protection Act of 2000, effective fiscal year 2001, the design and development of risk management commodity programs are now done through contracts and partnerships with other organizations under RMA's oversight.
- (3) Insurance Services has responsibility for delivering FCIC programs through a system of ten Regional Offices and reinsured companies. It provides support, information, and advice to the Office of the Administrator; delivers risk management education programs to producers through private and public education partners; coordinates FCIC responses to emergency situations; maintains existing FCIC products through field underwriting assessments; assists in new product development; and supports FCIC civil rights and outreach initiatives. Headquarters staff complement field activities by ensuring consistent application of actuarially sound insurance principles in field-level underwriting and by monitoring a uniform system of loss adjustment.
- (4) Compliance provides program oversight and quality control of the reinsured companies. It ensures the integrity of the crop insurance program through reviews of reinsured companies' operations and ensures the delivery of crop insurance is in accordance with applicable laws, regulations, and procedures. There are six Regional Compliance Offices that provide assurance of program integrity by conducting program reviews and audits to assure mandates, policies and procedures are effective and are followed by persons involved in delivering crop and livestock insurance. The Compliance offices conduct investigations into complaints alleging fraud or abuse of existing insurance programs. This ensures fair and equitable treatment of the farmer, taxpayer, and the FCIC.



- (5) Ten Regional Offices formulate and recommend policies specific to the needs of the region for which each is responsible. They provide customer service, problem identification, resolution and/or referral, as well as assistance to delivery system partners regarding program issues related to underwriting and claims administration.

## **Federal Crop Insurance Program – Insurance Plans**

### **Revenue Based Crop Insurance Plans**

**Group Risk Income Protection (GRIP)**--GRIP makes indemnity payments only when the average county revenue for the insured crop falls below the revenue chosen by the farmer. GRIP offers producers a guarantee against decline in county revenue, which is based on the Chicago Board of Trade futures prices and National Agricultural Statistics Service (NASS) county yields as adjusted by the FCIC. The GRIP policy provides coverage on an enterprise unit basis. The amount of any loss will be finalized when the final county yields and harvest price are known in the spring following the crop year. The GRIP policy contains no replant, late, or prevented planting provisions.

GRIP was originally submitted to RMA as a 508(h) product and was approved by the Federal Crop Insurance Corporation Board of Directors (Board) for corn and soybeans in all counties in Iowa that currently had Group Risk Plan (GRP) corn and soybean programs, and selected GRP corn and soybean counties in Illinois and Indiana beginning with the 1999 crop year. On October 22, 2002, the Board approved expansion of the GRIP program to all GRP corn and soybean counties in Michigan and Ohio. The expansion added 36 GRIP corn counties and 34 GRIP soybean counties in Michigan, and added 61 GRIP corn counties and 52 GRIP Soybean counties in Ohio. The expansion extended coverage to approximately 210,000 acres of corn in the two states and approximately 200,000 acres of soybeans currently under the GRP plan of insurance. RMA became the owner of the GRIP product effective December 31, 2002. On October 29, 2003, the Board approved expansion of the GRIP program to 39 GRP corn counties in Texas, 53 GRP corn counties in Wisconsin, and 4 GRP soybean counties in Wisconsin beginning with the 2004 crop year. This expansion added 154,060 acres of corn in the two states and 31,623 acres of soybeans in Wisconsin that were currently insured under the GRP plan. Proposed additional GRIP expansion to all remaining GRP corn, grain sorghum, and soybean counties for the 2005 crop year would add; GRIP corn in eleven expansion states with approximately 156,000 GRP acres, GRIP soybeans in 18 expansion states with approximately 598,000 GRP acres, and GRIP grain sorghum in the four expansion states with approximately 16,891 GRP acres. In 2004, there were approximately 10,826 policies sold nationwide, covering about 2.6 million of net acreage with a total liability and total premium of approximately \$1.3 billion and \$79 million, respectively.

**Adjusted Gross Revenue (AGR)**--insures the revenue of the entire farm rather than an individual crop by guaranteeing a percentage of average gross farm revenue, including a small amount of livestock revenue. AGR is a whole-farm revenue pilot program that bases the revenue coverage on 5-years of farm income tax records (Schedule F) and the current year's expected farm revenue. AGR provides coverage for all commodities on the farm. Farms with \$6.5 million or less in adjusted gross revenue may be insured by AGR with a maximum of 35 percent of total revenue received from animals and animal products. Total gross revenue is adjusted to remove income received from value added enterprises, and from timber, forest or forest products, and animals raised for sport, show, or pets. AGR is currently available in selected counties in 18 states. In 2004, participation data indicates 966 policies written, approximately \$302 million liability and \$11.7 million in total premiums.

**Crop Revenue Coverage (CRC)**--provides revenue protection based on price and yield expectations by paying for losses below the guarantee at the higher of an early-season price or the harvest price. CRC was developed by a private insurance company and first submitted to the FCIC Board for approval in 1995 for the 1996 crop year. For the 2005 crop year, the CRC plan of insurance will offer coverage for corn, cotton, grain sorghum, rice, soybeans and wheat in selected states.

**Income Protection (IP)**--protects producers against reductions in gross income when either a crop's price or yield declines from early-season expectations. IP was developed in 1997 by the FCIC. IP is designed to protect producers against reductions in gross income when either a crop's price or yield declines from early-season expectations. For the 2005 crop year, the IP plan of insurance will offer coverage in selected states for barley, corn, cotton, grain sorghum, soybeans and wheat.

**Revenue Assurance (RA)**--provides dollar-denominated coverage by the producer selecting a dollar amount of target revenue from a range defined by 65-75 percent of expected revenue. RA was developed by another private insurance company and submitted to the FCIC Board for approval in 1996 for the 1997 crop year. For the 2005 crop year the RA plan of insurance will provide coverage for feed barley, malting barley, canola/rapeseed, corn, cotton, soybeans, sunflowers, rice, spring wheat and winter wheat in selected states.

These plans respond to the directive of the 1994 Act which directed the FCIC to develop a pilot crop insurance program which provided coverage against reduced gross income as a result of a reduction in yield or price, and has generally been improved and/or expanded each year.

CRC, IP, and RA have many similar features. These programs guarantee revenue by

insuring yield and price variability. Indemnities are due when any combination of yield and price result in revenue that is less than the revenue guarantee. CRC, IP, and RA plans are similar because they use many of the same policy terms and conditions of the Multiple Peril Crop Insurance (MPCI) plan of insurance that uses Actual Production History (APH). APH provides the yield component and a yield forecast through the insureds records of historic yields. It also provides a documented process to determine the yield for the insurance period.

The price component common to the CRC, IP, RA, and GRIP plans is the use of commodity futures markets for price discovery. Price discovery occurs twice in the CRC, IP, RA and GRIP plans: first, before the insurance period (Projected, Base or Expected Price) to establish the revenue guarantee and premium, and second, at harvest time (Fall Harvest Price, Harvest Price). CRC provides increased protection when the Harvest Price is above the Base Price. The RA plan of insurance has similar coverage available if the Fall Harvest Price Option is selected by the producer, the option provides increased protection when the Fall Harvest Price is greater than the Projected Harvest Price. All revenue insurance plans pay the insured producer an indemnity when any combination of harvested and appraised yield and Harvest Price (Fall Harvest Price) results in revenue that is less than the revenue guarantee.

**Additional Insurance Products submitted under section 508(h) of the Act:**

The following crop insurance products were submitted by private companies under the provisions of section 508(h) of the Act and approved by the FCIC Board of Directors:

**AGR Lite**--Insures adjusted whole farm revenue and is based on the AGR policy with some modifications. AGR-Lite was first approved by the Board for the 2003 crop year. AGR-Lite is available to producers whose liability does not exceed \$250,000 and has no percentage limitation on revenue from animals and animal products and no requirement to purchase other federally reinsured insurance on commodities where it is available. AGR-Lite is available in: Connecticut-all counties, Delaware-all counties, Maine-all counties, Maryland except Baltimore City County, Massachusetts-all counties, New Hampshire-all counties, New Jersey-all counties except Hudson County, New York (52 out of 62 counties), Pennsylvania-all counties except Philadelphia County, Rhode Island-all counties, Vermont--all counties, and West Virginia. Work is currently underway to expand AGR-Lite to Alaska-selected counties, Idaho-all counties, Oregon-all counties, and Washington-all counties. This expansion will provide insurance in these areas if actuarially appropriate premium rates, as approved by the Manager of the Federal Crop Insurance Corporation, are provided by the private owner of AGR-Lite in time for the 2005 crop year. In 2004, 88 policies were sold with nearly \$3.3 million in liability and just under \$156,000 in total premium. AGR-Lite is available in most of the states that have been determined to be 'underserved', as designated by the Agricultural Risk Protection Act (ARPA) with respect to risk management products, so fills the need to provide risk management tools to these states.

**Livestock Risk Protection (LRP)**--LRP insurance insures against a decline in price. LRP is owned by a private company and was first introduced for swine with sales beginning on July 8, 2002 for all counties in Iowa. LRP expanded to cover Feeder Cattle (LRP-Feeder) and Fed Cattle (LRP-Fed) with sales beginning on June 9, 2003. LRP now insures Swine, Feeder Cattle, and Fed Cattle in Colorado, Indiana, Illinois, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, Nevada, North Dakota, Oklahoma, Ohio, South Dakota, Texas, Utah, West Virginia, Wisconsin, and Wyoming. LRP sales for the 2004 crop year totaled 91 policies with 350 specific coverage endorsements (groups of animals) insured at just under \$138 million in liability and slightly over \$3.8 million in total premium.

**Livestock Gross Margin (LGM)**--LGM is a gross margin index, designed to protect profit margins for swine producers, and is based on three futures contracts: lean hog prices traded on the Chicago Mercantile Exchange (CME) minus feed costs using corn and soybean meal futures settlement prices at the Chicago Board of Trade (CBOT)). For the 2004 reinsurance year, LGM has provided coverage for 760,731 head of slaughter hogs with a liability of \$57.4 million. To date LGM premium is \$3.2 million and total indemnities are \$6.9 million.

**Nutrient Best Management Practice (N-BMP)**--The N-BMP insurance policy provides insurance protection from crop production loss when a producer applies a rate of fertilizer (nitrogen and/or phosphorus) recommended by a Best Management Practice (BMP). Except for fertilizer, producers must use the same farming practices on both the check strip and management unit. Based on an appraisal, if the production per acre on the check strip is greater than adjacent strips within the management unit, less a deductible (5 percent), the producer receives an indemnity. N-BMP may be selected by an insured as an endorsement to the APH/Multiple Peril Crop Insurance Policy or the CRC policy.

#### **Yield-based (APH) Insurance Plans**

**Multiple Peril Crop Insurance**--These policies insure producers against yield losses due to natural causes such as drought, excessive moisture, hail, wind, frost, insects, and disease. The farmer selects the amount of average yield he or she wishes to insure; from 50 to 75 percent (in some areas to 85 percent). The farmer also selects the percent of the predicted price he or she wants to insure; between 55 and 100 percent of the crop price established annually by RMA. If the harvest is less than the yield insured, the farmer is paid an indemnity based on the difference. Indemnities are calculated by multiplying this difference by the insureds' percentage of the established price selected when crop insurance was purchased.

**Group Risk Plan of Insurance**-- GRP was created by FCIC as a risk management tool to insure against widespread loss of production of the insured crop in a county. It is primarily intended for use by those producers whose farm yields tend to follow the average county yield. These policies use a county index as the basis for determining a loss. When the county yield for the insured crop, as determined by the National

Agricultural Statistics Service (NASS), falls below the trigger level chosen by the farmer, an indemnity is paid. Payments are not based on the individual farmer's loss records. Yield levels are available for up to 90 percent of the expected county yield. GRP protection involves less paperwork and costs less than the farm-level coverage described above. However, individual crop losses may not be covered if the county yield does not suffer a similar level of loss. This type of insurance is most often selected by farmers whose crop losses typically follow the county pattern.

Covered crops currently include: corn, cotton, forage, peanuts, sorghum, soybeans, wheat, and rangeland. All GRP crops are permanent programs, with the exception of rangeland, which remains a pilot program. For the 2004 crop year, one or more GRP crop programs were offered in 24 states. In 2004, there were approximately 19,721 policies sold nationwide, covering about 13.9 million of net acreage with a total liability and total premium of approximately \$1.3 billion and \$39 million, respectively.

**Dollar Plans**--The dollar plan provides protection against declining value due to damage that causes a yield shortfall. The amount of insurance is based on the cost of growing a crop in a specific area. A loss occurs when the annual value of the crop is less than the amount of insurance. The maximum dollar amount of insurance is stated on the actuarial document. The insured may select a percent of the maximum dollar amount equal to CAT (catastrophic level of coverage), or additional coverage levels. The dollar plan is available for several crops, including fresh market tomatoes, strawberries, and cherries (on a pilot program basis in limited areas only).

RMA offers three different kinds of dollar plans: dollar revenue, dollar yield, and dollar asset. Typically, these plans set the amount of coverage using county average figures such as costs of production or other indicators. Indemnities are calculated using the actual results of each producer. The dollar revenue plan provides protection against loss of revenue. Crops covered include blackberries, cherries, chili peppers, citrus (California), fresh-market tomatoes, beans, sweet corn, peppers, processing cucumbers, raspberries, strawberries, and winter squash. The dollar yield plan provides protection against a decline in the amount of the crop produced. Crops covered include hybrid seed corn and sorghum. The dollar asset plan provides protection against the loss of a crop-producing asset, such as fruit trees, as well as certain crops. Coverage is provided for citrus trees (Texas), citrus fruit (Florida), clams, forage seeding, fruit trees (Florida), macadamia trees, nursery, raisins, and tropical fruit trees (Florida).

### **Pilot Programs**

The FCIC currently has 32 pilot programs underway that implement legislation or test new and innovative crop insurance concepts. Pilot insurance plans and other risk management tools available for the 2004 crop year include AGR and AGR-Lite, apple pilot quality option, avocado actual production history, avocado revenue, avocado/mango trees, blueberries, cabbage, cherries, citrus (dollar), corn rootworm integrated pest management,

coverage enhancement option, crambe, cultivated clams, cultivated wild rice, dairy options, Florida fruit trees, forage seed, fresh market beans, the IP plan of insurance, mint, mustard, onion pilot stage removal option, pecan revenue, processing chile peppers, processing cucumbers, rangeland (GRP), raspberry/blackberry, strawberries, sweet potatoes, and winter squash (including pumpkins). RMA converted the pilot programs for blueberries and pecans to permanent programs for the 2005 and succeeding crop years. In July 2004, the FCIC Board of Directors approved the termination of the crambe pilot program and the termination of the coverage enhancement option beginning with the 2006 crop year. In September 2004, the FCIC Board of Directors approved the conversion of the cultivated wild rice, cabbage and mint pilot programs for conversion to permanent status.

### **Increase Participation and Program Growth**

The FCIC continues to encourage producer acceptance and program participation through outreach and educational activities directed at informing the agricultural community of the “new risk environment” and how crop insurance is one component that can be used to mitigate potential losses. The FCIC’s goals include ensuring that producers have sufficient information to adequately assess their own risk in today’s uncertain agribusiness environment. Activities include participation in agricultural related events and expositions around the country and distributing the crop insurance industry’s guide entitled, “Managing Risk - Being Prepared” Outreach and education on the crop insurance program and other risk management tools will increase under the mandate found in the 1996 Act.

### **Risk Management Education**

RMA continues to partner with the Cooperative State Research, Education, and Extension Service (CSREES), the Commodity Futures Trading Commission (CFTC), and the USDA National Office of Outreach, to provide Risk Management Education (RME) to U.S. farmers and ranchers, as mandated in Section 192 of the 1996 FAIR Act. In addition, the Agricultural Risk Protection Act of 2000 significantly increased RMA’s role in delivering education and outreach programs.

The RME Division provides farmers with information and with educational opportunities to become more aware of risk, know the tools available to manage risk, and learn strategies for making sound risk management decisions.

The RME reached approximately 46,000 producers during fiscal year 2004, and 62,000 producers in fiscal year 2003. Total RME obligations incurred by the FCIC were approximately \$9.8 million for fiscal year 2004 and \$9.8 million for fiscal year 2003.

RMA seeks to increase the agricultural community’s awareness of risk management alternatives through education and information programs, an effort that was bolstered significantly with the passage of ARPA. ARPA provided RMA with the opportunity to

expand its educational programs on several fronts.

- *Risk Management Education for Specialty Crops.* ARPA directs RMA to establish partnerships for the purpose of providing producers of specialty crops and under-served commodities with risk management training.
- *Crop Insurance Education for Targeted Region States.* ARPA authorizes and directs RMA to establish crop insurance education and information programs in states that have been historically under-served by the Federal crop insurance program. The 15 states designated by the Secretary that are eligible for this program are Maine, New Hampshire, Vermont, Connecticut, Massachusetts, Rhode Island, New York, New Jersey, Pennsylvania, Delaware, Maryland, West Virginia, Utah, Nevada, and Wyoming.
- *Competitive Grants for Risk Management Education.* This is a cross-cutting program administrated by the CSREES using funding from the Federal Crop Insurance Fund.
- *Agricultural Management Assistance (AMA) Program.* This is another cross-cutting program authorized by ARPA that RMA administers jointly with the Natural Resource Conservation Service and the Agricultural Marketing Service.

### **Performance Goals, Objectives, and Results**

The key strategic goals and results that follow were selected from RMA's Strategic Plan for fiscal years 2004-2008.

Strategic Goal: Preserve and strengthen the economic stability of America's agricultural producers by promoting and supporting the use of sound risk management tools among farmers and ranchers.

The FCIC strategic goal will be achieved by accomplishing the tasks necessary to satisfy the objectives. The enabling strategies includes formalizing the use of strategic information and market analysis to improve decision making, improving internal and external communication, focusing and harmonizing products and services to address demonstrated market needs, and developing a comprehensive and coordinated assurance delivery system. The objectives represent a multifaceted approach to improving the stability of the agricultural economy through the expanded use of risk management tools. By promoting additional or improved products, enhancing product delivery, providing educational opportunities, and reducing program and administrative inefficiencies, FCIC will promote and support the use of sound risk management tools among farmers and ranchers.

## List of FY 2004-2008 Strategic Plan Objectives

1. Increase the availability and effectiveness of risk management solutions.
2. Improve and protect the soundness, safety, efficiency, and effectiveness of the risk management delivery system.
3. Ensure that customers and stakeholders have knowledge and awareness of risk management tools and products.
4. Ensure effective oversight of the crop insurance industry and enhance deterrence and prosecution of fraud, waste, and abuse.
5. Develop, acquire, and align activities, resources, and skills to efficiently achieve vision, mission, and strategic objectives.

### Objective 1. Increase the availability and effectiveness of risk management solutions.

Expanding the number and types of risk management solutions is one method of enhancing the economic stability of agricultural producers. RMA develops the USDA crop insurance policies and underwriting terms and provides policies for numerous commodities and revenue protection. RMA conducts studies to determine the feasibility of insuring many other commodities and conducts pilot programs for some new commodity policies in selected states and counties. And while RMA has streamlined the process of developing new policies in recent years, much has to be done prior to a policy becoming available nationwide, especially if it is a new type of policy or a policy on a commodity which is not similar to any crop already insured. The Federal Crop Insurance Act requires that submissions of insurance policies and plans and related materials be developed by third parties and approved by the FCIC Board of Directors. These submissions, including all new and substantial product modifications, are subject to review by no less than five independent expert actuarial and underwriting reviewers. Generally speaking, the process takes several years.

### Objective 2. Improve and protect the soundness, safety, efficiency, and effectiveness of the risk management delivery system.

Higher participation rates illustrate the enhanced ability of crop insurance to become the main risk management tool for American producers and illustrate the acceptability of the products offered. As codified by the 2002 Farm Bill, there are 15 States that have been underserved by crop insurance. They include Maine, New Hampshire, Vermont, New York, Connecticut, Massachusetts, Rhode Island, New Jersey, Delaware, Pennsylvania, Maryland, West Virginia, Wyoming, Utah, and Nevada. These states have a disproportionately large share of small farms. The ten staple crops consist of corn for grain, soybeans, wheat, cotton, sorghum, barley, rice, potatoes, tobacco, and peanuts. During its history, RMA has concentrated much of its effort successfully on ensuring that these core agricultural staples have received ample crop insurance coverage. It is



important to RMA that this level of participation remains high while RMA develops and implements new products for other crops and pilot programs while also maintaining and enhancing other crops with widespread crop insurance availability that have already moved out of pilot status. Additional participation data for these other categories will be incorporated into annual performance plans as they become available. In addition to providing new and revised products, RMA continues to review its general policy terms and conditions to ensure fair and effective delivery of these products to provide producers access with insurance coverage for their agricultural commodities. RMA continues to advocate enhanced delivery of products by insurance companies through enhanced agent training and focusing attention on the need for increased insurance agents in the States and/or areas determined to be underserved.

Objective 3. Ensure that customers and stakeholders have knowledge and awareness of risk management tools and products.

Producers face an increasingly complex agricultural environment that is exacerbated by such obstacles as rapidly changing technology, production alternatives, labor supply, and other factors. It has become increasingly important for American producers to understand the risk entailed by their operation and to manage them appropriately.

Changes to the Act in 1996 and 2000 established a strong role for the Federal government in providing farmers and ranchers with risk management education. The purpose of the program is to provide such education in management of the financial risks inherent in the production and marketing of agricultural commodities. RMA partners with the CSREES, the USDA, National Office of Outreach, and other public and private organizations to deliver risk management education programs to U.S. farmers and ranchers. Through partnership and cooperative agreements, RMA focuses its risk management education opportunities in three major areas; specifically underserved States, communities, and commodities. As codified by the 2002 Farm Bill, there are 15 States that have been underserved by crop insurance. These states have a disproportionately large share of small farms. There are other segments of the agricultural community that traditionally have not had access or information concerning available risk management tools. The RMA outreach program addresses these concerns and the RMA commitment to make crop insurance more affordable and encourage smaller specialty crop producers to try new insurance products.

Objective 4. Ensure effective oversight of the crop insurance industry and enhance deterrence and prosecution of fraud, waste, and abuse.

As directed by ARPA, RMA has been instituting new provisions to strengthen program integrity and compliance. While RMA believes that most producers use good farming practices and comply with Federal regulations, there are some instances of fraud, waste, and abuse. New prevention efforts, additional requirements, traditional investigations, and criminal, civil, and administrative processes have combined to enhance recoveries in overpaid indemnities. RMA works with numerous stakeholders, including Farm Service Agency (FSA) and insurance providers, to improve program compliance and integrity by enhancing data reconciliation, evaluating and amending procedures, and emphasizing deterrence and prevention. However, RMA needs to continue to strengthen its

compliance activities by conducting additional reviews of insurance providers to provide greater assurance in the integrity of all components of the risk management program. To this end, RMA has requested additional resources through the fiscal year 2005 budgetary process to conduct additional reviews.

Objective 5. Develop, acquire, and align activities, resources, and skills to efficiently achieve vision, mission, and strategic objectives.

Initiatives in the administrative infrastructure contribute significantly to supporting the Agency's mission and strategic goals and objectives. Attention to these elements will result in RMA usage of valuable resources to improve upon the agency conformity with Departmental guidelines and the President's Management Agenda. To enhance its program delivery systems, decision-making, and performance budgeting capabilities, RMA will need to invest heavily in updating its information technology systems and create a more corporate style database and communication system to provide automated timely and complete data for decision-making and information sharing. Simultaneously, RMA also will be integrating human capital management and other President's Management Agenda items into its planning and management cycles in order to ensure that there are no critical skills gaps.

#### **2004 and 2003 Crop Year Performance Measurements**

The FCIC's total estimated premium level for its reinsured business was \$4.2 billion for the 2004 crop year, with insured producers paying \$1.7 billion and the remaining \$2.5 billion paid in premium subsidies. The FCIC provided approximately \$46.8 billion of insurance protection on about 1.2 million policies for approximately 822 thousand insureds. These crop policies provide coverage for over 222.1 million acres, which are approximately 77.9% of the insurable acres nationwide. For the 2004 crop year policies, the FCIC estimates that approximately \$3.6 billion of indemnities will be paid to insureds on approximately 203,000 indemnity claims. For crop year 2003 policies, the FCIC paid approximately \$3.2 billion to insureds on approximately 292,000 indemnity claims. The loss ratio for 2004 is estimated to be 85.57% compared to the FCIC's actual loss ratio of 94.64% in 2003.

The FCIC has pursued several initiatives to improve actuarial soundness and contain costs within the MPCII program. The FCIC has steadily followed direction provided by the Act, to increase the share of risk to private insurance companies. Also, the FCIC has gradually reduced the rate of reinsured company administrative expense reimbursement. FCIC continues to work with the private insurance industry to review issues under contract. The objectives of this effort include:

- To seek changes which will strengthen the program through greater participation,
- To determine more accurately the approximate cost of required activities to effectively deliver crop insurance,

- To identify currently required activities that may be prudently eliminated, and
- To identify activities which can be accomplished more efficiently.

The FCIC has increased the risk to the private sector in the reinsurance agreement since passage of the Act. Following the major losses of the 1993 crop year when reinsured companies lost approximately \$83 million, the FCIC elected to make only minor changes to the reinsurance agreement so the FCIC could observe the performance of the reinsurance agreement under less severe conditions. The reinsured companies' net underwriting gain for the 2003 crop year was \$392.2 million, and the reinsured companies underwriting gains for the 2004 crop year are estimated to be \$ 758 million.

#### 1995-2004 Crop Years in Retrospect

An overall review of the period 1995 crop year through 2004 crop year reveals a substantial change in delivery of the MPCI product and unusually turbulent weather patterns. The FCIC's authorizing legislation was amended prior to the 1990 fiscal year to improve its ability to administer an actuarially sound program.

For the crop years 1995 through 2004, the program has paid out an average of \$1.00 for every dollar of premium. In addition to the cost of the excess losses, administrative expenses of the program and premium subsidy have averaged \$598 million and \$1,403 million respectively over the past ten years. Premium subsidies have increased significantly since the 1995 crop year due to the 100% subsidization of catastrophic insurance premiums by the U.S. government.

#### 10 Year Summary of Premiums and Losses

(in millions)

Crop Year	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	Est. <u>2004</u>	10 Yr. <u>Total</u>
Premiums(\$)	1,542	1,837	1,775	1,879	2,304	2,540	2,961	2,916	3,431	4,211	25,450
Losses(\$)	1,566	1,487	991	1,673	2,420	2,591	2,949	4,058	3,247	3,563	25,341
Loss Ratio:											
Actual	102%	81%	56%	89%	105%	102%	100%	139%	95%	--%	100%
Projected	110%	100%	72%	95%	93%	88%	108%	142%	117%	85%	101%
Difference	8%	19%	16%	6%	(12%)	(14%)	8%	3%	22%	--%	1%

As shown in the table, the difference between the estimated and actual loss ratios in 2003 is similar to differences that occurred in 1996 and 1997. The difference between the estimated and projected loss ratios has exceeded 10 points almost 50% of the time (5 of 10 years). The relatively high variance of the estimate reflects the large degree of uncertainty that is inherent in predicting losses before the growing season is over.

Although the variance is high, the estimates do not appear to indicate any long-term bias. The weighted average difference between the estimates and the actual loss ratio for the years 1995 to 2003 is +1%.

There are several sources of uncertainty when estimating losses based on data from early in the period of harvest. One source of uncertainty is in the projected crop yields by USDA's National Agricultural Statistics Service (NASS). The NASS projected crop yields are subject to a certain degree of measurement error, particularly during the early part of the harvesting for many insured crops. Also, changes in fall weather can have a major impact on final crop yields, such as from freezes, hurricanes, or excessive moisture that may affect the harvest or may damage the mature crop.

Revenue products introduce another source of uncertainty – data on crop prices obtained from the commodity exchanges. Commodity exchange crop values in the late August/early September period are themselves projections of the harvest contract values for some later date. Hence, there is an inherent amount of variability in the futures price from early September, when the loss estimates are made, to when the harvest prices for the revenue products are determined.

Finally, there is variance due to the loss estimation model itself. The model is an approximation based on the data available. There can be other variables which affect losses in any one year that are not predictable or whose impacts are uncertain.

The amount of the variance between the estimated and actual losses that can be accounted for by each source of uncertainty varies from year to year. However, it is clear that the major input data, projected crop yields issued by NASS, while informative, does not appear to be consistently predictive of aggregate crop insurance losses.

#### **Uncertainty in 2004 Estimated Losses**

The potential amount of variance due to uncertainty in the estimated losses for 2004 is heightened due to several factors. Given the factors discussed below, and the past history of variances between projected and actual losses, the 2004 estimated losses are subject to a higher level of uncertainty and potential variance than for most other years.

Several agricultural areas in Florida and the southeastern US have suffered unusually late

season crop damage due to hurricanes and excessive moisture. Also, early autumn freezes in parts of the extreme north central US are also responsible for late season crop damage. The loss estimates for these crops are subject to potentially large variances due to two significant factors: (1) the very short time between the events and the collection of the latest data used for estimating crop losses; and (2) the extremely low yields for certain crops in certain areas where the methods used to estimate losses are dependent on a very limited number of historical data points with similar low yields.

For major crops in several major agricultural areas in the central US, crop yield for major crops have been unusually high, suggesting very low crop insurance losses. The loss estimates for these crops are also subject to potentially large variances due to two significant factors: (1) the unusually high yields can impact the commodity prices and could affect the estimated crop losses for revenue insurance products; and (2) the extremely high yields for certain crops in certain areas where the methods used to estimate losses are dependent on a very limited number of historical data points with similar high yields.

#### **2004 and 2003 Fiscal Year Financial Performance**

Premium revenue is comprised of producer paid premium and premium subsidy appropriated by the federal government. Producer paid premium is recognized as earned ratably over each crop's growing season. The portion of producer premium not recognized at the conclusion of the fiscal year is classified as unearned revenue in the consolidated balance sheet. Premium subsidy is recognized as earned when expended. The unexpended premium subsidy remains an unexpended appropriation in the consolidated balance sheet.

The sum of producer paid premium and premium subsidy has been calculated using generally accepted actuarial methods to attain a break-even loss ratio of 100%. Premium subsidy is not considered written to the extent a portion remains unexpended and no unearned revenue is recorded in the consolidated balance sheets. As a result, the expected claim costs and claim adjustment expenses exceed the related unearned revenue. A premium deficiency is therefore recognized in the consolidated balance sheet by accruing a liability recorded as an other liability for the excess amount.

The following are measures of the FCIC's financial performance:

Net Operating Cost

(in millions)

		2004	2003
Total Program Costs	\$	3,871	4,661
Less Earned revenues		(746)	(1,073)
Net cost of operations	\$	3,125	3,588

The previous measure indicates the FCIC's net operating cost.

Operating Results

(in millions)

		2004	2003
Beginning Balance	\$	(1,338)	\$ (678)
Appropriations and other financing sources used		3,425	2,928
Less net cost of operations		(3,125 )	(3,588)
Net change in Cumulative Results of Operations	\$	(1,038)	\$ (1,338)

The previous measure indicates that future funding will be required for the 2004 fiscal year.

Financial Obligations

(in millions)

		2004	2003
Entity Assets	\$	3,753	3,249
Liabilities covered by budgetary resources	\$	3,938	2,348
Ratio of entity assets to liabilities covered by budgetary resources		.96	1.39

Net Position

(in millions)

	2004	2003
Total assets	\$ 3,753	3,249
Total liabilities	(3,944)	(3,687)
Net Position	\$ (191)	(438)

The previous measure provides an indication of the net position of the FCIC as of September 30, 2004 and 2003.

**Financial Highlights**

The FCIC has prepared its financial statements in accordance with the accounting standards codified in the Statements of Federal Accounting Standards and the Form and Content requirements contained in the Office of Management and Budget (OMB) Bulletin 01-09 and its updates.

**Financial Statements****Limitation on Financial Statements**

The financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of 31 U.S.C. 3515 (b). While the statements have been prepared from the books and records of the entity in accordance with the formats prescribed by OMB, the statements are in addition to the reports used to monitor and control budgetary resources, which are prepared from the same books and records. The statements should be read with the realization that they are a component of the U.S. Government, a sovereign entity. One implication of this is that liabilities cannot be liquidated without legislation that provides resources to do so.

**Consolidated Balance Sheet**

The FCIC's total assets as of September 30, 2004 were \$3.8 billion and as of September 30, 2003 were \$3.2 billion. The Fund Balance with Treasury, Cash Held Outside of Treasury, and Accounts Receivable Net, \$3.7 billion and \$3.1 billion, respectively, are 98.0 and 97.0 percent, respectively, of total assets. The Liability for Estimated Losses on Insurance Claims, \$2.4 billion in fiscal year 2004 and \$2.8 billion in fiscal year 2003, respectively, are approximately 59 percent of total liabilities in fiscal year 2004 and 76 percent of total liabilities in fiscal year 2003.

### Statement of Net Cost

The FCIC's net cost of operations for fiscal year 2004 was \$3.1 billion, a 14 percent decrease over the fiscal year 2003 net cost of operations that was \$3.6 billion. The indemnity costs and program delivery costs are 97.8 percent of the FCIC's cost of operations in fiscal year 2004 and 96.8 percent in fiscal year 2003. The indemnity costs decreased \$940 million due to a lower loss ratio estimate in fiscal year 2004 and the delivery costs increased \$157 million due to an increase in the estimated premium in fiscal year 2004.

### Statement of Net Position

The net cost of operations of the corporation decreased in fiscal year 2004. Our loss ratio was an estimated 117 percent in fiscal year 2003 and an estimated 85 percent in fiscal year 2004.

### Statement of Budgetary Resources

Appropriations, combined with other budgetary resources made available and adjustments totaled \$6.2 billion in fiscal year 2004 and \$6.0 billion in fiscal year 2003 (as restated), while total outlays were \$3.3 billion in both fiscal year 2004 and 2003.

<u>Budgetary Resources</u>		
(in millions)		
	2004	2003
		(as restated)
Appropriations	\$ 3,438	2,977
Unobligated balance brought forward	1,857	2,197
Offsetting Collections and Adjustments	936	834
<b>Total</b>	<b>\$ 6,231</b>	<b>6,008</b>

### Statement of Financing

The total budgetary and non-budgetary resources used to finance operations totaled \$3.1 billion in fiscal year 2004 and \$3.6 billion in fiscal year 2003. The fiscal year change in undelivered orders was not part of the net cost of operations, and totaled (\$11) million in fiscal year 2004 and \$16 million in fiscal year 2003.



## **Systems, Controls, and Legal Compliance**

### **Risk Compliance**

The focus of the compliance function continues to ensure the integrity of the crop insurance program and its delivery by increasing effectiveness, efficiency and timeliness of reviews performed on the companies which participate in the delivery of MPCl.

ARPA mandated new requirements in the areas of program compliance and integrity but the act did not cause a change to Risk Compliance's overall mission, goals, or business objectives. Instead ARPA impacted existing business processes and provided additional management tools.

The role of Risk Compliance is to ensure that laws, policies, and procedures are followed and administered effectively. Risk Compliance seeks to maintain program integrity. This is accomplished through a systematic review process for the detection and prevention of crop insurance program abuse. Properly done, this requires a proactive approach in which the FCIC and the industry work together to increase awareness, develop programs, identify systems and processes, and take other actions to minimize the potential for crop insurance program abuse. Such an approach is ultimately aimed at the proactive prevention of fraud and abuse, rather than reactive.

Risk Compliance's goal is to reduce taxpayer and producer burden generated by fraud and abuse, contract noncompliance, and program vulnerabilities. The reinsured companies counter fraud and abuse in program delivery by performing growing season inspections, reviewing reported producer yields, performing on sight inspections, avoiding conflicts of interest, and initiating and engaging in litigation on issues important to the MPCl program. The reinsured companies are also an important source of information concerning program vulnerabilities.

Risk Compliance's efforts are focused on investigation work generated by Office of the Inspector General (OIG) Hotline complaints, a variety of other external sources, and National Operations Reviews (NOR) of companies to determine compliance with the Standard Reinsurance Agreement (SRA) requirements and to determine MPCl program vulnerabilities.

Ultimately, Risk Compliance produces a positive impact on MPCl program integrity through its findings of noncompliance. Risk Compliance provides information and evidence to the FCIC Contracting Officer and other key operating and policy elements of the FCIC. This material provides a basis for action against wrong doers and for MPCl

program modification. Risk Compliance works with the Department of Justice through the USDA OIG's criminal division and the Office of General Counsel (OGC) (civil) where matters indicate a need for litigation.

#### **Federal Managers' Financial Integrity Act**

The FCIC takes measures to conduct self-assessments, identify material weaknesses, and implement timely corrective action through the annual Federal Managers' Financial Integrity Act (FMFIA) reporting process.

The FCIC addresses audit findings and recommendations timely and works closely with the OIG, GAO, OCFO, Department of Justice (DOJ), and Assistant US Attorneys (AUSA) to timely implement effective, responsive corrective actions and improvements.

The compilation of these activities has enabled FCIC to identify and reduce program vulnerabilities, which has contributed to improved program integrity and protection of taxpayer's funds. A reduction in program vulnerabilities, improved program integrity, and protection of taxpayer's funds, in turn, enhance the economic safety net for farmers and ranchers.

The Federal Financial Management Improvement Act (FFMIA) requires that agencies implement and maintain financial management systems that comply substantially with federal financial management system requirements, applicable federal accounting standards, and the U.S. government standard general ledger at the transaction level. During its financial statement audit, the OIG and independent auditors report on whether or not financial management systems comply substantially. If the systems do not, then a plan is required to bring the systems into compliance.

Through review of its programs and the use of OIG and GAO evaluations, RMA strives to ensure government resources are used efficiently and effectively to achieve the intended program results. Improvement to programs following these reviews are designed to further minimize the potential for waste, fraud, and mismanagement.

Additionally, our auditors noted instances of noncompliance with certain laws and regulations applicable to the FCIC. The findings noted that management has not established a continuous monitoring system over financial management systems.

#### **Agricultural Risk Protection Act of 2000**

The Agricultural Risk Protection Act (ARPA) of 2000, Section 515, mandated new requirements in the area of program compliance and integrity. These new requirements once fully implemented should enhance management information systems and facilitate the detection and enforcement of program fraud, waste, and abuse.

With the resources provided in the ARPA for data warehousing, data mining and other information technology capabilities, RMA continues to improve its compliance enforcement capabilities and reduce overall program vulnerabilities. Cooperative agreements and contracts are in place to greatly supplement this already existing effort in

incremental phases over the next 5 years. Using the trends, indicators and analyses provided by these systems, we will be more proactive and aggressive in managing and monitoring program integrity issues.

RMA has entered into a contractual agreement to establish a pattern recognition system, enabling the Agency to identify trends signaling poor performance and/or potential/actual fraud, waste, and abuse of resources. The objectives of the contract are to identify trends, patterns, anomalies and relationships between reinsured organizations, insurance agents, adjusters, and producers in crop insurance data indicative of excess claim adjustment over actual crop loss. The vendor shall incorporate Data Analysis and Data Mining techniques to accomplish this objective. Implementation of this system will enable the Agency to target review efforts in those areas deemed the most vulnerable, thereby enhancing program integrity and protecting taxpayers' funds. To manage both the increased span of control within the internal components of the agency and to ensure unity of authority without compromising the necessity for decentralized operations, RMA reviewed and updated its delegations of authority from the Administrator to the Deputy Administrator for Compliance. The revised delegation provides for the separation of authority at the various levels within Compliance that ensures that the processes for reviews and investigations, adjudication and appeals provides for administrative due process and are conducted fairly and impartially. By tailoring its management functions to meet and exceed the requirements of ARPA, RMA maintains the integrity of the compliance business processes and in doing so, is in a better position to maintain the integrity of crop insurance programs.

RMA conducts reviews designed to evaluate reinsured company performance, detect and correct program vulnerabilities, and collect underpaid premiums and overpaid indemnities. We also conduct investigations into complaints and allegations received from various sources such as producers, agents, and OIG hotline.

RMA's key partners in maintaining program integrity are the reinsured companies. We will continue to foster these relationships while emphasizing the need for the companies' quality control programs to improve and assisting the companies in that improvement process. Our objective is to develop within the companies the same stewardship of taxpayer's funds as our own values and beliefs.

As RMA implements the many changes specified and implied by ARPA requirements over the next several years, the agency will maintain close liaisons and partnerships with other government agencies and private sector companies to keep abreast of technological changes and innovative best practices especially in the areas of combating insurance fraud, investigative tactics and techniques, information management systems, or any other worthwhile venture that may assist the agency in its quest to save the taxpayers' dollars.

### **Actuarial and Underwriting Performance**

The systematic adjustment of premium rates and coverages by the FCIC is producing additional cost savings for the federal government by reducing crop losses and placing the

MPCI program on a more actuarially sound basis. These annual adjustments were initiated beginning with the 1991 crop year as a result of the Act and have stabilized the financial performance of the crop insurance program. The FCIC adjusts premium rates as necessary and appropriate for actuarial soundness. Annual premium rate increases are limited by law to no more than 20%. If rate increases greater than 20% are necessary for actuarial soundness, the FCIC will move toward the target rates over the following years, thus adhering to the 20% rule, but still moving toward the actuarially sound target rate.

The FCIC continues to review the premium rate making methodologies to increase the integrity and performance of the crop insurance program. In addition, the Economic Research Service (ERS), an agency of the USDA, is reviewing the FCIC's crop insurance program rates, financial elements of the standard reinsurance agreement, and yield coverage. Independently, the ERS has entered into a cooperative agreement with the actuarial firm of Milliman and Robertson to review the FCIC's actuarial processes. Additionally, the ERS provides feasibility studies of crops that represent opportunities for expansion of the crop insurance program. The FCIC also uses the resources of the CSREES to provide information about the financial situation of farmers so the FCIC can make more informed decisions for program improvement. During fiscal years 2001, 2002, and 2003, the FCIC has issued several contracts for completion of actuarial studies that will be evaluated and implemented to modify, update, and enhance actuarial methodology and the ratemaking process.

#### **Actual Production History Underwriting**

The FCIC's Actual Production History (APH) underwriting procedure of MPCI requires APH guarantees to be calculated with emphasis on the producer's actual yield records versus proxy yields. Yield guarantees are calculated using 4 years of actual records, building to a 10-year database. For producers who do not provide 4 years of actual yield records, the yield guarantee is a percentage of the proxy yield, which is calculated for each year's missing yield record. The percentage of the proxy yield is 100% when 3 years of records are provided, 90% for 2 years, 80% for 1 year, and 65% when no records are provided. New producers of crops who do not have records of actual yields may use 100 percent of the proxy yield. For APH yield calculation purposes, ARPA allows producers to substitute 60 percent of the applicable proxy yield for actual yields that are less than 60 percent of the applicable proxy yield to mitigate the effect of catastrophic years. Insureds may elect the APH Adjustment and substitute 60 percent of the applicable proxy yield for low actual yields caused by drought, flood, or other natural disasters.

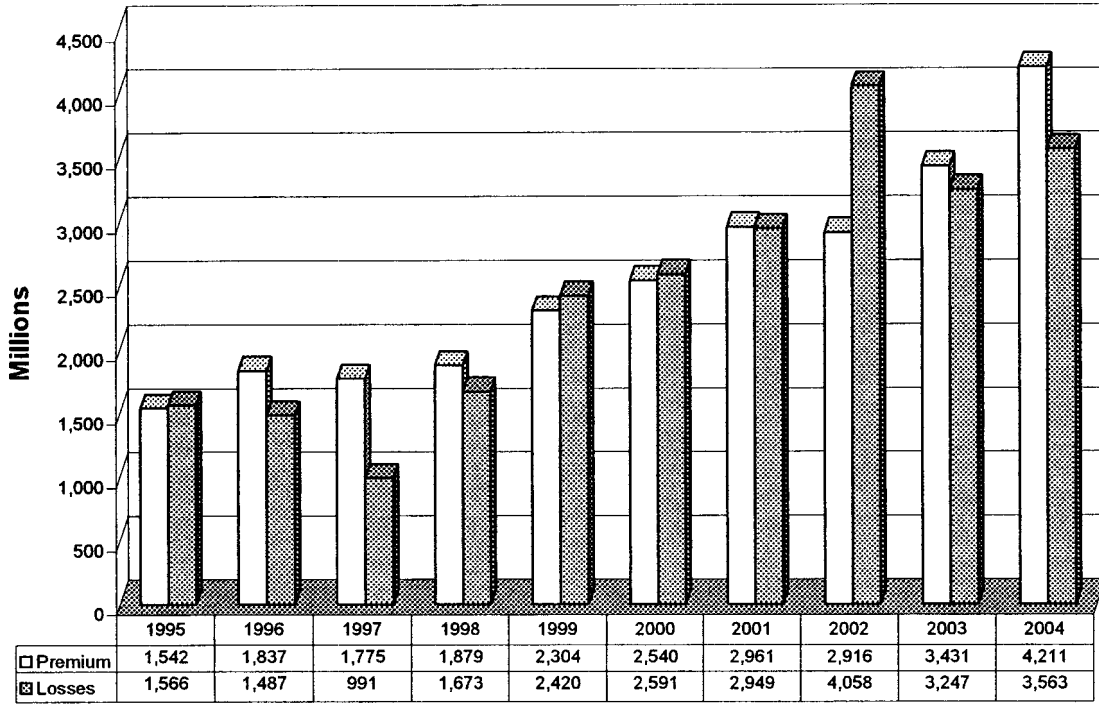
#### **Policyholder Tracking System**

The FCIC's Policyholder Tracking System (PHTS), a process within the DAS, uses the policyholder's Social Security Number or Employer Identification Number to track the policyholder's insurance history. The FCIC utilizes the PHTS to create a nationwide database to track producer participation in crop insurance programs, develop adequate production documentation, identify high-risk producers, assess the performance of insurance providers and other activities to improve the integrity and fiscal responsibility of the federal crop insurance program.

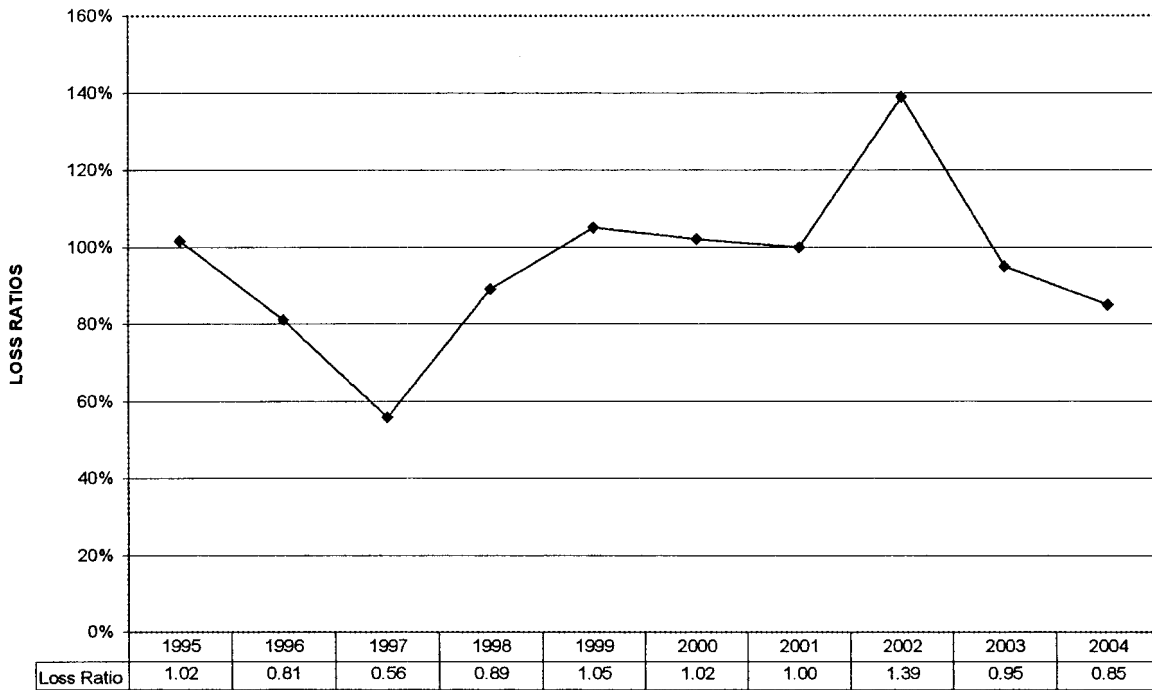
**Ineligible Tracking System**

The FCIC implemented the Ineligible Tracking System in October 1997, for the 1998 crop year. The ITS identifies persons who have rendered themselves ineligible for crop insurance benefits as a result of a violation of crop insurance policy provisions. The FCIC will not reinsure a crop insurance policy for a person identified as ineligible.

### SUMMARY OF PREMIUMS AND LOSSES



### SUMMARY OF LOSS RATIOS



**RISK MANAGEMENT AGENCY  
FEDERAL CROP INSURANCE CORPORATION  
CONSOLIDATED BALANCE SHEETS  
As of September 30, 2004 and 2003  
(in millions)**

	<u>2004</u>	<u>2003</u>
<b>Assets:</b>		
Intragovernmental		
Fund Balance with Treasury	\$ 2,181	\$ 1,996
Accounts Receivable, Net	-	1
Total Intragovernmental Assets	2,181	1,997
With the Public		
Accounts Receivable, Net	1,487	1,152
Cash Held Outside Treasury and Advances	84	100
General Property, Plant, and Equipment	1	-
Total Public Assets	1,572	1,252
Total Assets	3,753	3,249
<b>Liabilities:</b>		
Intragovernmental		
Other Liabilities	4	4
Total Intragovernmental Liabilities	4	4
With the Public		
Accounts Payable	82	112
Federal Employee Benefits	3	4
Other Liabilities:		
Estimated Losses on Insurance Claims	2,358	2,803
Unearned Revenue	292	235
Other Liabilities	1,205	529
Total Other Liabilities	3,855	3,567
Total Liabilities	3,944	3,687
<b>Commitments and Contingencies (Note 13)</b>		
<b>Net Position:</b>		
Capital Stock	500	500
Paid-in Capital	38	38
Unexpended Appropriations	309	362
Cumulative Results of Operations	(1,038)	(1,338)
Total Net Position	(191)	(438)
Total Liabilities and Net Position	\$ 3,753	\$ 3,249

See accompanying notes to consolidated financial statements.

**RISK MANAGEMENT AGENCY  
FEDERAL CROP INSURANCE CORPORATION  
CONSOLIDATED STATEMENTS OF NET COST  
For the Years Ended September 30, 2004 and 2003  
(in millions)**

	<u>2004</u>	<u>2003</u>
<b>Program Costs:</b>		
Multi-Peril Crop Insurance Program Costs		
Intragovernmental Gross Costs		
Benefit Program Costs	\$ 7	\$ 6
Imputed Costs	11	11
Reimbursable Costs	43	32
Intragovernmental Net Costs	61	49
Gross Costs With the Public		
Indemnities	2,828	3,768
Other Program Costs:		
Program Delivery Costs	900	743
Other Program Costs	82	101
Total Other Program Costs	982	844
Total Costs with the Public	3,810	4,612
Less: Earned Revenue from the Public:		
Premium Revenue	1,664	1,348
Net Loss on Business Ceded to Reinsured Companies	(969)	(327)
Other Revenue	51	52
Total Earned Revenue with the Public	746	1,073
Net Costs With the Public	3,064	3,539
<b>Net Cost of Operations</b>	<b>\$ 3,125</b>	<b>\$ 3,588</b>

See accompanying notes to consolidated financial statements.



**RISK MANAGEMENT AGENCY  
FEDERAL CROP INSURANCE CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN NET POSITION  
For the Years Ended September 30, 2004 and 2003  
(in millions)**

	<u>2004</u>			Cumulative Results of Operations
	Capital Stock	Additional Paid-in Capital	Unexpended Appropriations	
<b>Beginning Balances</b>	\$ 500	\$ 38	\$ 362	\$ (1,338)
<b><u>Budgetary Financing Sources:</u></b>				
Appropriations Received			3,438	
Appropriation Transfers - in/out			(5)	
Other Adjustments			(80)	
Appropriations Used			(3,406)	3,406
<b><u>Other Financing Sources:</u></b>				
Transfers without Reimbursement				5
Imputed Financing from Costs				
Absorbed by Others				11
Other				3
Total Financing Sources	-	-	(53)	3,425
Net Cost of Operations				(3,125)
<b>Ending Balances</b>	\$ 500	\$ 38	\$ 309	\$ (1,038)
<b><u>2003</u></b>				
	Capital Stock	Additional Paid-in Capital	Unexpended Appropriations	Cumulative Results of Operations
<b>Beginning Balances</b>	\$ 500	\$ 38	\$ 331	\$ (678)
<b><u>Budgetary Financing Sources:</u></b>				
Appropriations Received			2,982	
Appropriation Transfers - in/out			(5)	
Other Adjustments			(48)	
Appropriations Used			(2,898)	2,898
<b><u>Other Financing Sources:</u></b>				
Transfers without Reimbursement				
Imputed Financing from Costs				
Absorbed by Others				11
Other				19
Total Financing Sources	-	-	31	2,928
Net Cost of Operations				(3,588)
<b>Ending Balances</b>	\$ 500	\$ 38	\$ 362	\$ (1,338)

See accompanying notes to consolidated financial statements.

**RISK MANAGEMENT AGENCY  
FEDERAL CROP INSURANCE CORPORATION  
COMBINED STATEMENTS OF BUDGETARY RESOURCES  
For the Years Ended September 30, 2004 and 2003  
(in millions)**

	<u>2004</u>	<u>2003</u> (As Restated, see Note 16)
<b>Budgetary Resources:</b>		
Budget Authority		
Appropriations Received	\$ 3,438	\$ 2,982
Net Transfers	-	(5)
Unobligated Balances		
Beginning of Period (as restated, see note 16)	1,857	2,197
Spending Authority from Offsetting Collections		
Earned and Collected	928	833
Recoveries of Prior Year Obligations	10	7
Permanently not Available	<u>(2)</u>	<u>(6)</u>
Total Budgetary Resources	<u>6,231</u>	<u>6,008</u>
<b>Status of Budgetary Resources:</b>		
Obligations Incurred		
Direct (as restated, see note 16)	4,171	4,153
Unobligated Balance		
Apportioned	2,057	1,851
Unobligated Balance Not Available	<u>3</u>	<u>4</u>
Total Status of Budgetary Resources	<u>6,231</u>	<u>6,008</u>
<b>Relationship of Obligations to Outlays:</b>		
Obligations Incurred (as restated, see note 16)	4,171	4,153
Less: Spending Authority from Offsetting Collections and recoveries of Prior Year Obligations	(938)	(840)
Obligated Balance, Net, Beginning of Period (as restated, see note 16)	240	276
<u>Obligated Balance, Net, End of Period</u>		
Undelivered Orders	(75)	(87)
Accounts Payable (as restated, see note 16)	<u>(129)</u>	<u>(156)</u>
	<u>(204)</u>	<u>(243)</u>
Total Outlays	<u>3,269</u>	<u>3,346</u>
<u>Outlays Detail:</u>		
Disbursements (as restated, see note 16)	4,197	4,179
Collections	<u>(928)</u>	<u>(833)</u>
Subtotal	3,269	3,346
Less Offsetting Receipts	<u>-</u>	<u>-</u>
Net Outlays	<u>\$ 3,269</u>	<u>\$ 3,346</u>

See accompanying notes to consolidated financial statements.

**RISK MANAGEMENT AGENCY  
FEDERAL CROP INSURANCE CORPORATION  
CONSOLIDATED STATEMENTS OF FINANCING  
For the Years Ended September 30, 2004 and 2003  
(in millions )**

	<u>2004</u>	<u>2003</u>
		(As Restated, see Note 16)
<b>Resources Used to Finance Activities:</b>		
Budgetary Resources Obligated		
Obligations Incurred (as restated, see note 16)	\$ 4,171	\$ 4,153
Less: Spending Authority from Offsetting Collections and Recoveries	(938)	(840)
Obligations net of offsetting collections and recoveries	<u>3,233</u>	<u>3,313</u>
Other Resources:		
Imputed financing from costs absorbed by others	11	11
Other	3	19
Net Other Resources Used to Finance Activities	<u>14</u>	<u>30</u>
Total Resources Used to Finance Activities	<u>3,247</u>	<u>3,343</u>
<b>Resources Used to Finance Items Not Part of the Net Cost of Operations:</b>		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided	<u>(11)</u>	<u>16</u>
Total resources used to finance items not part of the cost of operations	<u>(11)</u>	<u>16</u>
Total resources used to finance the net cost of operations	<u>3,258</u>	<u>3,327</u>
<b>Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:</b>		
Components Requiring or Generating Resources in Future Periods		
Change in exchange revenue receivable from the public (as restated, see note 16)	(335)	89
Other (as restated, see note 16)	202	172
Total components of Net Cost of Operations that will not require or generate resources in the current period	<u>(133)</u>	<u>261</u>
<b>Net Cost of Operations</b>	<u>\$ 3,125</u>	<u>\$ 3,588</u>

See accompanying notes to consolidated financial statements.

**RISK MANAGEMENT AGENCY  
FEDERAL CROP INSURANCE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2004 and 2003**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

**Reporting Entity**

The Federal Crop Insurance Corporation (FCIC) is a wholly-owned government corporation within the United States Department of Agriculture (USDA) and is not subject to federal, state, or local income taxes and, accordingly, no provision for income taxes is reported. These consolidated financial statements include the Risk Management Agency (RMA) and the FCIC; hereafter the combined entity will be referred to as the FCIC. The FCIC was established by the Federal Crop Insurance Act, which was enacted as Title V of the Agricultural Adjustment Act of 1938 (52 Statute 72). The FCIC manages a Multiple-Peril Crop Insurance (MPCI) program to assist in stabilizing and protecting the farming sector of the nation's economy. This program was restricted until the Federal Crop Insurance Act of 1980 (Public Law 96-365) expanded the program nationwide to eventually phase out the disaster payment program that was authorized by the Agriculture Act of 1949, as amended.

The RMA was established under provision of the Federal Agricultural Improvement and Reform Act of 1996 (the 1996 Act), Public Law 104-127, signed April 4, 1996. This act amended the Department of Agriculture Reorganization Act of 1994 (the 1994 Act), P.L. 103-354, Title II, to require the Secretary to establish within the USDA an independent office responsible for supervision of the FCIC, administration and oversight of programs authorized under the Federal Crop Insurance Act (7 U.S.C. 1501 *et seq.*), any pilot or other programs involving revenue insurance, risk management education, risk management savings accounts, or the use of the futures market to manage risk and support farm income that may be established under the Federal Crop Insurance Act or other law; and such other programs the Secretary considers appropriate.

On June 20, 2000 the President signed the Agricultural Risk Protection Act of 2000 into law effective starting with fiscal year 2001. Major provisions of this new legislation include: expanded use of contracts and partnerships for the research and development of policies and other risk management tools; prohibited research and development by the FCIC; revisions in Catastrophic Insurance (CAT) administrative fees and loss adjustment expense reimbursement; significant premium subsidy changes; livestock coverage authorization; reimbursement of research, development and maintenance costs for products submitted to the FCIC; expanded risk management education and assistance; provisions to address under-served areas, states, and commodities; establishment of an expert review panel and procedures for reviewing policies, plans of insurance, and related material or modifications; improved program compliance and integrity provisions; availability and acceptance of electronic information; good farming practices to include scientifically sound sustainable and organic farming practices; and others not included herein.

The objectives include the following items:

- Increase the number of economically sound risk management tools that are available and utilized by producers to meet their needs;
- Increase the agricultural community's awareness of risk management alternatives; and
- Improve program integrity and protect taxpayers' funds.

The Farm Security and Rural Investment Act of 2002 (2002 Farm Bill) was signed into law on May 13, 2002. Major provisions to this new legislation included: Authorization for sweet potato insurance to extend beyond the time the crop is in the field (as in the case of tobacco and potatoes), and expansion of the adjusted Gross Revenue Insurance pilot program into additional counties in California and Pennsylvania.

The FCIC has one delivery system in place to market the MPCCI program. The reinsurance business permits private insurance companies to write MPCCI that is reinsured by the FCIC. These companies were compensated by the FCIC for expenses associated with marketing and fully servicing (including claims adjustment, claims processing, billings, and premium collections) the MPCCI policies reinsured by the FCIC. The reinsurance business has been the FCIC's sole delivery system for the MPCCI since 1998. MPCCI is available for 88 different commodities (approximately 600 commodities as enumerated for disaster assistance purposes) in over 3,000 counties with policies covering all 50 states and Puerto Rico.

The FCIC is under the direction and control of a board of directors, which is appointed by the Secretary.

The FCIC receives all federal appropriations from the U.S. Department of Agriculture, budget classification (code 350).

### **Basis of Presentation and Accounting**

The accompanying consolidated financial statements have been prepared to report the balance sheet, net cost, changes in net position, budgetary resources, and financing of the FCIC. The consolidated financial statements have been prepared from the books and records of the FCIC in accordance with Accounting Principles Generally Accepted in the United States of America (GAAP). GAAP for Federal financial reporting entities recognizes the Federal Accounting Standards Advisory Board (FASAB) as the standard setting body. The financial statements are presented in accordance with the Office of Management and Budget (OMB) Bulletin 01-09, *Form and Content of Agency Financial Statements*. All significant transactions and balances among FCIC's appropriations have been eliminated in consolidation. These consolidated financial statements are different from the financial reports, prepared by the FCIC pursuant to OMB directives, which are used to monitor and control the FCIC's use of budgetary resources.

The FCIC records accounting transactions on both an accrual and budgetary basis of accounting. Under the accrual method, revenues are recognized when earned and expenses are recognized when incurred, without regard to receipt or payment of cash.

Budgetary accounting facilitates compliance with legal constraints and controls over the use of federal funds. All inter-fund balances have been eliminated in the accompanying consolidated financial statements.

#### **Fund Balance With Treasury**

Fund Balance with Treasury represents the aggregate amount of funds in the FCIC's accounts with Treasury for which the FCIC is authorized to make expenditures and pay liabilities. The FCIC's Fund Balance with Treasury consists of appropriated funds and receipts collected from non-federal entities.

#### **Cash Held Outside Treasury and Advances**

Cash held outside Treasury consists of amounts funded to reinsured companies escrow accounts for which the companies' loss checks have not yet cleared.

#### **Accounts Receivable**

Accounts receivable with the public represent premiums from reinsured companies due to the FCIC for crop insurance written by the reinsured companies and reinsured by the FCIC. The reinsured companies are responsible for collecting the premium from the producer and paying the FCIC, whether or not the premium has been collected from the producer. Reinsured companies are also responsible for a portion of the underwriting losses.

Producers' accounts receivable represent amounts due from individual producers for interest, overpaid indemnities, and premiums which are payable directly to the FCIC. It also includes estimated buy-up and catastrophic fees turned over by reinsured companies to the FCIC for collection. The FCIC provides an allowance for uncollectible accounts based upon historical experience.

#### **Property and Equipment**

Property and equipment consists of office furniture, computer equipment, and computer software. Historically, property and equipment with an acquisition cost of \$5,000 or more and an estimated useful life of at least two years was capitalized. Property and equipment with an acquisition cost of less than \$5,000 was expensed when purchased. Beginning in fiscal year 2003, the threshold was increased to \$25,000. Property and equipment is depreciated using the straight-line method over useful lives that range from 6 to 10 years. There are no restrictions on the use or convertibility of the FCIC's property and equipment.

#### **Accounts Payable**

The FCIC accounts for reinsurance administrative expenses as program costs because they vary with, and are directly related to, acquiring new and carry-over business. Due to loss ratios at or in excess of 100% of producer premium without regard to the premium subsidy appropriation, all reinsurance administrative expenses have been expensed in the period in which they were incurred.

Section 508 (k) of the 1994 Act authorizes the FCIC to enter into reinsurance agreements with private insurance companies. Under these agreements, the FCIC assumes the majority of the risk of loss on MPCl written by the reinsured companies.

The 1998 Standard Reinsurance Act (SRA) was renewed through the 2004 reinsurance year, and provides for both proportional and non-proportional means by which the risk of loss may be ceded to the FCIC. The reinsured companies elect the method to transfer risk to the FCIC through their plan of operation. The plan of operation becomes a part of the SRA for each reinsurance year (July 1 through June 30).

Proportional reinsurance provides for a one-to-one percentage exchange of losses and premiums between the reinsured company and the FCIC. A reinsured company may not cede to the FCIC, under proportional methods, premiums that exceed 65% of its total book of business for the 2004 and 2003 reinsurance contracts. The FCIC uses nonproportional reinsurance programs (stop loss) which limit losses in the reinsured's retained book of business after the cessions made under proportional methods. Stop loss reinsurance is applied by state and by fund, if necessary, based upon the ratio of the reinsured's ultimate net losses to its retained net book premium.

The SRA provides for reimbursement to the reinsured companies for administrative expenses, including loss adjustment expenses. The SRA's reimbursement rates (as a percent of premium) are as follows for the 2004 and 2003 reinsurance years: Group Risk Plans (GRP), 22.7%; revenue plans that could increase liability at harvest, 21.1%; and all other plans, 24.5%. Reinsured companies were also allowed an expense reimbursement for adjusting catastrophic claims of 8% for the 2004 and 2003 reinsurance years.

#### **Retirement Plans**

Most employees hired after December 31, 1983 are covered by the Federal Employees Retirement System (FERS). FERS is a three-tiered retirement plan consisting of Social Security benefits, a basic plan benefit, and a thrift savings plan (TSP). The FCIC and the employee each contribute 6.2% of the employee's basic pay through payroll taxes for Social Security benefits. Under the FERS basic benefit plan, the employee contributes .8% of basic pay and the FCIC contributes 10.7% of basic pay for FERS employees. The cost of providing the FERS basic benefit is equal to the amounts contributed by the FCIC and the employees because the plan is fully funded.

A TSP account is automatically established for employees covered by FERS, and the FCIC makes a mandatory contribution of 1% of basic pay to this account. Employees are eligible to contribute up to 14% (13% in fiscal year 2003) of basic pay to their TSP account subject to a maximum overall yearly contribution of \$13,000 (\$12,000 in calendar year 2003). The FCIC makes matching contributions, ranging from 1% to 4%, for employees who contribute to their TSP accounts.

Most employees hired on or before December 31, 1983, participate in the Civil Service Retirement System (CSRS.) CSRS is a single benefit retirement plan. The FCIC and the employee each contribute 8% of the employee's basic pay. Employees covered under CSRS are eligible to contribute up to 9% of basic pay to a TSP account to a maximum overall yearly contribution of \$13,000 (\$12,000 in calendar year 2003). The FCIC makes no matching contributions to TSP accounts established by employees covered under CSRS.

The limits will continue to increase by one percentage point per year through fiscal year 2005, after which all participants will be eligible to contribute up to the Internal Revenue Code's annual deferral limit (\$14,000 in calendar year 2005).

The FCIC does not report FERS or CSRS assets, accumulated plan benefits, or unfunded liabilities on its consolidated financial statements. Reporting such amounts is the responsibility of the Office of Personnel Management (OPM).

Statement of Federal Financial Accounting Standards No. 5, *Accounting for Liabilities of the Federal Government*, requires Federal entities to recognize an expense for pensions and other retirement benefits at the time the employee's services are rendered. The purpose of recognizing this expense is to record and report the full cost of each entity's operation. A corresponding revenue, Imputed Financing Sources, is recognized to the extent pension and other retirement benefit expenses exceed the amount paid to the OPM. The OPM imputed costs were \$3.8 million in fiscal year 2004 and fiscal year 2003.

#### **Fair Value of Financial Instruments**

In the case of the FCIC's financial instruments, the carrying values approximate fair values because of their short-term maturity.

#### **Use of Estimates**

The preparation of these consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The significant estimates made are in connection with the recognition of the losses on insurance claims liability.

#### **Reclassifications**

Certain reclassifications were made to prior year amounts to conform to the current year presentation.

#### **Net Position**

Net position is the residual difference between assets and liabilities and is composed of capital stock, additional paid-in capital, unexpended appropriations, and cumulative results of operations. Unexpended appropriations represent the amount of unobligated and unexpended budget authority. Unobligated balances are the amount of appropriations or other authority remaining after deducting the cumulative obligations from the amount available for obligation and undelivered orders. Cumulative results of operations are the net result of the FCIC's operations since inception.

#### **Unearned Revenue**

Premium revenue is comprised of producer paid premium. Producer paid premium is recognized as earned ratably over each crop's growing season. The portion of producer paid premium not recognized at the conclusion of the fiscal year is classified as "unearned revenue, with the public" in the consolidated balance sheets. Premium subsidy is recognized as earned when expended. The unexpended premium subsidy remains an unexpended appropriation in the consolidated balance sheets.



The sum of producer paid premium and premium subsidy has been calculated using generally accepted actuarial methods to attain a forecasted break-even loss ratio of 100%. Premium subsidy is not considered written to the extent a portion remains unexpended and no unearned revenue is recorded in the consolidated balance sheets. As a result, the expected claim costs and claims adjustment expenses exceed the related unearned revenue. A premium deficiency is therefore recognized in the consolidated balance sheets by accruing a liability recorded as an other liability for the excess amount.

Insurance Fund appropriations, Administrative and Operation (A&O) Fund appropriations, and other financing sources are recognized when expended, which corresponds to when the expenses are incurred. The amount of appropriations not expended is a component of unexpended appropriations in the net position of the Balance Sheet.

In fiscal years 2004 and 2003, the FCIC received appropriations for the Insurance Fund and the RMA received appropriations for the A&O Fund. The Insurance Fund appropriations are available until expended, while the A&O Fund appropriations are available to cover obligations incurred in a given fiscal year. These consolidated financial statements include all activity related to the Insurance Fund and A&O Fund appropriations.

### **Claims Recognition**

The liability for estimated losses on insurance claims represents those claims that have been incurred, but for the most part, have not been reported to the FCIC as of the Balance Sheet date. The estimation of these liabilities relies on calculations using historical yield estimates provided by USDA National Agricultural Statistics Service (NASS) and future commodity prices.

There are certain uncertainties associated with assumptions used to estimate the losses on insurance claims. As a result, the ultimate liability may differ significantly from the recorded estimate. These uncertainties may include: actual yields which may be different than those provided by the NASS estimates; changes in weather patterns close to harvesting dates which could affect yields but not be reflected in the NASS estimates; commodity prices which may change from those in the market because of many factors such as: weather, yields and economic conditions; and significant catastrophic weather events (i.e. hurricanes and freezes) occurring near the balance sheet date which could affect estimated crop yields and crop prices.

Administrative expenses associated with claims adjusters and reinsured companies are paid through the FCIC's Insurance Fund. Indemnity costs are paid from premium proceeds, including premium subsidies and premium discounts, which are also a part of the FCIC's Insurance Fund.

The estimated aggregate loss ratio including the premium subsidy appropriation for 2004 crop year was approximately 85.57 % (\$0.86 of claims for every \$1.00 of premium and premium subsidy) and the actual aggregate loss ratio for 2003 crop year was approximately 94.64% (\$0.95 for every \$1.00 of premium and premium subsidy). In the 2004 and 2003 fiscal years, federal premium subsidy funded approximately 60% of the

total premium with approximately 40% being paid by the producer. This translates to an estimated \$1.72 billion and \$1.40 billion in farmer paid premium in crop years 2004 and 2003 respectively, with an estimated \$2.49 billion and \$2.09 billion in estimated premium subsidies for crop years 2004 and 2003.

## 2. FUND BALANCE WITH U.S. TREASURY:

<u>2004</u> (in millions)			
	<u>Appropriated</u> <u>Funds</u>	<u>Revolving</u> <u>Funds</u>	<u>Total</u>
Obligated	\$ 18	103	121
Unobligated available	-	2,057	2,057
Unobligated unavailable	3	-	3
<b>Total</b>	<b>\$ 21</b>	<b>2,160</b>	<b>2,181</b>

<u>2003</u> (in millions)			
	<u>Appropriated</u> <u>Funds</u>	<u>Revolving</u> <u>Funds</u>	<u>Total</u>
Obligated	\$ 18	123	141
Unobligated available	-	1,851	1,851
Unobligated unavailable	4	-	4
<b>Total</b>	<b>\$ 22</b>	<b>1,974</b>	<b>1,996</b>

The FCIC maintains separate accounts for the A&O (appropriated) and Insurance (revolving) Funds. The A&O Fund is used to pay administrative and operating expenses. The Insurance Fund is used to pay losses, and can also be used to pay claim adjustment expenses, reinsured company expenses, and costs referenced in the Agricultural Risk Protection Act. The FCIC does not earn interest on funds maintained in U.S. Treasury accounts. All funds are currently available to the FCIC except for the unobligated appropriated (i.e., A&O) funds that were only available for obligations through September 30, 2004.

## 3. ACCOUNTS RECEIVABLE:

Accounts receivable, net, federal and non-federal is as follows:

<b>2004</b> (in millions)	<u>Gross</u> <u>Accounts</u> <u>Receivable</u>	<u>Allowance for</u> <u>Uncollectible</u> <u>Accounts</u>	<u>Net</u> <u>Accounts</u> <u>Receivable</u>
Intragovernmental	\$ -	-	-
With the Public	1,501	14	1,487
<b>Total</b>	<b>\$ 1,501</b>	<b>14</b>	<b>1,487</b>

<b>2003</b> (in millions)	Gross Accounts <u>Receivable</u>	Allowance for Uncollectible <u>Accounts</u>	Net Accounts <u>Receivable</u>
Intragovernmental	\$ 1	-	1
With the Public	1,165	13	1,152
<b>Total</b>	<b>\$ 1,166</b>	<b>13</b>	<b>1,153</b>

The allowance for uncollectible accounts also represents approximately \$13.8 million and \$12.1 million for reinsurance recoverables in fiscal years 2004 and 2003 respectively, and \$0.6 million for uncollectible CAT and additional coverage fees in fiscal year 2003.

#### **4. CASH HELD OUTSIDE TREASURY AND ADVANCES:**

Cash Held Outside Treasury and Advances consist of the following:

	2004	2003
	(in millions)	
Cash held outside Treasury for Reinsurance escrow losses	\$ 83	99
Advances to reinsured companies for state premium subsidy	1	1
<b>Total Cash held outside Treasury and advances</b>	<b>\$ 84</b>	<b>100</b>

The FCIC's Cash Held Outside Treasury represents amounts funded to escrow accounts for which the companies' loss checks have not yet cleared.

#### **5. ACCOUNTS PAYABLE:**

Accounts payable, with the public, is as follows:

	2004	2003
	(in millions)	
Reinsured companies	\$ 82	112
<b>Total accounts payable with the public</b>	<b>\$ 82</b>	<b>112</b>

Accounts payable to reinsured companies represent the reimbursement to the reinsured companies for administrative expenses, including claim adjustment expenses, as provided by the SRA.

## 6. ESTIMATED LOSSES ON INSURANCE CLAIMS:

The following table summarizes the activity in the accrual for estimated losses on insurance claims.

	<u>2004</u>	<u>2003</u>
	(in millions)	
Balance as of October 1	\$ 2,803	2,874
Incurred Related to:		
Current year	3,553	3,967
Prior year	(725)	(199)
Total Incurred	<u>2,828</u>	<u>3,768</u>
Less Paid Related to:		
Current year	(781)	(775)
Prior year	(2,492)	(3,064)
Total Paid	<u>(3,273)</u>	<u>(3,839)</u>
Net Balance as of September 30	\$ 2,358	2,803

As a result of developments in losses from insured events in prior years, the estimated losses on insurance claims decreased by \$725 million and \$199 million for the years ended September 30, 2004 and 2003 respectively. Differences in actual versus estimated revenue/yield losses on corn contributed most significantly to the difference. The estimated losses for corn at September 30, 2003 were \$1,230 million versus actual incurred losses of \$700 million. The variance is primarily due to an overestimate of the revenue (price) component of the corn losses. As discussed above, the difference between the estimated losses and the actual incurred losses were due to differences in the actual crop yields and crop prices as compared to previous crop yield estimates provided to NASS and the crop prices from the commodities futures markets.

The potential amount of variance due to uncertainty in the estimated losses for 2004 is heightened due to several factors. Florida and the southeastern US experienced hurricanes and excessive moisture, and the north central US experienced early autumn freezes which are responsible for late season crop damage. Consequently, the loss estimates are subject to potentially large variances due to: (1) the very short time between the events and the collection of the latest data used for estimating losses; (2) the unusually high yields can impact the commodity prices and affect the estimated losses for revenue insurance products; and (3) the impact of extremely low or high yields for 2004 in certain major areas where the methods used to estimate losses are dependent on a very limited number of historical data points with similar low or high yields.

**7. UNEARNED REVENUE:**

Unearned revenue is as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Unearned producer premium	\$ 292	\$ 235

**8. OTHER LIABILITIES:**

Other liabilities covered by budgetary resources, federal and non-federal, are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Federal		
Other accrued liabilities	\$ 4	\$ 4
Total other liabilities, federal subtotal	4	4
Non-Federal:		
Underwriting gain payable to reinsured companies	776	180
Reserve for premium deficiency	420	342
Annual leave liability	4	3
Other accrued liabilities	5	4
Total other liabilities, non-federal subtotal	1,205	529
Total other liabilities	\$ 1,209	\$ 533

Premiums and losses are reported monthly under the SRA and a periodic settlement, as stipulated in the agreement is calculated whereby the results of the business written by the reinsured companies are determined and an experience-rated underwriting gain or loss is computed. Underwriting gains are paid to the reinsured companies while the reinsured companies pay underwriting losses to the FCIC. However, a portion of the underwriting gain payable includes amounts being held in reserve from prior years for any future underwriting losses incurred by the reinsured companies.

Liabilities not covered by budgetary resources are not funded by current appropriations from Congress. Included in other intragovernmental liabilities are liabilities that are not covered by budgetary resources that amount to approximately \$0.5 million and \$0.5 million for unfunded Federal Employees Compensation act (FECA) liability. Included in liabilities with the public are liabilities not covered by budgetary resources that amount to approximately \$3.7 million and \$3.4 million for unfunded annual leave for fiscal years 2004 and 2003, respectively. Annual leave is accrued as it is incurred and the accrual is reduced as it is taken. As of September 30, 2004 and 2003, the balance in the accrued

annual leave account was adjusted to reflect current pay rates and annual leave balances. Additional liabilities not covered by budgetary resources are \$1,339 million for indemnity costs as of September 30, 2003. There were no additional liabilities not covered by budgetary resources for indemnity costs as of September 30, 2004.

A premium deficiency has been recorded as the expected claim costs and claim adjustment expenses exceed the related unearned revenue.

## 9. NET POSITION:

<b>2004</b> (in millions)	Revolving Funds	Appropriated Funds	Total
Capital stock	\$ 500	-	500
Additional paid-in capital	38	-	38
Unexpended Appropriations:			
Unliquidated obligations	-	16	16
Unobligated, not available	-	3	3
Unobligated, available	290	-	290
Subtotal, unexpended Appropriations	290	19	309
Cumulative Results of Operations:			
Donated capital	3,958	-	3,958
Results of operations	(4,990)	(6)	(4,996)
Subtotal, cumulative results of operations	(1,032)	(6)	(1,038)
Total net position	\$ (204)	13	(191)

<b>2003</b> (in millions)	Revolving Funds	Appropriated Funds	Total
Capital stock	\$ 500	-	500
Additional paid-in capital	38	-	38
Unexpended Appropriations:			
Unliquidated obligations	-	16	16
Unobligated, not available	-	4	4
Unobligated, available	342	-	342
Subtotal, unexpended Appropriations	342	20	362
Cumulative Results of Operations:			
Donated Capital	3,958	-	3,958
Results of operations	(5,289)	(7)	(5,296)
Subtotal cumulative results of Operations	(1,331)	(7)	(1,338)
Total net position	\$ (451)	13	(438)

### Donated Capital:

Prior to the 1994 Act, the Secretary was authorized to use the funds of the Commodity Credit Corporation, (CCC) to pay claims of the FCIC if the funds available to the FCIC for that purpose were insufficient. The 1994 Act eliminated the need for the FCIC to request funds from the CCC. Although the authority to use the CCC funds still exists, the FCIC is now authorized to draw necessary funds directly from the U.S. Treasury (with USDA and OMB approval) to cover operating expenses including excess losses.

### Capital Stock:

Section 504 (a) of the 1994 Act authorizes capital stock of \$500 million subscribed by the United States. There has been no change in the capital stock issued since August 15, 1985.

## 10. INDEMNITY COSTS:

Insurance indemnity costs are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Catastrophic coverage	\$ 39	80
Additional coverage	2,789	3,688
Insurance claims and indemnities	\$ 2,828	3,768

## 11. PROGRAM DELIVERY AND OTHER PROGRAM COSTS:

Program delivery costs are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Reinsurance administrative expenses	\$ 900	743

Federal other program costs are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Reimbursable costs	\$ 43	32
Other retirement benefit, other post-employment benefit, FECA, and other costs	7	6
Imputed costs	11	11
Total federal other program costs	\$ 61	49

Non-federal program costs are as follows:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Other program costs	\$ 37	53
Administrative and other cost	45	48
<b>Total non-federal other program costs</b>	<b>\$ 82</b>	<b>101</b>

## 12. FINANCING SOURCES:

In fiscal years 2004 and 2003, the FCIC received an Insurance Fund appropriation of \$3.4 billion and \$2.9 billion respectively, for premium subsidy, reinsurance administrative expenses and other program expenses and for research and development. In fiscal years 2004 and 2003, the RMA A&O Fund appropriation was \$71.4 million and \$70.7 million respectively.

Provisions of Agricultural Risk Protection Act (ARPA) place a major emphasis on contracting and partnering for development of risk management products. ARPA provides incentives for private parties to develop and submit new risk management products to the FCIC Board of Directors. In fiscal year 2004, \$78 million was appropriated for ARPA expenses with \$5 million being transferred to Cooperative State Resource, Education, and Extension Service (CSREES.) In fiscal year 2003, \$68 million was appropriated for ARPA expenses with \$5 million being transferred to CSREES.

The following table summarizes appropriations used:

	<u>2004</u>	<u>2003</u>
	(in millions)	
Net A&O appropriation used	\$ 71	77
Appropriation for premium subsidy	2,507	1,868
Appropriation for ARPA costs	55	33
Appropriation for delivery costs	430	730
Appropriation for excess losses	342	190
Appropriation for Emergency Financial Assistance (EFA) discount	1	-
Insurance fund appropriations, subtotal	3,335	2,821
<b>Total appropriations used</b>	<b>\$ 3,406</b>	<b>2,898</b>



### **13. COMMITMENTS AND CONTINGENCIES:**

The FCIC is a defendant in various litigation cases arising in the normal course of business. Furthermore, in order to defend its policies and procedures, the FCIC may, in some instances, pay litigation expenses and judgments over and above indemnities found under the SRA for reinsured companies. For this reason, the FCIC is consulted with and approves significant decisions in the litigation process.

In fiscal year 2003, one of the reinsured companies, American Growers Insurance Company (AGIC), was placed under an order of supervision by the Nebraska Department of Insurance. On December 10, 2002, the FCIC signed a Memorandum of Understanding (MOU) with the Nebraska Department of Insurance that establishes the responsibilities and understandings between the FCIC and the Nebraska Department of Insurance with respect to AGIC. The FCIC is working with the Nebraska Department of Insurance and AGIC management to ensure that all outstanding policy claims will be paid and service to producers will continue.

The MOU establishes the framework to ensure that AGIC personnel, loss adjustors, and agents continue servicing policyholders. To achieve these goals, key employees at AGIC have been retained to finish servicing the 2002 crop year book of business. In addition, expenses related to loss adjustment, billing, and agents commissions associated with policies reinsured by the FCIC and paid to ensure the timely payment of crop insurance claims, adequate levels of service going forward, and the timely collection and transmission of premiums to the FCIC. Further, maintaining a viable agent network is essential to making sure that policyholders are quickly transferred to other crop insurance companies for subsequent crop years.

FCIC incurred \$6.8 million and \$34 million in administrative costs of AGIC in fiscal years 2004 and 2003, respectively. Additional costs may be incurred by FCIC for other administrative costs of AGIC; however, these costs are not currently quantifiable.

### **14. STATEMENT OF BUDGETARY RESOURCES:**

FCIC's Statement of Budgetary Resources serves as a tool to link budget execution data to information reported in the "actual" column of the Program and Financing Schedules in the Appendix of the Budget of the United States Government (referred to as the "President's Budget") as well as information reported in the Reports of Budget Execution and Budgetary Resources (SF-133). Some reporting differences do exist between comparable amounts in the Statement of Budgetary Resources, the President's Budget, and the SF-133. These differences are discussed in detail in Note 16.

## **15. STATEMENT OF FINANCING:**

The total budgetary and non-budgetary resources used to finance operations totaled \$3.1 billion in fiscal year 2004 and \$3.6 billion in fiscal year 2003. The fiscal year change in undelivered orders was not part of the net cost of operations, and totaled (\$11) million in fiscal year 2004 and \$16 million in fiscal year 2003. FCIC has determined that liabilities are incurred and the appropriation expended at the point in time the appropriations are used to subsidize a paid indemnity.

FCIC records estimates related to revenue from the public, delivery costs, and indemnity costs that are components of the statement of net cost but are not included in the Statement of Budgetary Resources. The fiscal year change in these accruals and estimates is included in the Statement of Financing section for Components of the Net Cost of Operations that will not require or Generate Resources in the Current Period. The revenue estimates and revenue accruals are included in the line entitled Change in Exchange Revenue from the Public. The Other line in this section includes liabilities that will be funded by future budgetary resources. These liabilities include the indemnity and delivery cost estimates and future funded expenses for annual leave and Federal Employees' Compensation Act.

## **16. CORRECTION OF ERROR AND CHANGE IN ACCOUNTING POLICY:**

FCIC determined that it had incorrectly recorded certain estimated losses on insurance claims as obligations incurred on its fiscal year 2002 combined statement of budgetary resources. Consequently, FCIC incorrectly reported beginning obligated and unobligated budgetary resources and obligations incurred in its 2003 financial statements. The 2003 combined statement of budgetary resources and consolidated statement of financing have been restated from the amounts previously recorded to correct for this error. A summary of the effects of the restatement is presented in the table below.

Additionally, in fiscal year 2004, FCIC changed its accounting policy related to its escrow accounts. Treasury issued requirements for reporting Cash Held Outside Treasury which required that amounts held in escrow accounts be reclassified to Cash Held Outside Treasury. The escrow accounts had formerly been reported as Advances to Others. The escrow account balance was approximately \$100 million and \$83 million as of September 30, 2003 and 2004, respectively. Furthermore, Treasury does not consider escrow account balances as outlays until the funds are transferred from an escrow account to the reinsured companies' clearing accounts to cover producers' cleared checks.

This change in accounting policy resulted in a reclassification on the Balance Sheet from Other Assets to Cash Held Outside of Treasury. It also resulted in a restatement of the fiscal year 2003 beginning obligated and unobligated balances and net outlays on the Statement of Budgetary Resources.

The following tables summarize the restatement of balances.

Statement of Budgetary Resources

2003 (in millions)	Obligated Balance, Net, Beginning of Period	Unobligated Balance, Beginning of Period	Obligations Incurred	Outlays, Disbursement s	Obligated Balance, Net, End of Period – Accounts Payable
Balance, as previously reported	\$ 1,331	\$ 1,027	\$ 2,983	\$ 4,163	\$ (57)
Correction of error	(1,170)	1,170	1,170		
Balance, as corrected	161	2,197	4,153	4,163	(57)
Change in accounting policy	115			16	(99)
Balance, as reflected herein	\$ 276	\$ 2,197	\$ 4,153	\$ 4,179	\$ (156)

Statement of Financing

2003 (in millions)	Obligations Incurred	Other Components Requiring or Generating Expenses in Future Years	Change in exchange revenue receivable from the public
Balance, as previously reported	\$ 2,983	\$ 1,520	\$ (89)
Correction of error	1,170	(1,348)	178
Balance, as reflected herein	\$ 4,153	\$ 172	\$ 89

**SUPPLEMENTARY STEWARDSHIP INFORMATION (UNAUDITED):****Schedule 1**

In response to the Secretary's 1996 Risk Management Education (RME) initiative, and as mandated by the 1996 Act, the FCIC has formed new partnerships with the Cooperative State Research, Education, and Extension Service (CSREES), the Commodity Futures Trading Commission, the USDA National Office of Outreach, Economic Research Service, and private industry to leverage the federal government's funding of its RME program by using both public and private organizations to help educate their members in agricultural risk management. The RME effort was launched in 1997 with a Risk Management Education Summit that raised awareness of the tools and resources needed by farmers and ranchers to manage their risks. RMA has built on this foundation during fiscal year 2003 by expanding State and Regional education partnerships; encouraging the development of information and technology decision aids; supporting the National Future Farmers of America (FFA) foundation with an annual essay contest; facilitating local training workshops; and supporting Cooperative Agreements with Educational and outreach organizations.

During fiscal years 2004 and 2003, the RME worked toward the goals by funding risk management sessions, most of which targeted producers directly. The number of producers reached through these sessions is approximately 46,000 in fiscal year 2004 and 62,000 in fiscal year 2003. In addition to reaching producers, some training sessions helped those who work with producers, such as lenders, agricultural educators, and crop insurance agents, better understand those areas of risk management with which they may be unfamiliar. Total RME obligations incurred by the FCIC were approximately \$9.8 million for fiscal year 2004 and \$9.4 million for fiscal year 2003. The following table summarizes the RME initiatives since fiscal year 2000.

	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
	(dollars in millions)				
RME Obligations	\$ 10	9	6	5	1
Number of producers attending RME sessions	46,000	62,000	50,000	50,000	30,000

One of the directives of ARPA is to step up the FCIC's educational and outreach efforts in certain areas of the country that have been historically underserved by the Federal crop insurance program. The Secretary determined that fifteen states met the underserved criteria. These states are Maine, Massachusetts, Connecticut, Wyoming, New Jersey, New York, Delaware, Nevada, Pennsylvania, Vermont, Maryland, Utah, Rhode Island, New Hampshire, and West Virginia.

**REQUIRED SUPPLEMENTARY INFORMATION (UNAUDITED):**  
**Schedule 2**

Intra-governmental balances:

FCIC reports the following amounts as intra-governmental assets and liabilities, which are included in the September 30, 2004 and 2003 consolidated balance sheets:

Intra-governmental assets:

<u>2004</u> (in millions)		
<u>Agency</u>	<u>Fund Balance with Treasury</u>	<u>Accounts Receivable</u>
Department of the Treasury	\$ 2,181	-
Other Federal Agencies	-	-
<b>Total intra-governmental assets</b>	<b>\$ 2,181</b>	<b>-</b>

<u>2003</u> (in millions)		
<u>Agency</u>	<u>Fund Balance with Treasury</u>	<u>Accounts Receivable</u>
Department of the Treasury	\$ 1,996	-
Other Federal Agencies	-	1
<b>Total intra-governmental assets</b>	<b>\$ 1,996</b>	<b>1</b>

Intra-governmental liabilities:

<u>2004</u> (in millions)		
<u>Agency</u>	<u>Accounts Payable</u>	<u>Other Liabilities</u>
Department of Agriculture	\$ -	4
Other Federal Agencies	-	-
<b>Total intra-governmental liabilities</b>	<b>\$ -</b>	<b>4</b>

<u>2003</u> (in millions)		
<u>Agency</u>	<u>Accounts Payable</u>	<u>Other Liabilities</u>
Department of Agriculture	-	5
Other Federal Agencies	-	(1)
<b>Total intra-governmental liabilities</b>	<b>\$ -</b>	<b>4</b>