



United States General Accounting Office  
Washington, DC 20548

Accounting and Information  
Management Division

B-285928

August 11, 2000

Ms. Chris Sale  
Chief Financial Officer and Deputy to the Chairman  
Federal Deposit Insurance Corporation

Subject: Financial Audit: Accounting and Internal Control Issues Identified  
During GAO's 1999 FDIC Financial Statement Audits

Dear Ms. Sale:

In May 2000, we issued our opinions on (1) the calendar year 1999 financial statements of the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and FSLIC Resolution Fund (FRF), (2) the effectiveness of the Federal Deposit Insurance Corporation's (FDIC) internal control as of December 31, 1999, and (3) our evaluation of FDIC's compliance with laws and regulations for the year ended December 31, 1999.<sup>1</sup> We conducted our audits pursuant to the provisions of section 17(d) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1827(d)), and in accordance with generally accepted government auditing standards.

The purpose of this letter is to advise you of financial accounting issues and internal control weaknesses identified during our audits of the 1999 financial statements and to suggest improvements.<sup>2</sup> Although these matters were not material in relation to the financial statements, we believe that they warrant your attention. In our calendar year 1999 audit, we identified accounting and internal control matters concerning policies and procedures over (1) losses in the securitization-related escrow account, (2) errors in the allowance calculation for FDIC receivables, and (3) weaknesses with account transaction controls within FDIC's Financial Information Management System. We have offered suggestions for resolving these problems or mitigating their effect on FDIC's operations at the end of our discussion of each of the matters

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<sup>1</sup>*Financial Audit: Federal Deposit Insurance Corporation's 1999 and 1998 Financial Statements* (GAO/AIMD-00-157 May 26, 2000).

<sup>2</sup>These matters were not reported in our audit report on FDIC's 1999 financial statements because they do not represent significant deficiencies in the design or operation of internal control. In our financial statement audit report (GAO/AIMD-00-157), we identified a reportable internal control weakness related to information systems control.

described in this letter. We discussed the contents of this letter with members of your staff. They generally agreed with our findings and suggestions. In all of the matters discussed in this letter, staff from the Division of Finance have indicated that they are reviewing current practices in order to formulate appropriate corrective actions. We will follow up on these matters during our audits of the 2000 financial statements.

### **FDIC Improperly Classified Certain Losses in the Securitization-Related Escrow Account**

In order to maximize the return from the sale of assets, the former Resolution Trust Corporation (RTC) engaged in numerous securitization deals, which consisted of selling loans from failed financial institutions (receiverships) to trusts that in turn issued bonds to investors. A portion of the proceeds from each securitization deal was placed in a credit enhancement escrow account (escrow account) to cover future credit losses on the loans underlying the bonds for each deal. In addition, the receiverships retained an interest in the residual certificates, which entitle the holder to any remaining cash flows after the bonds and other expenses have been paid. For some securitization deals, realized losses in the escrow account are reimbursed with funds received from the residual interest at termination. Currently, FRF owns the escrow accounts and the residual interests.

FDIC accounts for the escrow account as an investment and reports the net unrealized gain or loss amount as a valuation account against the escrow balance. Accounting standards applicable to the investment in the escrow account are set forth in Financial Accounting Standard No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. FAS No. 115 requires that when a decline in fair market value is judged to be other than temporary, the cost basis of the individual security be written down to its fair value as the new cost basis. The amount written down is required to be included in the calculation of earnings as a realized loss.

As of December 31, 1999, FDIC reported cumulative unrealized losses<sup>3</sup> on the escrow account of \$121.3 million. However, approximately \$105.7 million of the reported unrealized losses represented realized credit losses in securitization deals that did not have a provision for the reimbursement of credit losses from the residual interest at termination. Therefore, as of December 31, 1999, an estimated \$105.7 million in realized credit losses will not likely be recovered and represented a permanent decline in the value of the escrow account. FDIC did not adjust the cost basis of the escrow account to reflect these realized losses, nor did FDIC include the realized losses in its calculation of FRF's net income. FDIC included these realized losses in the unrealized losses reported in determining "other" comprehensive income<sup>4</sup> on the

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<sup>3</sup>Cumulative unrealized losses should represent temporary declines in the value since acquisition of the investment.

<sup>4</sup>Comprehensive income represents all changes in equity for a period, and would include net income and a category of "other" comprehensive income. Other comprehensive income generally includes items such as unrealized gains and losses on investments, minimum pension liability adjustments, and foreign currency items.

Statement of Income and Accumulated Deficit and in the valuation account for the escrow balance.

### Suggestions

We suggest that FDIC reclassify the realized credit losses that will not be reimbursed from the unrealized losses in the valuation account to adjust the related escrow accounts to a new cost basis in accordance with FAS 115. Additionally, the realized losses should be included in the calculation of net income, rather than in “other” comprehensive income.

### **Errors Identified in Allowance Calculation for FDIC Receivables**

FDIC calculates an allowance for loss on various types of loans receivable and accounts receivable from receiverships. The allowance for loss offsets the receivable amounts to arrive at an estimated net realizable value. FDIC uses the Loan Loss Reserve (LLR) system to compute the allowances for loss for the receivables from each receivership. The LLR system calculates the estimated net cash available for each receivership and distributes the estimated net cash available among all claimants, including FDIC. The allowance for loss for a particular receivership equals the shortfall between the estimated cash available in that receivership for distribution to FDIC and the amount FDIC has recorded as receivables from the receivership. The allowance for loss for BIF, SAIF, and FRF is obtained by aggregating the allowances for loss for each receivership within each respective fund. FDIC manually adjusts the estimated allowance for loss for any necessary additional adjustments.

We noted three types of errors in FDIC’s process for estimating its allowance for loss. One type of error resulted from account balances that were misclassified and erroneously processed by the LLR system. A second type of error resulted from the outdated nature of the general and administrative expense manual adjustment to the LLR estimate. The third type of error was the omission of receivables arising from receivership billings and goodwill litigation expense<sup>5</sup> from the allowance for loss calculations.

### **Errors in LLR Processing**

The LLR program incorrectly classified amounts already paid to outside claimants (account number 172322) as amounts owed to FDIC. This misclassification caused a

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<sup>5</sup>Approximately 120 cases have been filed against the United States concerning alleged breaches of agreement to count goodwill assets as part of regulatory capital. Some receiverships are plaintiffs in the litigation against the U.S. government. FDIC is tracking expenses incurred on behalf of the receiverships involved in the litigation as receivables from the receiverships.

\$14.3 million overstatement to the allowance for loss for FRF. In addition, amounts paid by receiverships (account number 172202) to FDIC were not properly classified in the LLR system. Finally, the LLR program incorrectly excluded some receivables (account number 061104) from the computation of the amounts due to FDIC, which resulted in a \$62.7 million understatement of FRF's allowance for loss.

These errors occurred because FDIC did not review the classification and grouping of receivership liability accounts prior to running the LLR program for the 1999 financial statements. Our *Standards for Internal Control in the Federal Government*<sup>6</sup> provides that one of the objectives of internal control is to ensure accurate and timely recording of transactions and events.

### Suggestions

To prevent the specific errors discussed above, we suggest that FDIC reclassify and/or include the accounts mentioned above (accounts 172322, 172202, and 061104) in the appropriate grouping within the LLR program prior to the next LLR program calculations. Also, FDIC should implement procedures to regularly review all new or newly defined corporate and receivership general ledger accounts to determine whether they are properly reflected in the LLR program.

### The General and Administrative Expense Adjustment to the Allowance for Loss Was Not Appropriate

FDIC calculates the allowance for loss on receivables from thrift resolutions by initially estimating recoveries from receivership assets. These estimated recoveries are used to arrive at the estimated net cash available for distribution within the LLR program for calculating the allowance for loss for each fund. FDIC reduces the estimated recoveries from receivership assets by the estimated future indirect and direct expenses related to receivership administration and asset disposition.

For FRF-RTC,<sup>7</sup> FDIC also estimates future overhead expenses, which consist of general and administrative expenses that are not already included in the direct and indirect receivership expenses. In the past, FDIC adjusted the allowance for loss on receivables from thrift resolutions to reflect FRF-RTC's estimated future overhead expenses because these expenses ultimately reduce recoveries from those assets. The reserving for overhead expenses was initially adopted by RTC in order to provide a full accounting for future liquidation expenses related to failed institutions.

In 1999, FDIC adjusted FRF's allowance for loss on receivables from thrift resolutions for the entire amount of future estimated general and administrative expenses. Although this procedure was consistent with prior years, we noted in 1999 that this

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<sup>6</sup>GAO/AIMD-00-21.3.1, November 1999.

<sup>7</sup>FRF-RTC refers to the distinct pool of assets and liabilities transferred to FRF from RTC on January 1, 1996.

treatment was no longer appropriate because a significant amount of assets had been transferred from the receiverships to FRF in recent years, and the majority of the future liquidation activity was no longer at the receivership level. In 1999, the future general and administrative expense adjustment was equal to 135 percent of estimated future recoveries from the receivership assets.

After we brought this issue to the attention of Division of Finance personnel, FDIC reclassified the general and administrative expense adjustment of \$223.5 million and \$128.5 million for 1999 and 1998, respectively, from FRF's allowance for loss included in the Receivables from Thrift Resolutions, net line item, to the Liabilities from Thrift Resolutions line item. As a result, the estimated future overhead expenses are reserved as a future liability on FRF's 1999 and 1998 comparative Statements of Financial Position.

Currently, FDIC has not documented its policy regarding the accounting for its general and administrative expenses, nor does FDIC have a documented policy on how these expenses are to be presented in the financial statements. Our *Standards for Internal Control in the Federal Government* provides that all transactions and other significant events be supported by management directives and policies that are clearly documented. In addition, transactions should be accurately recorded to maintain relevance and value to management decision-making.

### Suggestions

To ensure that estimated future general and administrative expense are properly handled, we suggest that FDIC document its policy and procedures for calculating, recording, and reporting FRF-RTC's estimated future overhead expenses. This policy should include a definition of the estimate, estimation guidelines, and how the estimate should be reported in the financial statements and related notes.

### FDIC Did Not Calculate Allowances for Loss on Two Categories of Receivables

FDIC records a receivable for receivership expenses that are paid by FDIC and then later reimbursed by the receiverships through the receivership billing process. Because the billings for administrative expenses are given the highest priority for payment, FDIC assumes that the related receivables will be paid by the receiverships and does not calculate an allowance for loss on those receivables. Using FDIC's LLR data, we estimated that approximately \$24 million of these billings will not be collectible from FRF receiverships and approximately \$11 million will not be collectible from BIF receiverships.

FDIC also records a receivable for expenses paid on behalf of receiverships that are plaintiffs in goodwill litigation lawsuits. FDIC does not include these receivables for goodwill expenses in its allowance for loss calculations. Because these receivables would have highest priority for payment, the omission of these receivables may result in other, lower priority liabilities of FDIC receiving distribution of cash that would

not be available if the higher priority liabilities had been included. Additionally, FDIC did not calculate an allowance for loss for the portion of the receivable for goodwill expenses paid on behalf of receiverships involved in goodwill litigation expected to be uncollectable.

FDIC correctly stated that the costs it has incurred on behalf of receiverships consist of administrative expenses that are given the highest priority when distributing estimated cash available from receivership asset recoveries. However, FDIC's assumption that these receivable balances will be reimbursed may not be correct. We have identified a number of receiverships with little or no expected asset recoveries available to reimburse FDIC for even the highest priority receivables. Therefore, we have concluded that a portion of these outstanding receivables from receiverships may not be repaid to FDIC. One of the objectives of internal control, according to our *Standards for Internal Control in the Federal Government*, is to ensure accurate and timely recording of transactions and events in order to maintain their relevance and value.

### Suggestions

We suggest that FDIC develop policies and procedures to properly consider the collectability of all outstanding receivership receivables, including receivership billings and goodwill litigation expenses, even though these receivables are given top priority for payment by receiverships. In addition, we suggest that FDIC establish an allowance for loss for all receivership receivables considered uncollectable.

### **Weaknesses Found With the Account Transaction Controls Within FIMS**

FDIC's Division of Finance is responsible for maintaining the Financial Information Management System (FIMS) account transaction tables. FIMS is the general ledger system for FDIC. Account transaction tables contain the accounting codes used by FIMS and are necessary to validate accounting data entered into FIMS. FDIC uses two primary tables within FIMS to store the key elements to the general ledger database record for use in the validation process.

FDIC does not fully log or review changes that are being made to the FIMS account transaction tables. Logging changes allows managers to conduct effective and timely reviews and helps to prevent unauthorized modification or destruction to the account transaction tables. Errors in these tables could potentially create systemic errors in the accounting data.

FDIC Circular 1360.1 requires that sensitive information, such as that contained in these account transaction tables, should be protected from unauthorized modification, destruction, or disclosure through the use of appropriate technical, administrative, physical, and personnel controls.

Suggestion

To ensure that these tables are fully protected from unauthorized modifications, we suggest that FDIC log and require supervisory review and sign-off on all changes made to the account transaction tables. FDIC has stated that corrective actions have already begun.

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This letter is intended for use by FDIC management, members of the FDIC Audit Committee, and the FDIC Inspector General. This letter is a matter of public record, and its distribution is not limited. Consequently, copies are available to others upon request. If you have any questions or need assistance in addressing these matters, please contact me at (202) 512-9508, or Jeanette Franzel, Assistant Director at (202) 512-9471.

Sincerely yours,



Linda M. Calbom

Director