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United States General Accounting Office
Washington, DC 20548

June 28, 2001

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

Subject: Financial Audit: Accounting and Internal Control Issues Identified During GAO's 2000 FDIC Financial Statement Audits

Dear Ms. Sale:

In May 2001, we issued our opinions on the calendar year 2000 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 effectiveness of the Federal Deposit Insurance Corporation's (FDIC) internal control as of December 31, 2000, and our evaluation of FDIC's compliance with selected provisions of laws and regulations for the three funds for the year ended December 31, 2000.[1]

The purpose of this letter is to advise you of internal control weaknesses identified during our audits of the 2000 financial statements, and to recommend improvements to address those weaknesses. Although these matters were not material in relation to the financial statements, we believe that they warrant the attention of management.

Results in Brief

FDIC has several internal control weaknesses related to financial reporting, including the execution of transactions. The weaknesses concern its asset valuation process and its allocation and recovery of operating expenses.

Specifically, we found the following,

Errors in valuing receivership assets caused both overstatements and understatements in determining the allowance for loss related to receivables. FDIC has instituted new control procedures to address our findings.

A calculation error in valuing equity partnership assets caused an overstatement in the allowance for loss related to other assets. FDIC changed its controls to correct this matter.

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[1]*Financial Audit: Federal Deposit Insurance Corporation's 2000 and 1999 Financial Statements* (GAO-01-635, May 9, 2001).

Incorrect operating expense amounts were allocated and recovered. This resulted in the incorrect distribution of operating expense charges among FDIC's funds. To help ensure correct distribution in the future, FDIC initiated new control procedures.

A draft of this letter was provided to FDIC officials, who generally agreed with our findings and recommendations. We will be following up on the actions taken by FDIC during our audits of the 2001 financial statements.

Scope and Methodology

As part of our financial statement audits of FDIC, we obtained an understanding of internal control related to financial reporting, including the safeguarding of assets, by interviewing key FDIC staff and reviewing applicable policies and procedures. We also tested relevant internal control over financial reporting, including the safeguarding of assets.

We did not evaluate all internal controls relevant to operating objectives as broadly defined under 31 U.S.C. 3512 (Federal Managers' Financial Integrity Act), such as those controls relevant to preparing statistical reports and ensuring efficient operations. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

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 U.S. generally accepted government auditing standards. Our work was performed from July 2000 through April 6, 2001. We obtained oral comments on the draft of this letter and have incorporated FDIC's planned actions to address the internal control issues in this letter.

Errors in the Asset Valuation Process

FDIC as part of its Asset Loss Reserve (ALR) process values assets using standard corporatewide methodologies. These valuations are used to calculate the allowance for loss for specified asset accounts.

Our *Standards for Internal Control in the Federal Government*[2] requires that transactions and events be accurately, promptly, and completely recorded. However, we found two types of errors related to FDIC's ALR projections and calculations that occurred because FDIC did not adequately review changes and calculations related to the recording of the asset valuations. One concerned the projection of receivership assets' values and the other concerned the valuing of Equity Partnership assets.

[2]GAO/AIMD-00-21.3.1, November 1999.

Error in Valuing Receivership Assets

For 2000, as in recent years, a statistical sample was used as part of the ALR process to value receivership assets. During 2000, because of a significant decrease in the population of receivership assets, FDIC revised the groupings of the receivership asset population that were used for selecting the statistical sample.

However, we found that while FDIC's statistician used the revised 2000 groupings in selecting the sample, the individual responsible for modifying the system (LOREN) that is used to calculate an estimated value rate for each grouping was not notified of all the changes. As such, this system projected the 2000 estimated sample values using 1999's groupings. This resulted in BIF's and FRF's valued assets being understated by approximately $2.7 million and $2 million, respectively, and an overstatement in SAIF of approximately $1 million. The overstatement and understatements affected the allowance for loss that is part of the Net Receivable line item in the Statements of Financial Position for each fund.

We recommend that FDIC officials develop procedures for verifying that all appropriate FDIC organizational components are informed of any changes in the ALR process so that all appropriate changes can be incorporated into the existing process or systems. FDIC has informed us that based on our findings, new procedures have been instituted to ensure that all FDIC organizational components related to the ALR process are aware of any changes so that appropriate modifications can be made.

Calculation Error in Valuing Equity Partnership Assets

The values for Equity Partnership assets are also estimated as part of the ALR process. These assets represent FDIC's equity interest in trusts and partnerships, most of which have been transferred from the receiverships to FRF. For year-end, FDIC uses these estimated values to calculate the changes to the allowance for loss related to the Other Assets line item in FRF's Statements of Financial Position. We found mathematical errors in the supporting spreadsheet for this calculation that caused the allowance for loss to be overstated by approximately $10 million.

We recommend that FDIC examine its current review controls, and revise them or add new ones if necessary. In response to our finding, FDIC stated that it changed its controls and added an additional level of review to ensure that the spreadsheet calculations are complete and accurate.

Incorrect Amounts Allocated and Recovered in Operating Expenses

To properly account for each fund as a separate reporting entity, FDIC allocates operating expenses among its funds and recovers the costs for specified expenses from the receiverships. These recovered costs are for expenses that FDIC incurs on behalf of the receiverships when liquidating and managing receivership assets.

FDIC allocates its expenses among the funds and recovers its costs using workload-based percentages. These percentages are incorporated into tables within FDIC's accounting system, and transactions are allocated among the funds and recovered from the receiverships based on these percentages as they are processed. FDIC's Division of Finance (DOF) is responsible for gathering and calculating these percentages and entering and maintaining them in its accounting system.

We found an instance where DOF loaded incorrect allocation percentages into its accounting system. DOF's staff did not verify the updated percentages before they were entered and used for allocating operating expenses. We also found an error in DOF's calculation of the recovery percentages that was not detected before being loaded into FDIC's accounting system. As a result, transactions based on these erroneous percentages were incorrect. We estimated that these two mistakes resulted in approximately $9 million of total operating expenses being incorrectly distributed among the funds.

Our *Standards for Internal Control in the Federal Government* requires that transactions and events be accurately, promptly, and completely recorded. However, a lack of proper review of these events caused these errors.

To ensure that the allocation and recovery of operating expenses is proper, we recommend that FDIC review its calculations, as well as the percentage updates to its accounting system, prior to entering the updates to the system. In acknowledging our findings, FDIC stated that all calculations of percentages and any needed changes to the accounting system will be reviewed and verified to ensure correctness.

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We would appreciate receiving your comments as well as a description and status of your corrective actions within 30 days of the date of this letter. We appreciate the cooperation and assistance the FDIC management and staff provided during our 2000 audits.

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 Jeanette Franzel, Acting Director, at (202) 512-9471, or Lynda Downing, Assistant Director, at (202) 512-9168.

Sincerely yours,

Jeffrey C. Steinhoff

Jeffrey C. Steinhoff
Managing Director
Financial Management and Assurance

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