

# Department of Homeland Security **Office of Inspector General**

National Flood Insurance Program's Management  
Letter for FY 2011 DHS Consolidated  
Financial Statements Audit  
(Redacted)





Homeland  
Security

APR 16 2012

## 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 presents the National Flood Insurance Program's Management Letter for FY 2011 DHS Consolidated Financial Statements Audit. It contains observations related to internal control that were not required to be reported in the financial statements audit report. The independent public accounting firm KPMG LLP (KPMG) performed the integrated audit of DHS' FY 2011 financial statements and internal control over financial reporting and prepared this management letter. KPMG is responsible for the attached management letter dated November 11, 2011 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 observations herein 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 "Anne L. Richards".

Anne L. Richards  
Assistant Inspector General for Audits



# **NATIONAL FLOOD INSURANCE PROGRAM**

**Management Letter for the  
Year Ended September 30, 2011**



KPMG LLP  
Suite 12000  
1801 K Street, NW  
Washington, DC 20006

November 11, 2011

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

Ladies and Gentlemen:

We have audited the balance sheet of the U.S. Department of Homeland Security (DHS or Department) as of September 30, 2011 and the related statement of custodial activity for the year then ended (referred to herein as the “fiscal year (FY) 2011 financial statements”). The objective of our audit was to express an opinion on the fair presentation of these financial statements. We were also engaged to examine the Department’s internal control over financial reporting of the balance sheet as of September 30, 2011, and statement of custodial activity for the year then ended based on the criteria established in Office of Management and Budget Circular No. 123, *Management’s Responsibility for Internal Control*, Appendix A. In connection with our audit, we also considered DHS’ compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the FY 2011 financial statements.

Our *Independent Auditors’ Report* issued on November 11, 2011, describes a limitation on the scope of our audit that prevented us from performing all procedures necessary to express an unqualified opinion on DHS’ FY 2011 financial statements and internal control over financial reporting. In addition, the FY 2011 DHS *Secretary’s Assurance Statement* states that the Department was unable to provide assurance that internal control over financial reporting was operating effectively at September 30, 2011.

During our FY 2011 DHS audit, we noted certain matters involving the Federal Emergency Management Agency’s (FEMA) National Flood Insurance Program (NFIP) internal control and other operational matters that are presented for your consideration. These observations and recommendations, all of which have been discussed with the appropriate members of management of the named insurance companies (where applicable), FEMA’s Office of the Chief Financial Officer, and FEMA’s Federal Insurance and Mitigation Administration, are intended to improve internal control or result in other operating efficiencies and are summarized in Exhibit I of this letter. These comments are in addition to the material weaknesses and significant deficiencies presented in our *Independent Auditors’ Report*, dated November 11, 2011, included in the FY 2011 DHS *Annual Financial Report*. The status of our prior year observations is presented in Exhibit II.

Certain control deficiencies 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 certain other control deficiencies related to FEMA’s internal controls exclusive of our IT findings will be presented in a separate letter to the DHS Office of Inspector General and the FEMA Chief Financial Officer.



Other deficiencies in internal control, potentially including additional material weaknesses and significant deficiencies, may have been identified and reported had we been able to apply sufficient audit procedures to express an opinion on DHS' internal control over financial reporting of the FY 2011 financial statements. We aim, however, to use our knowledge of the NFIP gained during our work to make observations and suggestions that we hope will be useful to you.

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

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

Very truly yours,

**KPMG LLP**

## I. BACKGROUND

The Federal Insurance and Mitigation Administration of the Department of Homeland Security (DHS) Federal Emergency Management Agency (FEMA) manages the National Flood Insurance Program (NFIP). Private insurance companies and the Direct Servicing Agent administer the flood insurance policies issued through the NFIP. The insurance companies and Direct Servicing Agent write NFIP policies, adjust flood claims, process and distribute claim payments to policyholders, and establish and maintain loss reserves. The data associated with flood policies and claims are used to calculate estimates included in the year-end NFIP financial statements, which are recorded in the year-end DHS financial statements. Thus, the precision of the estimates used to reflect actual events is dependent upon the accuracy and consistency of the underlying data submitted by the insurance companies and the Direct Servicing Agent on a monthly basis.

## II. INTERNAL CONTROL DEFICIENCIES RELATED TO CLAIMS

### A. Internal Control Deficiencies and Errors Identified over Claims Paid

*Observation:*

We selected nine insurance companies at which to perform audit procedures over claims paid for the periods October 1, 2010 through March 31, 2011, April 1 through June 30, 2011, and July 1 through August 31, 2011. For the nine companies selected, we tested a sample of claims paid totaling 450 items covering the three testing periods identified above. During this testing, we noted the following internal control deficiencies and errors:

- 1) Based on our March 31, 2011 testwork, for two sample items, the claim payment was not recorded in the correct fiscal year:

Company	Policy Number	Date of Loss	Claim Payment
[REDACTED]	[REDACTED]	03/30/2010	\$100,000
[REDACTED]	[REDACTED]	03/30/2010	\$400,000

- 2) Based on our March 31, 2011 testwork, for eight sample items, the loss reserve related to the claim transaction was not updated properly to reflect claim payments or additional adjustor reports, causing reserves to be overstated or understated:

Company	Policy No.	Date of Loss	Claim Payment
[REDACTED]	[REDACTED]	09/30/2010	\$34,823.74
[REDACTED]	[REDACTED]	10/01/2010	\$169,142.53
[REDACTED]	[REDACTED]	10/05/2010	\$237,905.80
[REDACTED]	[REDACTED]	12/13/2010	\$69,497.31
[REDACTED]	[REDACTED]	12/26/2010	\$55,667.97
[REDACTED]	[REDACTED]	09/13/2008	\$197,601.74
[REDACTED]	[REDACTED]	09/30/2010	\$36,547.24

<b>Company</b>	<b>Policy No.</b>	<b>Date of Loss</b>	<b>Claim Payment</b>
[REDACTED]	[REDACTED]	10/01/2010	\$417,755.32

- 3) Based on our March 31, 2011 testwork, for one sample item, the deductible was not properly applied to a contents claim:

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Claim Payment</b>
[REDACTED]	[REDACTED]	09/30/2010	\$6,238.15

- 4) Based on our March 31, 2011 testwork, for two sample items, the claim was not properly closed after the policy was closed and rewritten:

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Claim Payment</b>
[REDACTED]	[REDACTED]	09/13/2008	\$135,000
[REDACTED]	[REDACTED]	09/13/2008	\$145,000

- 5) Based on our March 31, 2011 and June 30, 2011 testwork, for four sample items, we noted that the claim payment made to the insured did not match the total claim payment on the final report, causing the insured to be underpaid or overpaid.

*March 31, 2011 Testwork Results:*

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Claim Payment</b>
[REDACTED]	[REDACTED]	06/05/2009	\$15,201.94

*June 30, 2011 Testwork Results:*

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Claim Payment</b>
[REDACTED]	[REDACTED]	05/01/2011	\$71,035.69
[REDACTED]	[REDACTED]	04/14/2011	\$26,889.74
[REDACTED]	[REDACTED]	02/28/2011	\$500,000.00

FEMA’s Federal Insurance and Mitigation Administration did not provide adequate oversight to ensure claim files were processed and reviewed in accordance with NFIP guidelines before the 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.

*Recommendations:*

We recommend that FEMA’s Federal Insurance and Mitigation Administration:

- 1) Follow-up with each of the insurance companies to determine that appropriate corrective action has been implemented to address the exceptions noted.

- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure claim files are being processed and reviewed in accordance with NFIP guidelines before the 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.

**B. Inaccuracies in Claims' Loss Reserves**

*Observation:*

We selected nine insurance companies at which to perform audit procedures over the accuracy and completeness of loss reserves established as of March 31, 2011 and August 31, 2011. For the nine companies selected, we tested a sample of loss reserves reported as of March 31, 2011 and August 31, 2011, totaling 130 items. During this testing, we noted the following inaccuracies at the respective insurance companies:

- 1) Based on March 31, 2011 and August 31 testwork, for seven sample items, the loss reserve recorded in the insurance company's NFIP claims system was not updated appropriately to reflect additional adjustor reports and/or claim payments, causing the reserves to be misstated.

*March 31, 2011 Testwork Results:*

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Loss Reserve</b>
██████████	██████████	03/11/2011	\$31,000
██████████	██████████	03/06/2011	\$17,000
██████████	██████████	03/06/2011	\$22,000
██████████	██████████	03/11/2011	\$50,000
██████████	██████████	03/11/2011	\$3,000

*August 31, 2011 Testwork Results:*

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Loss Reserve</b>
██████████	██████████		
██████████	██████████	07/18/2011	\$9,000
██████████	██████████	07/19/2011	\$500,000

- 2) Based on March 31, 2011 testwork, for three sample items, the claim was not closed in a timely manner, which caused reserves to be overstated.

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Loss Reserve</b>
██████████	██████████	11/11/2009	\$40,000
██████████	██████████	09/13/2008	\$30,000
██████████	██████████	09/18/2003	\$30,000



- 3) Based on March 31, 2011 testwork, for one sample item, the claim was closed without payment and then reopened in order to pay adjustor fees. However, the claim was not re-closed after the fees were paid, which in turn caused reserves to be overstated.

<b>Company</b>	<b>Policy Number</b>	<b>Date of Loss</b>	<b>Loss Reserve</b>
[REDACTED]	[REDACTED]	02/28/2011	\$10,000

*Recommendations:*

We recommend that FEMA’s Federal Insurance and Mitigation Administration:

- 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.
- 2) Provide increased oversight to ensure specific and consistent documentation of the established loss reserve and subsequent adjustment to the loss reserve per claim at the insurance companies participating in the NFIP is maintained.

**STATUS OF PRIOR YEAR OBSERVATIONS**

The status of each observation reported in our letter dated November 12, 2010 to the Office of Inspector General, U.S. Department of Homeland Security, and Acting Administrator, Mitigation Directorate, Federal Emergency Management Agency, U.S. Department of Homeland Security, is summarized in the table below. For each repeated observation, we provided the current year Observation Number and Notice of Findings and Recommendations (NFR) Number.

2010 Observation No.	Description	Disposition	
		Closed	Repeat (2011 Observation No./ NFR No.)
II.A	Internal Control Deficiencies Identified over Claims Paid		II.A/ FEMA 11-15
II.B	Inaccuracies in Claims' Loss Reserves		II.B/ FEMA 11-14
III.A	Internal Control Deficiencies Identified over Premiums Written	X	
III.B	Internal Control Deficiencies over the Retrospective Reserve Analysis	X	
III.C	Deficiency in the Methodology Used to Calculate the Non-Current Portion of the Insurance Liability Estimate	X	

MANAGEMENT'S RESPONSE


U.S. Department of Homeland Security  
500 C Street, SW  
Washington, DC 20472



FEMA

March 14, 2012

Memorandum For: Anne Richards  
Assistant Inspector General for Audits

From: Edward L. Connor   
Deputy Associate Administrator for Federal Insurance  
Federal Emergency Management Agency

Subject: Draft Report: NFIP Management Letter for DHS FY 2011  
Financial Statement Audit

Thank you for the opportunity to comment on the draft management letter for the DHS FY 2011 financial statement audit.

**Internal Control Deficiencies Related to Claims**

**A. Internal Control Deficiencies Identified over Claims Paid**

Management concurs with the recommendation and has initiated follow-up with the WYO companies on the exceptions noted. The NFIP will continue to review WYO company claims handling as part of the ongoing claims operation reviews to ensure compliance with NFIP guidelines and consistent establishment and reporting of loss reserves and subsequent adjustments. Management does not believe that individual claims loss reserves are material to the NFIP loss reserving process.

**B. Inaccuracies in Claims' Loss Reserves**

Management concurs with the recommendation and has initiated follow-up with the WYO companies on the exceptions noted and will continue to review WYO company claims loss reserving as part of the ongoing claims operation reviews to ensure consistent establishment and reporting of loss reserves and subsequent adjustments. Additional emphasis is given to these matters through Workshops during the National Flood Conference. Management does not believe that individual claims loss reserves are material to the NFIP loss reserving process.

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