



Department of Homeland Security Office of Inspector General

National Flood Insurance Program Management Letter for DHS' FY 2008 Financial Statement Audit





**Homeland
Security**

April 16, 2009

Preface

The Department of Homeland Security (DHS) Office of Inspector General (OIG) was established by the *Homeland Security Act of 2002* (Public Law 107-296) by amendment to the *Inspector General Act of 1978*. This is one of a series of audit, inspection, and special reports prepared as part of our oversight responsibilities to promote economy, efficiency, and effectiveness within the department.

This report addresses the management letter for DHS' FEMA National Flood Insurance Program FY 2008 financial statements audit. It contains observations and recommendations related to internal control that were not required to be reported in the financial statement audit report. The independent public accounting firm KPMG LLP (KPMG) performed the audit of DHS' FY 2008 financial statements and prepared this management letter. Material weaknesses and other significant deficiencies were reported, as required, in KPMG's Independent Auditor's Report, dated November 14, 2008, which was included in the FY 2008 DHS Annual Financial Report. KPMG is responsible for the attached management letter dated November 14, 2008 and the conclusions expressed in it. We do not express opinions on DHS' financial statements or internal control or provide conclusions on compliance with laws and regulations.

The recommendations herein have been developed to the best knowledge available to our office, and have been discussed in draft with those responsible for implementation. We trust this report will result in more effective, efficient, and economical operations. We express our appreciation to all of those who contributed to the preparation of this report.

A handwritten signature in cursive script that reads "Richard L. Skinner".

Richard L. Skinner
Inspector General

NATIONAL FLOOD INSURANCE PROGRAM

**Management Letter for the
Year Ended September 30, 2008**



KPMG LLP
2001 M Street, NW
Washington, DC 20036

Office of Inspector General, U.S. Department of Homeland Security, and
Acting Administrator, Mitigation Division, Federal Emergency Management Agency, U.S.
Department of Homeland Security,
Washington, DC

November 14, 2008

Ladies and Gentlemen:

We were engaged to audit the balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2008, and the related statement of custodial activity for the year then ended (referred to herein as "financial statements"). We were not engaged to audit the statements of net cost, changes in net position, and budgetary resources for the year ended September 30, 2008 (referred to herein as "other financial statements"). Because of matters discussed in our *Independent Auditors' Report* dated November 14, 2008, the scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the financial statements as of September 30, 2008.

In connection with our fiscal year 2008 engagement, we were also engaged to consider the Federal Emergency Management Agency's (FEMA) internal control over financial reporting (internal control) and to test FEMA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the financial statements. Our procedures did not include examining the effectiveness of internal control and do not provide assurance on internal control. We have not considered internal control since the date of our report.

During our audit engagement, we noted certain matters involving National Flood Insurance Program (NFIP) internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with the appropriate members of management of the named insurance companies, are intended to improve internal control or result in other operating efficiencies, and are summarized in Exhibit I of this letter.

In addition, we identified certain deficiencies in internal control that we consider to be significant deficiencies and material weaknesses, and communicated them in our *Independent Auditors' Report*, dated November 14, 2008, included in the FY 2008 DHS *Annual Financial Report*. Our findings related to FEMA information technology (IT) controls will be presented in a separate letter to the DHS Office of Inspector General and the FEMA Chief Information Officer, and our findings related to FEMA's internal controls exclusive of our IT and NFIP findings will be presented in a separate letter to the DHS Office of Inspector General and the DHS Chief Financial Officer.



As described above, the scope of our work was not sufficient to express an opinion on the balance sheet or statement of custodial activity of DHS as of September 30, 2008, and we were not engaged to audit the statements of net cost, changes in net position, and budgetary resources for the year ended September 30, 2008. Accordingly, other internal control matters and instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the fiscal year 2008 financial statements and had we been engaged to audit the fiscal year 2008 other financial statements. We aim, however, to use our knowledge of NFIP gained during our work to make comments and suggestions that we hope will be useful to you.

We would be pleased to discuss these comments and recommendations with you at any time.

Management's written response to our comments and recommendations has not been subjected to the auditing procedures applied in the financial statement audit engagement and, accordingly, we express no opinion on it.

This letter is intended solely for the information and use of DHS management, DHS Office of Inspector General, the Office of Management and Budget, U.S. Government Accountability Office, the U.S. Congress, and management of the named insurance companies, and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

KPMG LLP

Exhibit I

I. INTERNAL CONTROL DEFICIENCIES RELATED TO CLAIM PAYMENTS

A. Internal Control Deficiencies Identified over Claims Paid – Interim Testing

Observation

We randomly selected 9 insurance companies participating in the National Flood Insurance Program (NFIP) to perform procedures over claims paid for the period October 1, 2007 through April 30, 2008. For each of the 9 companies selected, we tested a random sample of 45 claims paid during this seven month period. During this testing of 405 claim payments, we noted the following internal control deficiencies and errors:

1. *Loss reserves were not properly established.*

Company	Policy Number	Date of Loss	Claim Amount
Allstate	1807628548	02/06/2008	109168

2. *Claim amounts per the Final Report¹ were not within policy limits.*

Company	Policy Number	Date of Loss	Claim Payment
American Bankers	1011152795	09/17/2004	\$21,775.00

3. *Claim file and the Final Report were not approved before claim payment was processed and issued.*

Company	Policy Number	Date of Loss	Claim Payment
State Farm	000RF7641	08/29/2005	\$10,100.00
	000RA5788	09/19/2003	\$15,000.00
	000RB4365	08/29/2005	\$3,864.52
	000RP5433	09/24/2005	\$83,599.74
	000RA4172	08/29/2005	\$100,000.00
	000RL7387	08/29/2005	\$110,000.00
	000RD3900	12/31/2005	\$2,661.65
	000RQ3114	08/29/2005	\$25,000.00
Allstate	3801417803	08/06/2007	\$58,116.00
	0805145489	08/29/2005	\$6,732.00
	1803589405	05/24/2007	\$15,000.00
	1805296124	08/29/2005	\$3,268.00
	1801562172	08/16/2007	\$6,443.68
	1804514923	08/25/2007	\$11,790.90
	1806134183	07/06/2007	\$8,532.92
	1807456023	08/16/2007	\$20,934.41
	2800385011	08/28/2007	\$14,861.52
	3801310404	08/09/2007	\$1,072.98
	3801522842	08/08/2007	\$6,627.83
	0809045024	08/29/2005	\$15,000.00

¹ As defined by FEMA, the Final Report is a form that is completed by the insured and the claims adjuster, enabling the insured to claim losses to property due to uninhabitability, water damage and claims against an existing mortgage. The NFIP requires that a preliminary report be received within 15 days of assignment, and an interim or Final Report not later than every 30 days thereafter.

Exhibit I

Company	Policy Number	Date of Loss	Amount Paid
	0809375629	03/01/2007	\$3,755.28
	1804748893	04/15/2007	\$2,257.35
	1803287489	08/21/2007	\$11,222.00
	1807508591	08/16/2007	\$2,061.25
	0804209427	09/24/2005	\$15,000.00
	1802052082	06/28/2006	\$6,000.00
	1803616240	08/29/2005	\$3,337.23
	0806794772	08/29/2005	\$10,000.00
	1806204416	06/27/2006	\$13,558.71
	0800992661	10/19/2007	\$612.96
	0804013696	05/10/2007	\$8,068.67
	1806143945	04/15/2007	\$2,877.37
	3801326806	07/16/2007	\$9,916.00
	0800599698	08/29/2005	\$70.00
	0803117746	08/29/2005	\$64,000.00
	0804013696	05/10/2007	\$8,068.67
	0806525085	08/29/2005	\$6,662.00
	1806296214	04/15/2007	\$508.29
	0809212780	08/29/2005	\$13,748.63
	2800011450	08/23/2007	\$2,340.50
	1807628548	03/06/2008	\$3,000.00
	1805364229	08/29/2005	\$4,956.00
	0807570049	12/03/2007	\$29,140.28
	1804736823	08/29/2005	\$15,000.00
	1800049742	10/22/2007	\$8,178.22
	1803234820	02/06/2008	\$6,520.07
	1803615853	01/08/2008	\$2,565.00
	1805219829	01/08/2008	\$4,489.70
	3801370796	04/15/2007	\$1,561.65
	1803605599	02/07/2008	\$9,831.49
	1806817043	02/21/2008	\$33,754.93
	1801525021	02/21/2008	\$4,201.81
	0807580535	03/05/2008	\$1,945.76

4. Total amount paid did not agree to amount on Final Report or population file (or to one check amount if claim had multiple payments).

Company	Policy Number	Date of Loss	Amount Paid
State Farm	601516	08/29/2005	\$17,500.00

5. Claim payment was not properly authorized.

Company	Policy Number	Date of Loss	Amount Paid
State Farm	601516	08/29/2005	\$17,500.00

Exhibit I

6. *Loss adjustment expenses were not in compliance with NFIP Fee Schedule.*

Company	Policy Number	Date of Loss	Loss Amount paid to policy
Covansys	4000039529	02/07/2008	\$7,247.56
Allstate	3801310404	08/09/2007	\$0.00
	3801522842	08/08/2007	\$0.00
	1803287489	08/21/2007	\$0.00
	1807508591	08/16/2007	\$0.00
	0800992661	10/19/2007	\$0.00
	3801326806	07/16/2007	\$0.00
	0800599698	08/29/2005	\$60.00

7. *Loss reserve amounts were not adjusted as claim payments were made. For closed claims, loss reserve amounts were not reduced to zero.*

Company	Policy Number	Date of Loss	Loss Reserve
Hartford Underwriters	71-00428700-2004	08/29/2005	\$3,036.88
Allstate	1807628548	02/06/2008	\$3,000.00

Recommendations

We recommend that the Federal Emergency Management Agency's (FEMA) Mitigation Division:

- 1) Follow-up with each of the insurance companies noted above to determine that appropriate corrective action has been implemented to address the exceptions noted in our testwork.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure claims files are being processed and reviewed in accordance with NFIP guidelines before approval and issuance of claim payments and to ensure the specific and consistent establishment and reporting of loss reserves and subsequent adjustments to the loss reserves.

Management Response

Management has developed a Management Action Plan to resolve the deficiencies. Management's initial attempts to contact the companies with regard to the findings were met with requests for policy number and date of loss. Now that KPMG has provided policy numbers and dates of loss, management will within 60 days once again contact the companies to determine the appropriate corrective action. Management will follow-up with each company to determine that the appropriate corrective action has been implemented for each of the areas of deficiency. Management will emphasize the issues identified during the audit in its next cycle of Claims Operation Reviews.

In addition, on December 22, 2008, Bulletin W-08095 was sent to Write Your Own (WYO) Company Principal Coordinators, the NFIP Servicing Agent, and Selected Claims Adjusting Firms Companies. This Bulletin corrected and clarified case reserving procedures the insurers must to follow. It must be stated that case reserves created by companies have no significant impact on reserves included in the Balance Sheet. Balance Sheet reserves are developed by the NFIP Bureau and Statistical Agent actuarial staff and is subject to an independent peer review.

Exhibit I

B. Internal Control Deficiencies Identified over Claims Paid – Final Testing

Observation

We randomly selected 9 insurance companies to perform procedures over claims paid from the period May 1 through July 31, 2008. For each of the 9 companies selected, we tested a random sample of 45 claims paid during this three month period. During this testing of 405 claim payments, we noted the following internal control deficiencies and errors:

1. Total amount paid did not agree to amount on Final Report¹ or population file (or to one check amount if claim had multiple payments).

Company	Policy Number	Date of Loss	Final Payment
Fidelity	2510091424	06/13/2008	\$8,531.28
	7700718599	04/09/2008	\$2,065.87
American Bankers	RI00511094	03/19/2008	\$1,064.50
Hartford Underwriters	72-00029512-2008	06/12/2008	\$8,809.40
	72-00012670-2008	04/13/2008	\$10,046.94

2. Loss adjustment expenses were not in compliance with the NFIP Fee Schedule.

Company	Policy Number	Date of Loss	Final Payment
Allstate	0802911032	08/29/2005	\$0.00
	1805895974	08/29/2005	\$250.00
Covansys	2024101657	03/19/2008	\$13,295.42
Fidelity	7700718599	04/09/2008	\$500.00
American Bankers	2023977000	03/21/2008	\$1,980.56
	2027539600	05/13/2008	\$3,545.80
	0790016823	03/17/2008	\$1,764.18
	AB00010554	06/08/2008	\$2,091.03
	3019033500	07/01/2007	\$5,469.94
	790016823	03/17/2008	\$1,764.18
Hartford Underwriters	AB00010554	06/08/2008	\$2,091.03
	72-00018411-2008	03/18/2008	\$850.00

3. Loss reserve amounts were not adjusted as claim payments were made. For closed claims, loss reserve amounts were not reduced to zero.

Company	Policy Number	Date of Loss	Final Payment
State Farm	RD6993	01/08/2008	\$4,576.50
	RB0794	03/22/2008	\$14,796.00
Allstate	1807313208	05/13/2008	\$7,654.98

Recommendations

We recommend that FEMA's Mitigation Division:

- 1) Follow-up with each of the insurance companies noted above to determine that appropriate corrective action has been implemented to address the exceptions noted in our testwork.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure claims files are being processed and reviewed in accordance with NFIP guidelines before

Exhibit I

approval and issuance of claim payments and to ensure the specific and consistent establishment and reporting of loss reserves and subsequent adjustments to the loss reserves.

Management Response

Management has developed a Management Action Plan to resolve the deficiencies. Management's initial attempts to contact the companies with regard to the findings were met with requests for policy number and date of loss. Now that KPMG has provided policy numbers and dates of loss, management will within 60 days once again contact the companies to determine the appropriate corrective action. Management will follow-up with each company to determine that the appropriate corrective action has been implemented for each of the areas of deficiency. Management will emphasize the issues identified during the audit in its next cycle of Claims Operation Reviews.

In addition, on December 22, 2008, Bulletin W-08095 was sent to Write Your Own (WYO) Company Principal Coordinators, the NFIP Servicing Agent, and Selected Claims Adjusting Firms Companies. This Bulletin corrected and clarified case reserving procedures the insurers must to follow. It must be stated that case reserves created by companies have no significant impact on reserves included in the Balance Sheet. Balance Sheet reserves are developed by the NFIP Bureau and Statistical Agent actuarial staff and is subject to an independent peer review.

C. Inaccuracies in Interim Claims' Loss Reserves

Observation - April 30, 2008

We randomly selected 9 insurance companies to perform procedures over the accuracy and completeness of loss reserves established as of April 30, 2008. For each of the 9 companies selected, we tested a random sample of 30 loss reserves reported as of April 30, 2008. During this testing of 270 items, we identified 1 instance where the appropriate amount of the loss reserve was not established as compared to the information obtained in the claim file and 3 instances where the loss reserve was not closed in a timely manner after full payment of the claim was made to the policyholder. See below for details:

1. Loss reserve not established as compared to the information in the claim file:

Company	Policy Number	Date of Loss	Reserve Amount
Travelers	6010027988	03/18/2008	\$65,000.00

2. Loss reserve was not closed in a timely manner after full payment of the claim was made to the policyholder:

Company	Policy Number	Date of Loss	Reserve Amount
Fidelity - FNIC	2510057861	08/29/2005	\$97,493.46
	2510071183	08/29/2005	\$34,600.00
Hartford Underwriters	71-00428700-2004	08/29/2005	\$30,000.00

Exhibit I

Observation - July 31, 2008

We randomly selected 9² insurance companies to perform procedures over the accuracy and completeness of loss reserves established as of July 31, 2008. For each of the 9 companies selected, we tested a random sample of 35 loss reserves reported as of July 31, 2008. During this testing of 315 items, we identified 13 instances where the supporting documentation received did not support the loss reserve balance, 2 instances where the loss reserve was not updated based on receipt of the Preliminary Report, 12 instances (10 of 12 related to Increased Cost of Compliance (ICC) claims) where the loss reserve was not reduced for an advanced payment or partial payment, 1 instance where the loss reserve was not closed in a timely manner after full payment of the claim was made to the policyholder, and 3 instances where the inaccurate amount of the loss reserve was caused by a data input error. See below for the claim numbers associated with these exceptions at the respective insurance companies:

3. Supporting documentation received did not support the loss reserve balance:

Company	Policy Number	Date of Claim	Reserve Amount
Allstate	1804402285	08/29/2005	\$800.00
	1801847615	08/28/2005	\$15,000.00
	0808970347	08/29/2005	\$100.00
	1802762136	08/29/2005	\$160.00
	1807230055	08/21/2007	\$9,250.00
	1803908837	08/29/2005	\$12,000.00
	3801039797	06/07/2008	\$44,000.00
	0805784279	06/07/2008	\$19,500.00
	1806533137	06/13/2008	\$20,000.00
	1805201629	06/04/2008	\$15,300.00
	0801554486	08/21/2007	\$10,000.00
0807873153	08/22/2007	\$12,000.00	
Travelers	6010042916	06/18/2008	\$17,385.00

4. Loss reserve was not updated based on receipt of the Preliminary Report:

Company	Policy Number	Date of Claim	Reserve Amount
American Bankers	2036461900	06/25/2008	\$700,000.00
	AB00011921	07/09/2008	\$10,000.00

5. Loss reserve was not reduced for an advanced payment or partial payment:

Company	Policy Number	Date of Claim	Reserve Amount
Hartford Fire	99013809642005	08/29/2005	\$30,000.00
	87040381452007	08/24/2007	\$30,000.00
	1240922972004	08/29/2005	\$30,000.00
	87021341032007	06/20/2008	\$33,692.64
	99027857312007	06/08/2008	\$78,000.00

² On July 1, 2008, Fidelity National Insurance Company (FNIC) merged with Fidelity National Property & Casualty Insurance (FNPAC). As a result, the loss reserve testwork as of July 31, 2008 for both companies selected was performed under FNPAC.

Exhibit I

Company	Policy Number	Date of Loss	Reserve Amount
Hartford Underwriters	71004287002004	08/29/2005	\$30,000.00
	72000074472005	08/29/2005	\$30,000.00
	70000302752005	08/30/2005	\$30,000.00
	71000166202005	08/29/2005	\$30,000.00
	72000205872005	08/29/2005	\$30,000.00
State Farm	000RB4278	08/29/2005	\$30,000.00
	000D60066	08/31/2005	\$30,000.00

6. Loss reserve was not closed in a timely manner after full payment of the claim was made to the policyholder:

Company	Policy Number	Date of Loss	Reserve Amount
Hartford Fire	87017647952004	08/29/2005	\$30,000.00

7. Inaccurate amount of the loss reserve was caused by a data input error:

Company	Policy Number	Date of Loss	Reserve Amount
Covansys	4000051600	06/15/2008	\$17,000.00
Travelers	6005372542	06/04/2008	\$70,000.00
Hartford Fire	99014551022008	06/16/2008	\$35,848.32

Recommendations

We recommend that FEMA's Mitigation Division:

- 1) Follow-up with each of the insurance companies noted above to determine that appropriate corrective action has been implemented to address the exceptions noted in our testwork.
- 2) Provide increased oversight to ensure the specific and consistent documentation over the establishment of the loss reserve and subsequent adjustment to the loss reserve per claim in the claim file at the insurance companies participating in the NFIP.

Management Response

Management has developed a Management Action Plan to resolve the deficiencies. Management's initial attempts to contact the companies with regard to the findings were met with requests for policy number and date of loss. Now that KPMG has provided policy numbers and dates of loss, management will within 60 days once again contact the companies to determine the appropriate corrective action. Management will follow-up with each company to determine that the appropriate corrective action has been implemented for each of the areas of deficiency. Management will emphasize the issues identified during the audit in its next cycle of Claims Operation Reviews.

In addition, on December 22, 2008, Bulletin W-08095 was sent to Write Your Own (WYO) Company Principal Coordinators, the NFIP Servicing Agent, and Selected Claims Adjusting Firms Companies. This Bulletin corrected and clarified case-reserving procedures the insurers are to follow. It must be stated that case reserves created by companies have no significant impact on reserves included in the Balance Sheet. Balance Sheet reserves are developed by the NFIP Bureau and Statistical Agent actuarial staff and is subject to an independent peer review.

D. Internal Control Deficiencies in the Claims Reinspection Program

Observation

Throughout the year, the NFIP third party service provider conducts a Claims Reinspection Program. The reinspection process involves reviewing existing flood claims for propriety and accuracy. Requests for reinspections come from the insurance companies participating in the NFIP or FEMA, or if 400 or more claims are reported under a single flood event, the service provider is required to select a random sample of open and closed claims for reinspection. During our testwork as of April 30, 2008 over a sample of 35 claim reinspections, we identified the following exceptions:

- For 15 sample items, the NFIP insurance company did not receive the claims reinspection report from FEMA or its service provider as required in the *Financial Control Plan Requirements and Procedures*. See below for applicable claim numbers.

RL00035682
6005402802
3000279117
7700094227
1803603362
6004202740
6002670898
6005007247
6010050831
6010042029
6001909347
6010055601
2565845043
6001444659
4000001545

- For 2 sample items, required follow-up was not performed on the results of the reinspections. We reviewed the results of these reinspections and identified that the service provider's claims adjuster made recommendations that the NFIP insurance company should have taken action on. See below for applicable claim numbers.

0615RB3085
1927557646

- For 1 sample item (claim number 7700635553), adequate follow-up was not performed with the insurance company to ensure the company followed the conclusions reached in the reinspection. The insurance company did not follow the conclusions reached by FEMA and instead decided to maintain its prior decision.

Recommendations

We recommend that FEMA's Mitigation Division:

- 1) In conjunction with the service provider, work with the NextGen system developer to ensure the new system addresses the functionality and data reporting needs of the claims adjusters to properly carryout the Claims Reinspection Program.

Exhibit I

- 2) Provide increased oversight to ensure the Claims Reinspection Program is operating according to policies and procedures outlined in Part 3 of the *Financial Control Plan Requirements and Procedures*.

Management Response

Management will ensure that the required coordination between the new B&SA contractor and the new NFIP service contractor occurs. These contractors are in the process of transitioning and when the transition is complete, management will address this recommendation. Since October 2008, the current contractor (CSC) is using systems developed by the new contractor to randomly select claim files for reinspection using the definition provided by the Office of Inspector General. By June 2009 new standard operating procedures, reporting of findings, and tracking of reinspections will be in place. All of these and other system enhancements should be available through the new contractor, IService.

II. INTERNAL CONTROL DEFICIENCIES RELATED TO PREMIUMS WRITTEN

A. Internal Control Deficiencies Identified over Premiums Written

Observation

We randomly selected 9 insurance companies to perform procedures over flood insurance premiums written during the period October 1, 2007 through April 30, 2008. For the 9 companies selected, we noted the following internal control deficiencies related to our 405 sample items:

1. Check did not agree with the appropriate policy.

Company	Policy Number
State Farm	13103852950RA0 19609808210DJ7 19609861220RV4 22609859160D02 25305306070RR6

2. Check received from insured was not in the name of the company issuing the policy.

Company	Policy Number
State Farm	13103852950RA0 19609808210DJ7 19609861220RV4 22609859160D02 25305306070RR6 21609055640RA1

Recommendations

We recommend that FEMA's Mitigation Division:

- 1) Follow-up with the insurance company noted above to determine that appropriate corrective action has been implemented to address the exceptions noted in our testwork.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure policies written are being processed and reviewed in accordance with NFIP guidelines

Exhibit I

relating to premium payments received from policyholders and to ensure NFIP insurance companies are maintaining supporting documentation relating to premium receipts.

Management Response

Management will follow-up with the insurance company to determine that appropriate corrective action has been implemented to address the exceptions noted. Management will provide increased oversight to insurance companies participating in the NFIP as noted in this NFR.

B. Internal Control Deficiencies in the Submit for Rate Program

Observation

The NFIP third party service provider conducts a Submit for Rate Program over the insurance companies participating in the NFIP for all new submit for rate policy business for the fiscal year (approximately 12,000-14,000 policies). The service provider reviews the packages to determine if the policies were underwritten correctly. During our testwork as of April 30, 2008 over a sample of 35 Submit for Rate policies under the Submit for Rate Program, we identified that the service provider's documentation of the Submit for Rate underwriters' review and follow-up on underwriting errors was not consistently maintained for all items tested. See below for applicable policy numbers.

Policy Number
7700903569
4100351602
6010098957
af71230357
2108RC15363
9904146152
8703041789
AB00014502
1338RC28915
FL11036788
AF73120267
FL11033897
2740RE28528
3801740220
9903011684
1756RB49119
1537RC75700
A197143759
135476000
9904064102
9904047983
9770121310600
1998dk67365
8702889672
87.02950237
29-7701407290-00
9251010943503
FLD1213988
FLD1214345

Exhibit I

Policy Number
608025225
097701163739 00
5050210987
7701410985
030731221F
FLD1202555

Recommendations

We recommend that FEMA's Mitigation Division:

- 1) Develop and implement policies and procedures that require the servicing agent to maintain specific documentation evidencing the procedures performed during the servicing agent's review of and follow-up on Submit for Rate policies.
- 2) Develop and implement a process to adequately monitor the review procedures performed by the servicing agent under the Submit for Rate Program.

Management Response

Management does not agree with this deficiency because the Bureau and Statistical Agent (BSA) reviews Submit for Rate (SFR) files for all risks that meet the SFR criteria. Many SFRs are quotes that never become actual flood insurance policies. It would be time consuming and costly for the BSA to identify and compare quotes with that the actual insurance policies that result from them. This would entail a monthly search of the policy master file by property address to determine whether a policy was actually issued.

Instead, BSA underwriters have been instructed to advise FEMA when a WYO company or vendor consistently make errors in calculating rates. When a trend is identified, FEMA's and the BSA's underwriters provide training to the WYO Company or, if the situation is not resolved, do not allow the company to have SFR authority. When a SFR issue surfaces, FEMA may choose to examine a company's SFR policies as part of an underwriting operational review.

We expect this issue to be resolved when the new NextGen system is operational. All SFRs submitted to the BSA will be calculated by the new rating engine and, when the property address is entered into the system as a policy in force, the actual rate will be matched to the quoted rate.

III. OTHER INTERNAL CONTROL DEFICIENCY

A. Insufficient Documentation of Methodology Used to Calculate NFIP Estimates Reported in the FEMA Financial Statements

Observation

We reviewed the estimate methodology for deferred revenue, deferred acquisition cost, and accounts payable. The methodology used by the service provider is insufficiently documented to allow a reasonable person to re-perform the year-end estimates and yield the same results. The final estimates rely heavily on undocumented management judgments, historical knowledge, and/or assumptions to determine the final value of account balances reported in the NFIP financial statements and ultimately recorded in the FEMA financial statements.

Exhibit I

Recommendations

We recommend that FEMA require:

- 1) The NFIP third party service provider to sufficiently document the estimation methodology to determine the year-end NFIP financial statement amounts by incorporating quantitative factors to use based on the level of year-end hurricane/flooding activity, when appropriate.
- 2) A formal review and approval of this methodology by a knowledgeable individual within FEMA's Office of the Chief Financial Officer once the methodology is fully documented and when changes are made to it.

Management Response

Management will review and as necessary update the documentation of the estimation process prior to the next audit cycle.

It is recommended that the NFIP incorporate "...quantitative factors to use based on the level of year-end hurricane/flooding activity." Management does not concur with this recommendation, however Management will review and as necessary update the documentation of the estimation process which currently incorporates estimated amounts based on the level of year-end hurricane/flooding activity provided directly by all reporting entities.

The management letter is not accurate in stating that the current estimation process omits "quantitative factors to use based on the level of year-end hurricane/flooding activity." It is also not accurate to state that "Although the methodology discussed above is used to estimate *all line items on the NFIP balance sheet and NFIP income statement except for the actuarial estimate for the loss reserve...*" These are not accurate because each WYO Company, the Servicing Agent, and the actuary separately provided estimated amounts for September 2008 which include "quantitative factors based on their level of year-end hurricane/flooding activity. In this regard, KPMG was provided a copy of the letter which specifically requested that the following selected estimates be reported for September 2008:

From All Companies

- Written premium
- Claims paid
- Accounts payable
- Claims payable

From the Actuary

- Actuarial loss reserves
- Actuarial loss adjustment expenses
- Actuarial development of paid claims

The above data estimates represent the material line items on the estimated financial statements and are provided directly by the WYO Companies, the Servicing Agent, and the actuary. Each data estimate includes the "level of year-end hurricane/flooding activity" for September and it was reported as received by the NFIP third party service provider. Neither trending nor analytic judgment was applied to these data estimates.

The management letter states that "... we focused our review of the methodology on deferred revenue, deferred acquisition cost, and accounts payable." Deferred revenue and deferred

Exhibit I

acquisition costs are a function of premium and are not impacted by year-end hurricane/flooding activity as inferred as a resulting Condition by this NFR.

Finally, the accounts payable as noted above was provided directly by each WYO Company and the Servicing Agent, and does incorporate their respective impact on the level of year-end hurricane/flooding activity. Again, there is no trending or analytic judgment applied to these data estimates.

Only remaining non-material line items are the only estimates based upon historical trends which are consistent year over year and applied by the NFIP third party service provider. Only in these isolated data estimates is quantifiable historical trending applied. Analysis (or judgment as referred in the management letter) of these non-material items is applied to eliminate non-recurring values. More important, these line items do not vary with the impact of any year-end hurricane/flooding activity.

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