



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

**National Flood Insurance Program's
Management Letter for FY 2010 DHS
Consolidated Financial Statements
Audit**

(Redacted)





Homeland Security

MAR 28 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 National Flood Insurance Program's Management Letter for FY 2010 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 2010 financial statements and internal control over financial reporting and prepared this management letter. KPMG is responsible for the attached management letter dated November 12, 2010 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 black ink 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, 2010**



KPMG LLP
2001 M Street, NW
Washington, DC 20036-3389

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, Washington, DC

November 12, 2010

Ladies and Gentlemen:

We were engaged to audit the balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2010, and the related statement of custodial activity for the year then ended (referred to herein as "financial statements"). We were also engaged to examine DHS' internal control over financial reporting (internal control) of the financial statements as of and for the year ended September 30, 2010. We were not engaged to audit the statements of net cost, changes in net position, and budgetary resources for the year ended September 30, 2010 (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 12, 2010, 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, 2010, and we were unable to perform procedures necessary to form an opinion, and we did not express an opinion, on DHS' internal control over financial reporting of the financial statements as of and for the year ended September 30, 2010.

In connection with our fiscal year 2010 audit 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. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement, and accordingly, we do not express such an opinion.

During our DHS 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 and are summarized in Exhibit I of this letter. These comments are in addition to the significant deficiencies presented in our *Independent Auditors' Report*, dated November 12, 2010, included in the FY 2010 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.



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, 2010, 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, 2010. Accordingly, other internal control matters and instances of noncompliance may have been identified and reported had we been able to perform all procedures necessary to express opinions on the fiscal year 2010 financial statements and on fiscal year 2010 internal control over financial reporting of the financial statements and had we been engaged to audit the fiscal year 2010 other financial statements and fiscal year 2010 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. BACKGROUND

The Mitigation Directorate 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. To assist the NFIP in the management of the program, the NFIP has contracted with a third-party service provider. 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 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 Identified over Claims Paid

Observation

We selected 10 insurance companies to perform audit procedures over claims paid for the periods October 1, 2009 through March 31, 2010, April 1 through June 30, 2010, and July 1 through August 31, 2010. For the 10 companies selected, we tested a sample of claims paid totaling 600 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, 2010 testwork, for one sample item, we noted that evidence of the claim examiner’s review of the increased cost of compliance (ICC) report and claim file prior to claim payment was not available and included in the claim file.

Company	Policy Number	Date of Loss	Claim Payment
[REDACTED]	[REDACTED]	03/10/2009	\$15,000.00

- 2) Based on our March 31, 2010 testwork, for one sample item, we noted that the claim file was not appropriately reviewed prior to the claim payment to the policyholder based on the claim examiner’s payment authority limit.

Company	Policy Number	Date of Loss	Claim Payment
[REDACTED]	[REDACTED]	09/21/2009	\$4,000.00

- 3) Based on our March 31, 2010 testwork, for 19 sample items, we noted that based on the claim file, the loss reserve was not updated in the appropriate accounting month for subsequent preliminary/final reports received from the adjustor and/or payments made to the policyholder.

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	11/11/2009
[REDACTED]	[REDACTED]	11/05/2009
[REDACTED]	[REDACTED]	11/13/2009

Exhibit I

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	12/18/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	10/30/2009
[REDACTED]	[REDACTED]	01/25/2010
[REDACTED]	[REDACTED]	11/11/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	11/13/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	10/29/2009
[REDACTED]	[REDACTED]	09/21/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	11/13/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	09/21/2009
[REDACTED]	[REDACTED]	08/29/2005

- 4) Based on our March 31, 2010 testwork, for one sample item, we noted that a loss reserve was not established upon the insurance company receiving the notice of loss.

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	06/18/2008

- 5) Based on our March 31, 2010 testwork, for one sample item, we noted that the loss reserve was not closed in the month that the final payment was made.

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	11/12/2009

- 6) Based on our March 31, 2010 testwork, for one sample item, we noted that the loss reserve was closed before the month of final payment.

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	08/29/2005

- 7) Based on our March 31, 2010 and June 30, 2010 testwork, for seven sample items, we noted that the Loss Adjustment Expense (LAE) payment was incorrect based on supporting documentation in the claim file and the NFIP LAE Schedule.

March 31, 2010 Testwork Results:

Company	Policy Number	Date of Loss	LAE Payment
[REDACTED]	[REDACTED]	03/10/2009	\$1,350.00
[REDACTED]	[REDACTED]	09/21/2009	\$2,547.48
[REDACTED]	[REDACTED]	06/14/2008	\$1,920.27
[REDACTED]	[REDACTED]	09/13/2008	\$1,669.63
[REDACTED]	[REDACTED]	12/12/2009	\$2,000.00
[REDACTED]	[REDACTED]	09/16/2004	\$575.00

June 30, 2010 Testwork Results:

Company	Policy Number	Date of Loss	LAE Payment
[REDACTED]	[REDACTED]	04/28/2009	\$4,726.28

- 8) Based on our March 31, 2010 and June 30, 2010 testwork, for three sample items, we noted an overpayment/underpayment of claim payments to the insured based on the adjuster’s final report and other supporting documentation in the claim file.

March 31, 2010 Testwork Results:

Company	Policy Number	Date of Loss	Claim Payment
[REDACTED]	[REDACTED]	01/08/2009	\$4,396.25

June 30, 2010 Testwork Results:

Company	Policy Number	Date of Loss	Claim Payment
[REDACTED]	[REDACTED]	11/12/2009	\$498.80
[REDACTED]	[REDACTED]	05/02/2010	\$15,000.00

Recommendations

We recommend that FEMA’s Mitigation Directorate:

- 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 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 10 insurance companies to perform audit procedures over the accuracy and completeness of loss reserves established as of January 31, 2010 and June 30, 2010. For the 10 companies selected, we tested a sample of loss reserves reported as of January 31, 2010 and June 30, 2010, totaling 587 items and 612 items tested, respectively. During this testing, we noted the following inaccuracies at the respective insurance companies:

- 1) Based on our January 31, 2010 testwork, for two sample items, the recorded date of loss in the company's NFIP claims system was not accurate based on the supporting documentation in the claim files.

Company	Policy No.	Date of Loss per System	Date of Loss per Claim File
[REDACTED]	[REDACTED]	12/24/2009	08/29/2005
[REDACTED]	[REDACTED]	12/23/2009	08/29/2005

- 2) Based on our January 31, 2010 testwork, for three sample items, the loss reserve amount was incorrectly adjusted by the claims examiner based on the claim file supporting documentation.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	11/13/2009
[REDACTED]	[REDACTED]	10/17/2009

- 3) Based on our January 31, 2010 testwork, for 17 sample items, the loss reserve was not adjusted for partial and/or advance payments made to the policyholder.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	12/17/2009
[REDACTED]	[REDACTED]	05/02/2009
[REDACTED]	[REDACTED]	11/19/2009
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	06/08/2001
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	02/04/2008
[REDACTED]	[REDACTED]	12/17/2009
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	12/13/2009
[REDACTED]	[REDACTED]	11/25/1999
[REDACTED]	[REDACTED]	08/20/2008

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	06/15/2008
[REDACTED]	[REDACTED]	09/25/2009
[REDACTED]	[REDACTED]	09/13/2008

- 4) Based on our January 31, 2010 testwork, for three sample items, the insurance company attempted to correct an attribute related to the claim file in the company's NFIP claims system; however, this reset the loss reserve to the default system amount. Therefore, claim payments made prior to January 31, 2010 did not reduce the loss reserve balance as of that date.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	05/09/2009
[REDACTED]	[REDACTED]	06/13/2008
[REDACTED]	[REDACTED]	11/12/2009

- 5) Based on our January 31, 2010 testwork, for eight sample items, the loss reserve was not adjusted for subsequent adjuster reports and/or the final denial letter.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	12/24/2009
[REDACTED]	[REDACTED]	10/23/2009
[REDACTED]	[REDACTED]	12/24/2009
[REDACTED]	[REDACTED]	11/09/2009
[REDACTED]	[REDACTED]	11/13/2009
[REDACTED]	[REDACTED]	06/11/2002
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	11/13/2009

- 6) Based on our January 31, 2010 testwork, for one sample item, the preliminary report indicated a loss reserve for both building and contents; however, a loss reserve was not established for the contents portion by the claims examiner.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	10/28/2009

- 7) Based on our January 31, 2010 testwork, for three sample items, the loss reserve was not closed in a timely manner after full payment of the claim was made to the policyholder.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	12/24/2009

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	12/23/2009
[REDACTED]	[REDACTED]	06/12/2008

- 8) Based on our January 31, 2010 testwork, for four sample items, the loss reserve was not appropriately established/adjusted because of a claims examiner clerical error.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	01/25/2009
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	12/17/2009
[REDACTED]	[REDACTED]	11/12/2009

- 9) Based on our January 31, 2010 testwork, for one sample item, the loss reserve was converted from a previous insurance company vendor and did not reflect the activity identified in the claim file supporting documentation.

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	09/13/2008

- 10) Based on our January 31, 2010 and June 30, 2010 testwork, for 75 sample items, the claim file supporting documentation did not support the loss reserve recorded in the insurance company's NFIP claims system.

January 31, 2010 Testwork Results:

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	12/03/2007
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	09/12/2008
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	07/10/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	09/01/2006
[REDACTED]	[REDACTED]	09/18/2003

Exhibit I

Company	Policy No.	Date of Loss
[REDACTED]	[REDACTED]	06/30/2007
[REDACTED]	[REDACTED]	09/17/2004
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	09/13/2008

June 30, 2010 Testwork Results:

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	06/28/2006
[REDACTED]	[REDACTED]	05/01/2010
[REDACTED]	[REDACTED]	06/08/2008
[REDACTED]	[REDACTED]	06/14/2010
[REDACTED]	[REDACTED]	05/02/2010
[REDACTED]	[REDACTED]	10/08/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	05/01/2010
[REDACTED]	[REDACTED]	08/19/2008
[REDACTED]	[REDACTED]	10/14/2005
[REDACTED]	[REDACTED]	01/08/2009
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	04/26/2010
[REDACTED]	[REDACTED]	04/30/2010
[REDACTED]	[REDACTED]	12/17/2009
[REDACTED]	[REDACTED]	05/02/2010
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	05/01/2010
[REDACTED]	[REDACTED]	04/26/2010
[REDACTED]	[REDACTED]	03/31/2010
[REDACTED]	[REDACTED]	02/08/2010
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	06/09/2001
[REDACTED]	[REDACTED]	04/09/2008
[REDACTED]	[REDACTED]	06/09/2010
[REDACTED]	[REDACTED]	06/09/2010
[REDACTED]	[REDACTED]	09/13/2008
[REDACTED]	[REDACTED]	06/17/2009

Exhibit I

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	06/09/2010
[REDACTED]	[REDACTED]	06/09/2010
[REDACTED]	[REDACTED]	11/12/2009
[REDACTED]	[REDACTED]	03/29/2010
[REDACTED]	[REDACTED]	06/10/2010
[REDACTED]	[REDACTED]	03/13/2010
[REDACTED]	[REDACTED]	05/01/2010
[REDACTED]	[REDACTED]	05/10/2010
[REDACTED]	[REDACTED]	03/30/2010
[REDACTED]	[REDACTED]	06/12/2010
[REDACTED]	[REDACTED]	03/30/2010
[REDACTED]	[REDACTED]	05/02/2010
[REDACTED]	[REDACTED]	08/30/2005
[REDACTED]	[REDACTED]	05/01/2010
[REDACTED]	[REDACTED]	06/28/2006
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	05/02/2010
[REDACTED]	[REDACTED]	05/02/2010
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	08/29/2005
[REDACTED]	[REDACTED]	06/09/2010
[REDACTED]	[REDACTED]	05/02/2010
[REDACTED]	[REDACTED]	06/14/2010
[REDACTED]	[REDACTED]	06/21/2010
[REDACTED]	[REDACTED]	06/15/2008
[REDACTED]	[REDACTED]	05/01/2010
[REDACTED]	[REDACTED]	06/12/2010

11) Based on our June 30, 2010 testwork, for one sample item, we noted that a claim was opened with an incorrect date of loss and remained open when a new claim was opened with the correct date of loss, resulting in a duplicate claim.

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	05/01/2010

12) Based on our June 30, 2010 testwork, for one sample item, the insurance company did not provide the file for this claim.

Company	Policy Number	Date of Loss
[REDACTED]	[REDACTED]	08/29/2005

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.
- 2) Provide increased oversight to ensure the 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.

III. OTHER INTERNAL CONTROL DEFICIENCIES

A. Internal Control Deficiencies Identified over Premiums Written

Observation

We selected 10 insurance companies to perform audit procedures over premiums written for the periods October 1, 2009 through March 31, 2010, April 1 through June 30, 2010, and July 1 through August 31, 2010. For the 10 companies selected, we tested a sample of premiums written totaling 500 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, 2010 and August 31, 2010 testwork, for two sample items, we noted that the designated flood zone per the policy declaration page did not agree to the FEMA flood maps for the insured property address. Based on the incorrect flood zone used, we noted that the policy premium was calculated incorrectly.

March 31, 2010 Testwork Results:

Company	Policy Number	Premium Receipt Date
[REDACTED]	[REDACTED]	01/20/2010

August 31, 2010 Testwork Results:

Company	Policy Number	Premium Receipt Date
[REDACTED]	[REDACTED]	08/16/2010

- 2) Based on our March 31, 2010 testwork, for two sample items, we noted that the policy declaration page indicated that the premium should be calculated using pre-firm construction rates, but the policy premium was calculated using post-firm rates. Per the NFIP Manual, elevated pre-firm premiums may be calculated using post-firm rates if an elevation certificate is completed. However, we were unable to obtain the elevation certificates to support the use of post-firm rates for those policies.

Company	Policy Number	Premium Receipt Date
[REDACTED]	[REDACTED]	01/27/2010
[REDACTED]	[REDACTED]	03/01/2010

- 3) Based on our March 31, 2010 testwork, for one sample item, we noted that the premium was calculated using a basement and above contents rate. However, the application indicated that contents should be calculated using lower floor only – above ground level rates.

Company	Policy Number	Premium Receipt Date
[REDACTED]	[REDACTED]	12/17/2009

- 4) Based on our March 31, 2010 testwork, for one sample item, we noted that the premium was calculated based on a preferred risk policy without basement or enclosure rates. However, the application indicated that the property had a finished basement below the building.

Company	Policy Number	Premium Receipt Date
[REDACTED]	[REDACTED]	11/17/2009

Recommendations

We recommend that FEMA’s Mitigation Directorate:

- 1) Follow-up with each of the insurance companies noted above to determine that they have implemented the appropriate corrective action to address the exceptions identified.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure they process and review underwriting files in accordance with NFIP guidelines.

B. Internal Control Deficiencies over the Retrospective Reserve Analysis

Observation

We identified that the monthly Retrospective Reserve Analysis over the insurance liability estimate for July 31, 2010 prepared by third-party service provider’s actuary contained discrepancies in the calculation of “total reserves retrospectively” and the reserve “redundancy/deficiency” amount for the month of July 2010. We noted the subsequent losses paid, current outstanding case reserve, and current incurred but not reported (IBNR) reserve for the Direct Servicing Agent were improperly excluded from the “total reserves retrospectively,” which resulted in the calculation of the “redundancy” being misstated by \$45,919,624.

	Subsequent Loss Paid	Current O/S Case Reserve	Current IBNR Reserve	Total Reserves Retrospectively	Financial Statement Reserves	Redundancy / (Deficiency)
FEMA	\$82,779,557	\$90,716,321	\$129,274,906	\$ 256,851,160	\$334,758,959	\$77, 907,799 *
KPMG	\$82,779,557	\$90,716,321	\$129,274,906	\$ 302,770,784	\$334,758,959	\$31,988,175
Difference						\$45,919,624

* The documented “redundancy/deficiency” in the Retrospective Reserve Analysis was \$23,477,443 because of a formula error. Based on the documented “total reserves retrospectively” and “financial

statement reserves,” the amount that should have been shown as the “redundancy/deficiency” was \$77,907,799.

Recommendation

We recommend that FEMA’s Mitigation Directorate enhance the Chief Actuary’s Retrospective Reserve Analysis review procedures to include a review of the accuracy of the amounts and calculations in the analysis.

C. Deficiency in the Methodology Used to Calculate the Non-Current Portion of the Insurance Liability Estimate

Observation

We noted the following conditions relate to the calculation of the current and non-current portions of the insurance liability estimate:

- 1) In fiscal year (FY) 2009, FEMA’s Office of the Chief Financial Officer (OCFO) calculated the current and non-current portions of the insurance liability estimate using a 33% and 67% split, respectively. In FY 2010, the third-party service provider’s actuary was asked to determine the percentage and calculated the current and non-current portions of the insurance liability as 85% and 15%, respectively. FEMA did not provide rationale for the large change in percentages used for the current and non-current portions of the insurance liability from FY 2009 to FY 2010, explain the methodology used in FY 2009, or provide rationale for the change in methodology from the prior year to the current year.
- 2) In FY 2010, the methodology used by FEMA to calculate the current and non-current portions of the insurance liability estimate, developed by the third-party service provider’s actuary, utilized the assumption that non-current liabilities represented estimated losses for accident months September 2009 and earlier. FEMA explained that, absent any major disasters, it would expect that a similar percentage of claims would have accident months older than one year at September 30 each year. FEMA’s reasoning provided for the current and non-current portions of the insurance liability calculation is not consistent with Statement of Federal Financial Accounting Standards No. 1 and is not supported by actual FY 2010 claim payment data. The non-current portion of the liability should represent the insurance claims that will not be paid within the next year, not insurance claims with an accident month older than one year.

Recommendation

We recommend that FEMA’s OCFO and Mitigation Directorate develop, document, and approve procedures to periodically reassess a methodology for calculating the current and non-current portions of the insurance liability estimate that is in compliance with the applicable accounting standards.

Status of Prior Year Observations

Exhibit II

The status of each observation reported in our letter dated November 13, 2009 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.

2009 Observation No.	Description	Disposition		
		Follow-up not within 2010 Scope	Closed	Repeat (2010 Observation No./ NFR No.)
I.A	Internal Control Deficiencies Identified over Claims Paid			II.A/ FEMA 10-01 & FEMA 10-01a
I.B	Inaccuracies in Interim Claims' Loss Reserves			II.B/ FEMA 10-02 & FEMA 10-02a
II.A	Internal Control Deficiencies Related to NFIP Restricted Bank Accounts	X		
II.B	Internal Control Deficiencies in the Claims Reinspection and Submit for Rate Programs	X		
II.C	Insufficient FEMA Oversight of the NFIP Service Provider's Methodology Used to Calculate Estimates Reported in the FEMA Financial Statements		X	
II.D	Monitoring and Communication of Significant Financial-Related Matters in the NFIP		X	

Management's Response

Exhibit III


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



FEMA

February 7, 2011

Memorandum For: Anne Richards
Acting Assistant Inspector General for Audits

From: 
Edward L. Connor
Acting Federal Insurance and Mitigation Administrator

Subject: Draft Report: NFIP Management Letter for DHS' FY 2010
Financial Statement Audit

Thank you for the opportunity to comment on the draft management letter for the DHS FY 2010 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 claims loss reserves are material to the 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. Management does not believe that claims loss reserves are material to the loss reserving process.

Other Internal Control Deficiencies

A. Internal Control Deficiencies Over Premiums Written

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 underwriting processes as part of the ongoing underwriting operation reviews.

B. Internal Control Deficiencies over the Retrospective Reserve Analysis

Management concurs with the recommendation. The Chief Actuary has enhanced the retrospective reserved analysis review process to include a review of the accuracy of the amounts and the calculations used in the analysis.

C. Deficiency in the Methodology Used to Calculate the Non-current Portion of the Insurance Liability Estimate

Management concurs with the recommendation. FEMA's OCFO and the Mitigation Directorate are developing procedures to reassess periodically a methodology for calculating the current and non-current portions of the insurance liability estimate that complies with the applicable accounting standards.

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