Department of Homeland Security
Office of Inspector General

National Flood Insurance Program Management Letter for DHS' FY 2009 Consolidated Financial Statements Audit

(Redacted)

OIG-10-64

April 2011 (Revised)

Office of Inspector General

U.S. Department of Homeland Security
Washington, DC 20528

APR 01 2011

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 revised National Flood Insurance Program Management Letter for DHS FY 2009 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 2009 financial statements and internal control over financial reporting and prepared this management letter. KPMG is responsible for the attached management letter dated November 13, 2009 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.

Anne L. Richards
Assistant Inspector General for Audits

NATIONAL FLOOD INSURANCE PROGRAM

Management Letter for the
Year Ended September 30, 2009

KPMG LLP
2001 M Street, NW
Washington, DC 20036

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

November 13, 2009

Ladies and Gentlemen:

We were engaged to audit the balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2009, and the related statement of custodial activity for the year then ended (referred to herein as "financial statements"). We were also engaged to examine internal control over financial reporting (internal control) of the financial statements. In connection with our fiscal year 2009 engagement, we considered compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the 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, 2009 (referred to herein as "other financial statements"), or to examine internal control over financial reporting over the other financial statements. Because of matters discussed in our *Independent Auditors' Report* dated November 13, 2009, 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, 2009, and we were unable to perform procedures necessary to form an opinion, and we did not express an opinion, on internal control over financial reporting of the financial statements as of September 30, 2009.

During our audit engagement, 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 Mitigation Directorate, are intended to improve internal control or result in other operating efficiencies, are not considered to reflect significant deficiencies or material weaknesses in internal control over financial reporting, and are summarized in Exhibit I of this letter. The status of our prior year observations is presented in Exhibit II.

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 13, 2009, included in the fiscal year 2009 DHS *Annual Financial Report*. 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 DHS Acting 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 or the related internal control as of September 30, 2009, and we were not engaged to audit the statements of net cost, changes in net position, and budgetary resources or the related internal control for the year ended September 30, 2009. 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 opinions on the fiscal year 2009 financial statements and on fiscal year 2009 internal control over financial reporting of the financial statements and had we been engaged to audit the fiscal year 2009 other financial statements and fiscal year 2009 internal control over financial reporting of the other financial statements. We aim, however, to use our knowledge of 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.

Management's written response to our observations and recommendations in Exhibit III 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 and FEMA 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

I. INTERNAL CONTROL DEFICIENCIES RELATED TO CLAIMS

A. Internal Control Deficiencies Identified over Claims Paid

Observation
We selected 12 insurance companies to perform audit procedures over claims paid for the periods October 1, 2008 through March 31, 2009, April 1 through June 30, 2009, and July 1 through August 31, 2009. For the 12 companies selected, we tested a sample of claims paid totaling 688 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, 2009 testwork, for one sample item,the claims file was not complete and the Final Report was not approved before the claim payment was processed and issued.

Company	Policy Number	Loss Date	Claim Payment
		09/13/2008	$ 4,250.23

2) Based on our March 31, 2009 testwork, for six sample items, the total amount paid to the insured did not agree to the amount indicated on the Final Report.

Company	Policy Number	Loss Date	Claim Payment
		09/13/2008	$ 44,008.02
		08/21/2008	$ 9,876.40
		09/06/2008	$ 1,668.50
		09/06/2008	$ 6,929.06
		09/13/2008	$ 32,330.15
		09/13/2008	$ 31,400.00

3) Based on our March 31, 2009 testwork, for one sample item, the claim check was not properly authorized.

Company	Policy Number	Loss Date	Claim Payment
		09/12/2008	$ 10,025.96

4) Based on our March 31, 2009, June 30, 2009, and August 31, 2009 testwork, for 14 sample items, the payments to the insurance company/adjusting firm for servicing the claim did not agree with the National Flood Insurance Program (NFIP) Fee Schedule.

March 31, 2009 Testwork Results:

Company	Policy Number	Loss Date	LAE Payment
		09/13/2008	$ 1,795.55
		09/13/2008	$ 1,725.39
		08/01/2008	$ 925.00
		09/01/2008	$ 1,001.31
		05/01/2008	$ 2,000.00

Company	Policy Number	Loss Date	LAE Payment
		09/13/2008	$ 2,981.94
		09/14/2008	$ 3,935.62
		09/21/2008	$ 1,025.00

June 30, 2009 Testwork Results:

Company	Policy Number	Loss Date	LAE Payment
		08/29/2005	$ 123.72
		06/23/2008	$ 225.00
		08/29/2005	$ 3,947.70

August 31, 2009 Testwork Results:

Company	Policy Number	Loss Date	LAE Payment
		08/22/2007	$ 1,790.00
		04/28/2009	$ 1,099.31
		09/13/2008	$ 4,319.14

5) Based on our March 31, 2009 testwork, for eight sample items, loss reserves were not established at the correct amount when the insurance company received notification of loss.

Company	Policy Number	Loss Date
		09/13/2008
		09/01/2008
		09/01/2008
		09/01/2008
		09/01/2008
		09/01/2008
		06/01/2008
		09/01/2008

Based on the results for the period ended March 31, 2009, this control was not tested during the periods of April 1 through June 30, 2009 and July 1 through August 31, 2009.

6) Based on our March 31, 2009 testwork, for 15 sample items, the loss reserve amounts were not adjusted as claim payments were made to the policyholder.

Company	Policy Number	Loss Date
		09/13/2008
		09/13/2008
		09/13/2008
		09/01/2008
		09/01/2008

Company	Policy Number	Loss Date
		08/01/2008
		09/01/2008
		09/01/2008
		09/01/2008
		09/01/2008
		09/12/2008
		08/21/2008
		09/21/2008
		09/21/2008
		09/22/2008

Based on the results for the period ended March 31, 2009, this control was not tested during the periods of April 1 through June 30, 2009 and July 1 through August 31, 2009.

7) Based on our March 31, 2009 testwork, for one sample item, for an open claim, the loss reserve amount was prematurely reduced to zero prior to the claim being closed.

Company	Policy Number	Loss Date
		09/01/2008

Based on the results for the period ended March 31, 2009, this control was not tested during the periods of April 1 through June 30, 2009 and July 1 through August 31, 2009.

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

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.

B. Inaccuracies in Claims' Loss Reserves

Observation
We selected 12 insurance companies to perform audit procedures over the accuracy and completeness of loss reserves established as of March 31, 2009 and June 30, 2009. For the 12 companies selected, we tested a sample of loss reserves reported as of March 31, 2009 and June 30, 2009, totaling 210 items and 275 items tested, respectively. During this testing, we noted the following inaccuracies at the respective insurance companies:

1) Based on our March 31, 2009 and June 30, 2009 testwork, for eight sample items, the loss reserve was not adjusted for subsequent claims adjuster documentation:

March 31, 2009:

Company	Policy Number	Loss Date	Loss Reserve
		09/13/2008	$ 13,000.00
		09/13/2008	$ 10,000.00
		09/13/2008	$ 32,719.00
		09/13/2008	$ 15,000.00

June 30, 2009:

Company	Policy Number	Loss Date	Loss Reserve
		04/28/2009	$ 140,000.00
		04/27/2009	$ 8,700.00
		05/09/2009	$ 15,000.00
		04/28/2009	$ 5,000.00

2) Based on our March 31, 2009 and June 30, 2009 testwork, for 11 sample items, the loss reserve was not adjusted for partial and/or advance payments made to the policyholder:

March 31, 2009:

Company	Policy Number	Loss Date	Loss Reserve
		09/24/2005	$ 30,000.00
		09/13/2008	$ 30,000.00
		08/29/2005	$ 8,650.00

June 30, 2009:

Company	Policy Number	Loss Date	Loss Reserve
		09/13/2008	$ 230,000.00
		06/10/2009	$ 26,303.14
		03/28/2009	$ 17,062.29
		05/09/2009	$ 41,193.22
		05/09/2009	$ 79,913.86
		04/24/2009	$ 55,000.00
		08/29/2005	$ 30,000.00
		08/29/2005	$ 30,000.00

3) Based on our March 31, 2009 and June 30, 2009 testwork, for 14 sample items, the loss reserve was not closed in a timely manner after full payment of the claim was made to the policyholder:

March 31, 2009:

Company	Policy Number	Loss Date	Loss Reserve
		08/29/2005	$ 20,050.00

Company	Policy Number	Loss Date	Loss Reserve
		07/10/2005	$ 30,000.00
		08/29/2005	$ 30,000.00
		05/19/2004	$ 30,000.00
		09/06/2004	$ 30,000.00
		05/30/2004	$ 30,000.00
		09/08/2004	$ 30,000.00
		02/07/2008	$ 2,510.26

June 30, 2009:

Company	Policy Number	Loss Date	Loss Reserve
		10/24/2005	$ 20,622.90
		09/16/2004	$ 30,000.00
		09/16/2004	$ 30,000.00
		09/05/2004	$ 30,000.00
		05/30/2004	$ 30,000.00
		09/13/2008	$ 4,250.00

4) Based on our June 30, 2009 testwork, for two sample items, the entire or partial loss reserve was not supported by adequate documentation:

Company	Policy Number	Loss Date	Loss Reserve
		09/04/2004	$ 41,829.85
		06/08/2001	$ 30,000.00

5) Based on our June 30, 2009 testwork, for two sample items, the loss reserve was not appropriately established/adjusted due to a claims adjuster clerical error:

Company	Policy Number	Loss Date	Loss Reserve
		04/18/2009	$ 5,000.00
		06/10/2008	$ 10,675.00

6) Based on our June 30, 2009 testwork, for one sample item, the loss reserve resulted from a duplicate reserve being created for a policy that was transitioned to a different policy number:

Company	Policy Number	Loss Date	Loss Reserve
		04/26/2008	$ 30,000.00

7) Based on our June 30, 2009 testwork, for one sample item, the loss reserve was adjusted for a claim payment prior to the claim payment being paid to the policyholder:

Company	Policy Number	Loss Date	Loss Reserve
		06/04/2008	$ 1,128.29

Recommendations
We recommend that FEMA's Mitigation Directorate:

1) Provide adequate oversight for each insurance company during a vendor merger or vendor transition to ensure the new vendor maintains the necessary documents in order to support the financial transactions and balances it is inheriting.
2) 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.
3) Provide increased oversight to ensure the specific and consistent documentation of the established loss reserve and subsequent adjustment to the loss reserve per claim in the claim file at the insurance companies participating in the NFIP is maintained.

II. OTHER INTERNAL CONTROL DEFICIENCIES

A. Internal Control Deficiencies Related to NFIP Restricted Bank Accounts

Observation
We selected 12 insurance companies to perform audit procedures over the NFIP restricted bank account reconciliations, and we noted the following exceptions for the period ended March 31, 2009:

1) For 5 of the 12 insurance companies selected, we noted that lockbox receipts received on the last day of the month (i.e., March 31, 2009) were not included in each company's general ledger but were included in the company's bank balance. Therefore, the amount of cash recorded in the insurance company's general ledger was understated for these insurance companies for the period ended March 31, 2009.
2) For , we noted that its prior NFIP vendor wired $1,424,596 to the company in fiscal year 2009 before the transition to new NFIP vendor. At the time of our audit procedures, neither nor the prior vendor could explain the purpose of the transaction or provide supporting documentation for the item. The current vendor determined that $319,353 of the transfer related to stale checks and subsequently recorded this amount in general ledger in February 2009. As of July 31, 2009, the purpose of the transaction had not been determined.
3) For , we noted two unsupported reconciling items on the March 31, 2009 bank reconciliation. The current vendor purchased the prior vendor in fiscal year 2005 and inherited the two reconciling items included in the prior vendor's bank account. Thus, these items were included in the bank account but not in the general ledger.

The table below provides a listing of the insurance companies discussed above, the understatement of cash dollar value per company at March 31, 2009, and the total understatement of cash dollar value at March 31, 2009.

Insurance Company	Understatement
	$ (13,656)
	$ (69,404)
	$ (8,318)
	$ (1,175,855)

Insurance Company	**Understatement**
	$ (6,420)
	$ (47,971)
Total	**$ (1,321,624)**

Recommendations

We recommend that FEMA's Mitigation Directorate:

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 that NFIP cash management procedures are being followed by insurance companies in accordance with NFIP guidelines.

3) Provide adequate oversight for each insurance company during a vendor merger or vendor transition to ensure the new vendor maintains the necessary documents in order to support the financial transactions and balances it is inheriting.

B. Internal Control Deficiencies in the Claims Reinspection and Submit for Rate Programs

Observation

In fiscal year 2008, during our interim control testwork, we identified instances where FEMA did not consistently maintain documentation of the Submit for Rate review and/or follow-up on underwriting errors nor follow-up appropriately on claim reinspections with the insurance companies.

As of the start of our fiscal year 2009 audit procedures, the current NFIP service provider had been instructed by FEMA's Mitigation Directorate to begin using the NextGen 'FREE' and 'ezClaims' applications for all Submit for Rate Program and Claims Reinspection Program functions, respectively, even though NextGen did not have the authority to operate on a Department of Homeland Security (DHS) network and was not the system of record.

Based on that information, the Submit for Rate Program and the Claims Reinspection Program were not operating using policy and claim data from the NFIP system of record (i.e., Transaction Record Reporting and Processing [TRRP] system) throughout fiscal year 2009.

Recommendation

We recommend that FEMA's Mitigation Directorate use the official NFIP system of record as the basis for the Submit for Rate and Claims Reinspection Programs and not transition these program activities to a new system before it is authorized to operate as the system of record.

C. Insufficient FEMA Oversight of the NFIP Service Provider's Methodology Used to Calculate Estimates Reported in the FEMA Financial Statements

Observation

In fiscal year 2008, we noted that the NFIP service provider's methodology was insufficiently documented to allow a reasonable person to re-perform the year-end estimates and yield the same results. For fiscal year 2009, the NFIP service provider updated the methodology to address the prior year documentation deficiency.

The financial statement estimates for the NFIP are based on the service provider's judgments, historical knowledge, and assumptions to determine the final value of a variety of material account balances. Since the Mitigation Directorate is the responsible division within FEMA for the management and oversight of the NFIP and the Office of the Chief Financial Officer (OCFO) inherits the risks associated with the third party service provider's processing and reporting of the NFIP financial data to FEMA, the Mitigation Directorate should have obtained and provided this information to the OCFO's Financial Management Division, which in turn should have reviewed and approved the methodology used by the service provider to report significant line items.

For fiscal year 2009, we obtained and reviewed the updated deferred revenue, deferred acquisition cost, and accounts payable methodology from the service provider and followed-up with the FEMA OCFO concerning the sufficiency of the methodology. Based on the follow-up performed, we observed that the Mitigation Directorate did not provide the deferred revenue, deferred acquisition cost, and accounts payable methodology to the FEMA OCFO, and consequently, we concluded that as of July 1, 2009, the OCFO had not reviewed and approved the service provider's estimation methodology for the NFIP financial statements and ultimately the FEMA financial statements.

The OCFO reviewed and approved the methodology on July 10, 2009 after we informed them of this deficiency.

Recommendation
We recommend that FEMA's OCFO and Mitigation Directorate develop and implement procedures for the OCFO's Financial Management Division to timely complete such a review and approval whenever changes are made to the NFIP service provider's estimation methodology, to include procedures for the Mitigation Directorate to obtain and provide the changes to the OCFO timely.

D. Monitoring and Communication of Significant Financial-Related Matters in the NFIP

Observation
During fiscal year 2008, based on control testwork and observations and communications with FEMA personnel, we noted the following areas where financial management improvements were needed in monitoring the NFIP operations:

- Retrospective Reserve Analysis
- Change in Service Provider
- Change in NFIP Systems
- Changes to the Actuarial Liability and the Related Actuary Report

Based on our fiscal year 2009 control testwork, observations and communications with FEMA personnel, we noted the aforementioned conditions had been remediated during the current fiscal year. However, during our testwork in current year over the NFIP deferred revenue estimate, we noted that the service provider unilaterally changed the estimation methodology on October 7, 2009. The methodology changed from deferred revenue being based on a two-year historical growth percentage, which was applied to August deferred revenue to calculate September deferred revenue, to deferred revenue being based on a function of written premium. A three-year historical percentage of deferred revenue derived from written premium was applied to the September 2009 written premium balance to estimate deferred revenue at September 30, 2009. Based on our corroborative inquiry with the OCFO and Mitigation Directorate, we noted that both divisions were unaware of the change to the year-end deferred revenue methodology. The related estimate was recorded in FEMA's general ledger.

Recommendations

We recommend that the:

1) Mitigation Directorate develop and implement communication protocols with the service provider to ensure that significant financial-related events are timely communicated to the Mitigation Directorate.

2) Mitigation Directorate designate a point of contact responsible for the timely communication of significant financial-related events with the service provider and the OCFO.

3) OCFO develop and implement communication protocols with the Mitigation Directorate for significant financial-related events and designate a point of contact responsible for these communications and related accounting and reporting action.

Status of Prior Year Observations

The status of each observation reported in our letter dated November 14, 2008 to the 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, 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.

		Disposition	
2008 Observation No.	Description	Closed	Repeat (2009 Observation No./ NFR No.)
I.A	Internal Control Deficiencies Identified over Claims Paid – Interim Testing		I.A/ FEMA 09-36
I.B	Internal Control Deficiencies Identified over Claims Paid – Final Testing		I.A/ FEMA 09-36
I.C	Inaccuracies in Interim Claims' Loss Reserves		I.B/ FEMA 09-37
I.D	Internal Control Deficiencies in the Claims Reinspection Program		II.B/ FEMA 09-41
II.A	Internal Control Deficiencies Identified over Premiums Written	X	
II.B	Internal Control Deficiencies in the Submit for Rate Program		II.B/ FEMA 09-41
III.A	Insufficient Documentation of Methodology Used to Calculate NFIP Estimates Reported in the FEMA Financial Statements		II.C/ FEMA 09-39

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

FEMA

National Flood Insurance Program
Mitigation Directorate
Response to Management Letter for the Year Ended September 30, 2009

February 23, 2010

I. Internal Control Deficiencies Related to Claims

A. Internal Control Deficiencies Identified over Claims Paid

Management has initiated follow-up with the WYO companies on the exceptions noted and will continue to review WYO company claims handling as part of the ongoing claims operation reviews.

While there is a referenced to reliance on these claims data in establishing reserves, Management does not believe that it is material to the reserving process. As Management has explained, reserving works best when there is consistency in case loss reserves.

B. Inaccuracies in Claims' Loss Reserves

Management will reissue the *NFIP Case Loss Reserving Procedures* and will address the vendor merger or vendor transition issue in the cover letter of the reissued bulletin. During the FY 2010 claims operation review cycle, Management will review WYO companies' compliance with the revised claims loss reserve procedures. Management will initiate follow-up with the WYO companies on the exceptions noted above.

While there is a referenced to reliance on these claims data in establishing reserves, Management does not believe that it is material to the reserving process. As Management has explained, reserving works best when there is consistency in case loss reserves.

II. Other Internal Control Deficiencies

A. Internal Control Deficiencies Related to NFIP Restricted Bank Accounts

All exceptions were addressed by September 30, 2009.

Management has and will continue to monitor the cash management practices of the WYO program through monthly reconciliations of financial and statistical information, ongoing audit programs, and WYO Standards Committee of company performance. Management has and will continue to monitor vendor transitions through monthly data reconciliations, ongoing audit programs, and WYO Standards Committee oversight.

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B. Internal Control Deficiencies in the Claims Reinspection and Submit for Rate Programs

Management will continue to use the official NFIP system of record as the basis of the Submit for Rate and Claims Reinspection Program and not transition these program activities to a new system before it is authorized to operate as the system of record.

C. Insufficient FEMA Oversight of the NFIP Service Provider's Methodology Used to Calculate Estimates Reported in the FEMA Financial Statements

Management will seek FEMA OCFO's approval whenever changes are made to the NFIP service provider's estimation methodology and will develop procedures for the Mitigation Directorate to obtain and provide changes to the OCFO in a timely manner.

D. Monitoring and Communication of Significant Financial-Related Matters in the NFIP

Management will develop and implement communication protocols with the service provider to ensure communication of significant financial-related events in a timely manner and has designated a point of contact for communicating these matters to the OCFO and the NFIP service provider.

Edward L. Connor
Acting Federal Insurance and Mitigation Administrator

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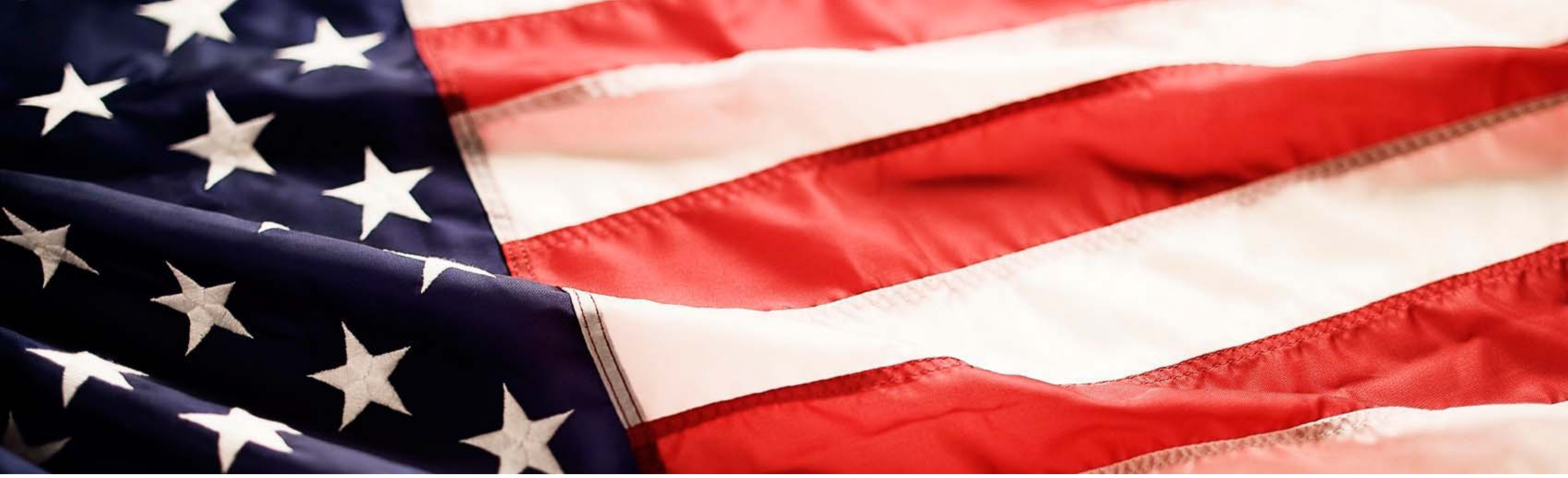

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