GAO

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

Accounting and Information
Management Division

B-277528

August 1, 1997

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

Subject: Financial Audit: Other Matters Identified During GAO's 1996 Financial Statement Audits

Dear Mr. Hove:

In June, we issued our opinions on the calendar year 1996 financial statements of the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and FSLIC Resolution Fund (FRF). We also issued our opinion on the Federal Deposit Insurance Corporation (FDIC) management's assertions regarding the effectiveness of its system of internal controls as of December 31, 1996, and reported on FDIC's compliance with significant provisions of selected laws and regulations for the three funds for the year ended December 31, 1996 (GAO/AIMD-97-111 June 30, 1997). In addition, we are communicating several other matters to you--in a separate letter because of their sensitive nature--concerning electronic data processing security.

The purpose of this letter is to advise you of accounting policies and procedures and internal control matters identified during our audits of the 1996 financial statements. We suggest improvements to address those weaknesses, which include the need to improve controls related to asset valuation, receipt processing, check disbursement procedures, disbursement documentation, and payroll records. In addition, FDIC should review the impact of using cash based accounting to record securitization reserve interest.

Although these matters were not material in relation to the financial statements, we believe that they warrant the attention of management. We provided FDIC officials with a draft of this letter and discussed the matters addressed in

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it with them. They agreed with our findings and suggestions. We will follow up on these matters during our audits of the 1997 financial statements.

VALUATION OF ASSETS IN LIQUIDATION

As part of its Asset Loss Review (ALR) project, FDIC implemented the Standard Asset Valuation Estimation (SAVE) methodology in 1996 to estimate the recovery values for failed institution assets in liquidation. The objective of the ALR project is to prepare fund-level asset recovery estimates for use in the FDIC's calculation of loss reserves for BIF, SAIF, and FRF. The ALR instruction manual requires first- and second-level review of all SAVE work products to verify that asset valuations are reasonable. In order to ensure compliance with these requirements, quality control procedures over the preparation and review of individual asset estimates are a necessary element of FDIC fieldwork.

However, during our audits we found that FDIC preparers did not always use all relevant file information for estimating the recovery values for individual assets. In addition, we found numerous errors in the valuation of certain complex assets, such as subsidiary equity and subsidiary loan assets. We found that FDIC's primary and secondary review procedures were not adequate to detect the above errors.

According to FDIC officials, preparers did not have sufficient time to ensure a thorough file review and to accurately complete the related valuation documents. Therefore, preparers overlooked information significant to the asset estimates or made errors when preparing the cash flow worksheets (CFW) used to value the assets. FDIC's review procedures were also subject to the same time pressures, and in some cases, were not properly conducted. As a result, FDIC lacked assurance that individual assets were reasonably valued. This, in turn, could affect the accuracy of FDIC's statistical projections to that class of assets. These projections are an integral component in FDIC's calculation of the allowance for losses on BIF's and FRF's receivables from resolution activity and investment in corporate owned assets.

During our audits, we found that the errors made on individual asset values were generally offsetting and, therefore, did not affect the overall estimates. However, a continued quality control problem with individual asset valuations presents risk for future estimates. Therefore, during the course of our audits, we suggested that FDIC review its fieldwork implementation procedures to identify specific actions which could be taken to improve quality control during its asset valuation process. In addition, we suggested that FDIC assign personnel with specialized knowledge to estimate recoveries for complex assets, such as subsidiary equity and subsidiary loan assets.

For its summer 1997 valuation round, FDIC has developed and implemented improved review requirements. These requirements direct the primary reviewer to compare each CFW to the source documents in the file to verify the preparer's appropriate use of information in developing the asset's value. In addition, the primary reviewer is required to ensure that the proper valuation methodology was followed, and that the preparer's analysis is reasonable. FDIC is also planning to establish a team with the specialized knowledge required to value complex assets, such as subsidiary equity and subsidiary loans.

RECEIPTS PROCESSING IN FIELD OFFICES

The Division of Administration's (DOA) standard operating procedures for mail room operations require that mail containing monetary items be opened under dual control. Also, the Division of Finance's (DOF) Regional Accounting Manual (RAM) required establishing control totals for each day's receipts when received. The RAM also required that monetary items held (i.e., not included in the daily deposit) be logged until released or deposited. The Comptroller General's Standards for Internal Controls in the Federal Government require supervisory review of staff's work to ensure management objectives are met and errors or misunderstandings of procedures are detected, and that duties are properly segregated.

During our audits, we found that receipts were not properly controlled at six field offices. Specifically, we noted the lack of (1) dual control at two offices, (2) establishing control totals at the initial point of receipt at three offices, (3) accountability (no "Hold" log) for monetary items held for research at three offices, (4) supervisory review on receipts forwarded to the Field Finance Center (FFC)[1] at four offices, and (5) segregation of duties at one office.

Receipts were not properly controlled because when DOF consolidated its cashier function into FFC, DOF and DOA did not modify receipt and mail room procedures and borrowers

[1]FFC was formerly the National Financial Service Center.

continued to mail their payments to field offices. These control weaknesses created the opportunity and potential for monetary items to be misplaced, temporarily forgotten, misappropriated, or misdirected.

In December 1996, FFC directed field offices to not hold monetary items, but rather to immediately forward them to FFC. Also, in February 1997, DOF placed in operation the Field Financial Operation (FFO) Accounting Manual. The new manual replaces the RAM and establishes specific procedures field offices are required to perform when monetary items are received and then transferred to FFC. FFC obtained the field offices affirmation that they are now in compliance with the FFO Accounting Manual. Further, DOA has proposed working with DOF to review its mail room procedures, develop a directive pertaining to mail room operations, and establish a review program to ensure compliance with the new directive.

We suggest DOA and DOF proceed with DOA's proposal. DOA's revised mail room operations should include adequate safeguards, accountability, and supervisory controls over receipts.

GAPS IN CHECK NUMBERS

FDIC's Accounts Payable Procedures Manual and FFO Accounting Manual, in effect through 1996, required that disbursements be accurately recorded in the appropriate period and correctly classified in general ledger accounts to permit preparation of reports and statements in conformity with the Corporation's policies. These manuals also required that checks be issued in numerical sequence and that missing documents be immediately reported.

Prior to selecting our sample of 1996 check disbursements for testing, we reviewed the population of check disbursement data from FDIC's accounts payable systems for possible gaps in issued check numbers. Based on this review, we found 25 Liability Dividend System (LDS) checks that were not uploaded into the accounts payable system and were not recorded in the general ledger during 1996. In addition, we found two LDS checks that were not used. For these two checks, FDIC was unable to provide sufficient documentation to show why these checks were not used.

Because FDIC did not have procedures in place to identify and explain check number gaps, controls were not in place during 1996 to account for all checks or to ensure that funds were safeguarded against unauthorized use. In addition, the general ledger did not properly reflect all check disbursement activity that occurred during 1996. Although these amounts were immaterial in 1996, material misstatements could occur in the future if check gap control procedures are not in place.

We suggest that FDIC implement specific procedures to ensure that all check number gaps are identified and resolved promptly. In addition, we suggest that LDS be modified so that the system automatically generates the next starting check number as dividends are processed.

DISBURSEMENT PROCEDURES

The Comptroller General's Standards for Internal Controls in the Federal Government require that transactions be authorized and executed only by persons acting within the scope of their authority. Accordingly, FDIC's Accounts Payable Procedures Manual established the scope of authority relating to approval of disbursements within the Accounts Payable System (APS). The manual required that only supervisory personnel with release authority approve disbursements within the APS.

During our 1996 audits, we found that the accounts payable supervisor and the accounting manager in the FFC granted clerks in the accounts payable unit the authority to approve disbursements within APS. Although FFC management stated that the change was due to the downsizing of staff, FFC did not provide documentation supporting that the proper official approved this deviation from established procedures. Changes in authorizations without proper approval could lead to transactions not being processed in accordance with FDIC's policies and procedures.

FFC management informed us that the clerks are no longer authorizing transactions and their supervisory capability within APS has been deleted. Further, security records indicate that the clerks did not have concurrent input and approval capability within APS, thereby maintaining segregation of duties.

Nonetheless, we suggest that FDIC require personnel to obtain approval by the proper official before implementing any deviations from established disbursement procedures.

DISBURSEMENT DOCUMENTATION

The Comptroller General's Standards for Internal Controls in the Federal Government require written evidence of all pertinent aspects of transactions and require the transaction documentation to be complete and readily available for examination. The FDIC's Accounts Payable Manual and Accounts Payable Procedures Manual, in effect during 1996, required a DOF approving official to initial the Group Edit Report (GER) or sign the Daily Invoice Register (DIR) after reviewing for validity, accuracy, and completeness of critical disbursement data entered into the accounts payable system. The manuals specifically identified the GER and the DIR as documentation required to be retained for disbursement transactions.

However, for eight disbursement transactions we tested as part of our 1996 audits, FFC personnel could not provide us with all the required documents. Specifically, FDIC was unable to provide five GERs and three DIRs. FFC management stated that one GER was destroyed based on its local GER retention policy and that another GER was discarded after being used as part of Financial Information Management System testing.[2] FFC personnel could not locate the remaining signed/initialed three GERs and three DIRs. By not maintaining these documents, FFC is not complying with its established procedures. Further, the absence of the GERs and DIRs reduces the amount of evidence that critical disbursement data entered into the accounts payable system was reviewed for validity, accuracy, and completeness.

We suggest that FDIC review its procedures to (1) identify disbursement documents that should be retained and (2) ensure documentary evidence of the review of critical disbursement data entered into its accounts payable system be readily available for examination.

TIME AND ATTENDANCE AND RELATED REPORTS

FDIC's record retention and disposition procedures require that copies of payroll and related records be retained for 6 years. FDIC could not locate time and attendance related reports for five of the payroll transactions we tested as part of our 1996 audits. The missing records pertained to employee representations and supervisory approvals of hours worked.

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[2]Beginning in 1997, FDIC established a new general ledger system called the Financial Information Management System.

FDIC representatives stated their belief that these are isolated instances and not indicative of a systemic internal control weakness and that records may have been misplaced during downsizing of field offices and decentralizing of payroll records. However, FDIC acknowledged the importance of retaining payroll related records in order to deter fraud, waste, and abuse, and to maintain an audit trail; it recently issued internal communication to all Divisions and Offices reiterating record retention requirements. FDIC is also planning to (1) list the specific record retention responsibilities in its upcoming revised Time & Attendance Reporting Directive scheduled for implementation during the third quarter of 1997 and (2) revise its time and attendance process in 1998 to be able to maintain electronic copies of documents in place of hard copies.

We suggest that the FDIC Division of Administration continue to periodically emphasize its record retention policies to all FDIC personnel responsible for payroll and time and attendance record keeping.

FRF'S SECURITIZATION RESERVE

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

During 1996, FDIC recorded the interest income on FRF's securitization reserve (established to cover future estimated losses on securitization transactions) on a cash basis of accounting. Thus, interest income was only recognized when cash payments were received. Because some of the reserve funds are invested in securities with maturities up to 6 months, an accrual basis of accounting would more fairly state securitization reserve fund interest income in accordance with GAAP. During 1996, FDIC recorded $82.1 million in interest income on a cash basis. This figure represented 3 months of interest receipts, as FRF owned the securitization reserves for the last 3 months of

1996.[3] For 1997, the interest income figure will be significantly greater, as FRF will earn income for the entire year.

We suggest that FDIC review the impact of using cash-based amounts for recording interest income on the securitization reserve funds. FDIC should evaluate whether the cash-based income amount approximates an accrual-based figure or if adjustments are necessary for financial reporting purposes.

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We would appreciate receiving your comments as well as a description and the status of your planned corrective actions within 30 days from the date of this letter. We appreciate the cooperation and assistance the FDIC management and staff provided during our 1996 audits. We are sending copies of this letter to the FDIC Inspector General and the FDIC Audit Committee. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-9406 or Jeanette Franzel, Assistant Director, at (202) 512-9471.

Sincerely yours,

Robert W. Gramling

Robert W. Gramling
Director, Corporate Audits
and Standards

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[3]In October 1996, the securitization reserve funds used to cover future estimated losses were transferred from the receiverships to FRF in its corporate capacity. The transfer was offset by amounts owed by the receiverships to FRF. The reserve funds are generally invested in U.S. Treasury Bills, highly collateralized securities, and money market funds. As of December 31, 1996, the balance in the reserve fund totaled $6.3 billion.

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