United States General Accounting Office

GAO

Report to the Congress

April 1990

FINANCIAL AUDIT

Federal Crop Insurance Corporation's Fiscal Year 1988 Financial Statements

GAO/AFMD-90-43

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-114834

April 18, 1990

To the President of the Senate and the
Speaker of the House of Representatives

This report presents our opinion on the Federal Crop Insurance Corporation's financial statements for the fiscal year ended September 30, 1988. The Corporation's financial statements present fairly, in all material respects, its financial position, the results of its operations, and its cash flows. This report also includes our reports on the Corporation's system of internal accounting controls and on its compliance with laws and regulations. We conducted our audit pursuant to 31 U.S.C. 9105 and in accordance with generally accepted government auditing standards.

Our opinion on the Corporation's financial statements emphasizes its continued losses, which are due to claims exceeding premiums, and the need for additional government capital to sustain operations. Claims have exceeded premiums every year since enactment of the Federal Crop Insurance Act of 1980, with 1988 losses amounting to $617 million. The Corporation's accumulated deficit for 1988 amounts to about $1.8 billion. Without significant changes in insurance program operations, the Corporation's ability to pay its losses will depend on additional government assistance.

Our report on internal accounting controls discusses weaknesses regarding (1) the Corporation's oversight of reinsured companies and (2) controls over processing and payment of administrative expenses. Our report on compliance with laws and regulations discloses that the Corporation complied with the provisions of laws and regulations for the transactions we tested.

We are sending copies of this report to the Director of the Office of Management and Budget, the Secretary of the Treasury, the Secretary of Agriculture, and the Board of Directors of the Federal Crop Insurance Corporation.

Charles A. Bowsher
Comptroller General
of the United States

The Corporation's Financial Outlook

Since 1984, the Corporation's accumulated deficit has more than tripled, increasing from $516 million to about $1.8 billion by 1988. This can be attributed to the continuing effects of several factors. First, the Federal Crop Insurance Act of 1980 considerably expanded the role of the Corporation. The act included provisions for increasing coverage (1) from a limited number of states to nationwide availability, (2) from a limited number of events to "all-risk" coverage for a wide variety of crop damage, (3) from a few agricultural crops to any agricultural commodity the Corporation's Board of Directors decides to insure. According to the 1980 act and its legislative history, the increased coverage provided by the act was intended to replace the federal disaster program which had been administered by the Agricultural Stabilization and Conservation Service. In 1988, all-risk crop insurance was available in over 3,000 counties with policies covering 50 different commodities. The 1980 act also authorized the Corporation to request funds from the Commodity Credit Corporation to cover losses in excess of premiums.

Second, recent widespread drought conditions have also contributed to the Corporation's deficit. In 1988, the United States suffered a drought which was among the worst in the twentieth century. Consequently, the Corporation experienced a record high $1 billion in claims for crop losses which exceeded premiums by $617 million, resulting in a net loss of $626 million. This experience was the worst in the Corporation's history. The Corporation estimated that, due to continued drought conditions, fiscal year 1989 will result in a new high of about $1.2 billion in claims.

Claims have exceeded premiums every year since nationwide expansion of the insurance program as a result of the 1980 act. However, the Corporation has not established premium rates that adequately cover losses on insured crops and that would enable it to build a reasonable reserve against unforeseen losses, as authorized by the act. The Corporation's position is that higher premium rates would reduce producer participation in the crop insurance program.

To overcome these deficits, the Commodity Credit Corporation has provided $1.7 billion of capital contributions from its appropriations since 1984, as authorized by the 1980 act and the Food Security Act of 1985. Also, in response to the severity of the drought conditions in 1988, the Congress authorized about $3.4 billion in disaster payments in addition to the insurance claims paid by the Corporation.

Our study and evaluation, made for the limited purpose described in the second paragraph, would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the Corporation's system of internal accounting controls taken as a whole or on the categories of controls identified in the second paragraph.

In our prior reports since 1984, we have reported material weaknesses relating to internal controls over reinsurance loss adjustments, administrative expenses, reconciliation of subsidiary records to control accounts, and an accounting system which did not provide all information on insurance losses and premiums required for fair financial reporting by fiscal year. The results of our fiscal year 1988 audit showed that the Corporation had improved its internal control procedures relating to reconciliation of subsidiary records and the accounting system.

However, our study and evaluation disclosed that further improvements are needed with respect to two conditions which we noted in our fiscal year 1986 financial audit and a 1987 report. These two conditions, which we believe could result in errors or irregularities in amounts material to the Corporation's financial statements and not be promptly detected, relate to (1) insufficient oversight over reinsured companies and (2) the lack of accounting controls over administrative expenses. We considered these conditions in determining the nature, timing, and extent of our audit tests. We extended our audit tests sufficiently to conclude that these conditions would not require qualification of our opinion on the Corporation's financial statements for the year ended September 30, 1988.

Oversight of Reinsured Companies Has Improved

The Corporation's oversight of reinsured companies' loss adjustment activities has improved, but further improvements can be made. In 1987, we reported that reinsured companies had overpaid about 31 percent of selected claims for crop years 1984 and 1985.[1] Subsequent reviews by us and one by the U.S. Department of Agriculture's (USDA) Office of Inspector General focused on claims adjusted by reinsured companies for crop years 1987 and 1988 and found that improvements had been made. For crop year 1987, we reported that the reinsured companies' overpayment rate was about 16 percent.[2] The Inspector General

[1] Crop Insurance: Overpayment of Claims by Private Companies Costs the Government Millions (GAO/RCED-88-7, November 20, 1987).

[2] Crop Insurance: Private Company Loss Adjustment Improving, but Overpayment Still High (GAO/RCED-90-32, November 7, 1989).

Lack of Internal Accounting Controls Over Administrative Expenses

Our financial audit of fiscal year 1988 disclosed that the Corporation did not have sufficient internal controls over the processing and payment of some administrative expenses. Specifically, the Corporation had not established internal accounting control procedures to ensure that all transactions sent to the U.S. Department of Agriculture's National Finance Center (NFC) in New Orleans were accurately processed and recorded. The audit of the Corporation's 1987 financial statements resulted in a disclaimer of opinion due to the Corporation's lack of control over administrative expenses.

During fiscal year 1988, the Corporation sent a total of $232 million of administrative expense vouchers to NFC for processing and payment. NFC functions as USDA's central accounting office responsible for processing and making administrative payments for all agriculture agencies, including the Corporation. Approximately $177 million of expense vouchers involving sales agents' commissions, loss adjustors' expenses, reinsurance reimbursements, bad debt expense, and interest expense were processed at the Corporation's Kansas City headquarters Finance Branch. We found that Finance Branch personnel performed appropriate reconciliations of these transactions with NFC reports. However, we found weak controls over the remaining $55 million of administrative expenses, which involve salaries and other expenses processed by individual Corporation cost centers.

GAO's Policy and Procedures Manual for Guidance of Federal Agencies, Title 2, requires that general ledger balances be reconciled with subsidiary accounts and records on a regular basis to ensure their accuracy. Cost center personnel do not adequately reconcile expense vouchers for salaries and other administrative expenses to ensure that they are properly recorded. Individual Corporation cost centers (e.g., branches and divisions) are responsible for submitting these administrative expense vouchers to NFC. Each cost center receives a detailed transaction register from NFC at the end of each month to show what was processed. Each cost center maintains copies of the administrative expense vouchers submitted to NFC, but cost center personnel do not compare these documents with the transaction register on a regular and systematic basis. Cost center personnel may scan the monthly transaction register and review copies of source documents for questionable items. However, this procedure does not ensure that all transactions have been properly recorded in the accounts and included in the Corporation's financial statements.

Report on Compliance With Laws and Regulations

We have audited the financial statements of the Federal Crop Insurance Corporation for the year ended September 30, 1988, and have issued our opinion thereon. We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the Corporation is the responsibility of the Corporation's management. As part of obtaining reasonable assurance as to whether the consolidated financial statements were free of material misstatement, we performed tests of the Corporation's compliance with the following provisions of laws and regulations:

- Federal Crop Insurance Act, as amended (7 U.S.C. 1501-1520), and related regulations;
- Anti-Deficiency Act (31 U.S.C. 1341-1519);
- Debt Collection Act of 1982 (31 U.S.C. 3711-3719); and
- Prompt Payment Act (31 U.S.C. 3901-3906).

The results of our tests indicate that, with respect to the items tested, the Corporation complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the Corporation had not complied, in all material respects, with those provisions.

Statement of Loss and Changes in Accumulated Deficit

FOR FISCAL YEARS ENDED SEPTEMBER 30, 1988, AND SEPTEMBER 30, 1987
(In thousands of dollars)

REVENUES	FISCAL YEAR 1988		FISCAL YEAR 1987	
Premium(note 2.b & note 3)				
Direct premium	$61,963		$62,876	
Reinsurance premium	361,078	$423,041	289,095	$351,971
Interest income		4,750		5,046
Other		2,681		1,539
Total Revenues		430,472		358,556
EXPENSES				
Insurance Claims(note 2.c)				
Direct claims	154,058		75,184	
Reinsurance	885,818	1,039,876	338,935	414,119
Administrative Expenses				
Sales agent's commissions(note 2.e)	13,618		10,388	
Claims adjustment(note 2.c)	7,441		3,724	
Reinsurance administrative(note 2.f)	154,663		106,990	
Provision for uncollectible accounts	1,542		2,403	
Interest expense	34		43	
Salaries & other expenses(note 9)	55,346		56,760	
		232,644		180,308
Total Expenses		1,272,520		594,427
(Loss) from operations		(842,048)		(235,871)
OTHER FINANCING SOURCES				
Operating appropriations(note 2.g)		215,675		175,341
Net loss for the year		(626,373)		(60,530)
Credit arising from transfer of invested capital for depreciation on contributed assets		249		271
Loss transferred to accumulated deficit		(626,124)		(60,259)
Accumulated Deficit, beginning of fiscal year		(1,142,911)		(1,082,652)
Accumulated Deficit, end of fiscal year		($1,769,035)		($1,142,911)

The accompanying notes are an integral part of the statements.

Notes to Financial Statements

September 30, 1988 and 1987

(1) Organization

The Federal Crop Insurance Corporation (FCIC) was established with the Federal Crop Insurance Act (the Act), which was enacted as Title V of the Agricultural Adjustment Act of 1938 (52 Stat. 72). FCIC manages an all-risk crop insurance program to assist in stabilizing and protecting the farm sector of the nation's economy. The program was restricted until the Federal Crop Insurance Act of 1980 (Public Law 96-365) called for expanding it nationwide to eventually phase out the disaster payment program which was authorized by the Agriculture Act of 1949, as amended. All-risk crop insurance is available in over 3,000 counties with policies covering 50 different commodities in 1988.

FCIC is a wholly-owned Government corporation within the United States Department of Agriculture (USDA), under the direction and control of a Board of Directors. The Board of Directors is appointed by the Secretary of Agriculture. The accompanying financial statements include only those operations under the control of the Board of Directors.

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

FCIC maintains separate accounts for the insurance program and for administrative support. However, for financial statement presentation purposes, the two sets of accounts are combined and are presented on the accrual basis of accounting following generally accepted accounting principles.

(b) Revenue Recognition Including Federal Premium Subsidy

Premiums (including premium subsidies) are recognized as earned during a fiscal year based on a pro rata amount with respect to each crop's growing season. The portion of premium not recognized during the fiscal year is classified as unearned. FCIC's risk of loss commences when the crop is planted and continues through the respective growing season until the crop is harvested, destroyed, or removed from the field. Premiums are generally collected at the end of the growing season when the crops are harvested. A provision is made for federal premium amounts expected to be uncollectible based on historical experience.

September 30, 1988 and 1987

(e) Sales and Service Contractors' Commissions and Administrative Expenses

The 1988 crop year commissions and administrative expenses were 20% of direct premium. The 1987 crop year commissions and administrative expenses were 15% of direct premium.

(f) Reinsurance Administrative Expenses and Payables

Section 508(e) of the Act, as amended, authorizes FCIC to enter into reinsurance agreements with private insurance companies, under which FCIC assumes the majority of the risk of loss on crop insurance written by the reinsured companies.

The 1988 and 1987 standard reinsurance agreements provided for both proportional and nonproportional means by which the reinsured may cede business to FCIC. The reinsured company elects the methods by which it intends to cede business to FCIC through its plan of operations which is submitted with and becomes a part of the reinsurance agreement.

Proportional reinsurance provides for a one-to-one percentage exchange of losses and premium between the reinsured company and FCIC. The reinsured company may not cede to FCIC, under the proportional methods, premium that exceeds 57% of its total book of business. Nonproportional reinsurance refers to mandatory stop loss provisions which apply to the reinsured's entire retained book of business after the cessions made under proportional methods. Stop loss reinsurance may be applied on both a state and national level based upon the ratio of the reinsured's retained ultimate net losses to its retained net book premium. Limitations under stop loss reinsurance are dependent upon the business retained and the ratio of losses to premium.

The reinsurance agreement provides that all premium written under the agreement is remitted to FCIC and that all losses on claims incurred are paid by FCIC. An annual settlement is calculated whereby the results of the business written by the reinsured companies are determined and an experience-rated gain or loss computed. If this annual settlement (which is calculated monthly during the reinsurance year on a cumulative basis) results in an underwriting loss, the reinsured company

September 30, 1988 and 1987

However, in fiscal year 1988, the administrative appropriation was short of actual obligations. Accordingly, all administrative and program expenses have been reported in the fiscal year incurred because of the premium deficiency which existed in fiscal year 1988. Excess expenses of $14 million not covered by appropriation have been reported in the Statement of Operations for the fiscal year ended September 30, 1988, and these expenses have been paid out of the Insurance Program Fund. There were no excess expenses not covered by appropriation for fiscal year 1987.

(h) Depreciation of Furniture and Equipment and Invested Capital

Depreciation expense of $249,000 and $271,000 was recorded in fiscal years 1988 and 1987. Furniture and equipment is stated at cost and depreciated using the straight-line method over the estimated useful lives of the related assets, ranging from five to nine years. Invested capital is recorded at the cost of furniture and equipment acquired, as all furniture and equipment purchases are paid for through the annual operating appropriation at the time of purchase. Invested capital is decreased by the amount of depreciation for a fiscal year.

(i) Administrative & Other

The liability for administrative and other expenses includes $2.1 million for accrued annual leave for fiscal year 1988 and $2.2 million for 1987. This amount is not administratively funded by current appropriation from Congress.

(j) Due to United States Treasury

This amount represents net adjustments to the appropriation accounts subsequent to completion of the year-end closing statement with the United States Treasury.

(k) Cash Flow Statement

The Consolidated Statement of Cash Flows has been prepared in accordance with the direct method as set forth in Statement of Financial Accounting Standards No. 95 "Statement of Cash Flows" (FASB 95). The reconciliation of Net Loss to Net Cash Outflow from Operating Activities is as follows (in thousands of dollars):

September 30, 1988 and 1987

	FISCAL YEAR 1988	FISCAL YEAR 1987
Earned Premium:		
Producer	$318,910	$264,842
Subsidy	104,131	87,129
Total	$423,041	$351,971
Unearned Premium:		
Producer	$53,300	$44,535
Subsidy	17,774	14,319
Total	$71,074	$58,854

The appropriated premium subsidy FCIC received was $229 million in fiscal year 1988 and $136 million in 1987. This resulted in $121 million in excess subsidy earned for fiscal year 1988 and $60 million for 1987. This is reflected in the liability for unearned premium subsidy of $181 million on the September 30, 1988 Statement of Financial Condition and $60 million for 1987.

The subsidy appropriation of $229 million for fiscal year 1988 and $136 million in 1987 was based on a percentage of premiums estimated for 1988 and 1987 crop years. Since 1981, FCIC has received a total of $866 million in appropriations for premium subsidy, of which $685 million has been earned and $181 million is unearned as of September 30, 1988.

(4) Cash in United States Treasury

FCIC maintains separate accounts for the insurance program and for administrative support. The administrative account can only be used to pay administrative and operating costs of FCIC as well as certain program expenses, and cannot be used to pay indemnity losses. Cash maintained in these Treasury accounts does not accumulate interest.

(5) Loan Payable to United States Treasury

On August 19, 1985, a promissory note was executed between the Secretary of Agriculture and the Secretary of the Treasury under the borrowing authority granted by section 516(d) of the Act. The

September 30, 1988 and 1987

September 30, 1985. As of September 30, 1988, FCIC has issued all authorized capital stock as follows (in millions of dollars):

Public Law	Issued	Amount
97-103	December 23, 1981	$250
97-370	December 18, 1982	150
98-396	August 22, 1984	50
99-088	August 15, 1985	50
		$500

(8) Paid-In Capital

Unexpended balance of original stock issue

The Federal Crop Insurance Act of 1980 directed the Secretary of the Treasury to cancel the original $200 million of outstanding capital stock of the Corporation. Cumulative expenses of $162 million were written off against the original amount of capital stock leaving $38 million which was transferred to paid-in captial.

Transfers of funds from the Commodity Credit Corporation (CCC)

At September 30, 1986, FCIC owed CCC, an affiliated organization within the USDA, $450 million for funds advanced. In September 1987, the $450 million was designated by USDA as non-reimbursable, and consequently has been classified as additional paid-in captial. Additional paid-in captial has been received from CCC as shown in the following summary (in millions of dollars):

Summary of Paid-In Capital		Amount
September 30, 1981	Balance of original stock issue	$ 38
September 30, 1986	CCC transfer	450
September 30, 1987	CCC transfer	300
Balance September 30, 1987		788
September 30, 1988	CCC transfer	900
Balance September 30, 1988		$1,688

September 30, 1988 and 1987

(10) Lease Commitments

FCIC has entered, at a total rental cost of $2.3 million, into operating lease agreements for certain office facilities. Rent expense amounted to $545,000 in fiscal year 1988. Lease commitments on the rental of office facilities at September 30, 1988 were as follows (in thousands of dollars):

Fiscal 1989	$ 568
Fiscal 1990	579
Fiscal 1991	591

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

September 30, 1988 and 1987

(9) Employee Benefits

The majority of FCIC's employees are covered by the Civil Service Retirement System (CSRS), which is currently two-tiered. For employees hired prior to January 1, 1984, FCIC withholds approximately 7% of their gross earnings, which is matched by FCIC. The amount withheld from employees is then remitted to the Civil Service Retirement Fund. For employees hired on or after January 1, 1984, FCIC withholds, in addition to Social Security Withholdings, approximately 1.3% of their gross earnings, but matches such withholdings with a 7% contribution, as above. This second employee group will receive retirement benefits from the CSRS along with the Social Security System to which they currently contribute. By December 31, 1987, each employee covered by the CSRS made a decision to remain under the CSRS or transfer to the new Federal Employees Retirement System (FERS). Under FERS, employees will receive retirement benefits from Social Security, a government retirement benefit of 1 to 1.1% of "high-3" salary base and benefits from a defined contribution plan (thrift). Under the contribution plan, an employee may contribute (tax deferred) up to 10% of their salary to an investment fund. The government will then match this amount up to 5%. Those employees electing to remain under CSRS will receive the benefits now in place, plus they may contribute (tax deferred) up to 5% of salary to the thrift plan, with no matching amount to be contributed by the government. During the year ended September 30, 1988, FCIC contributed $1.6 million to the CSRS and $.09 million to the Social Security System. During the 1987 fiscal year, FCIC contributed $1.7 million to the CSRS and $.08 million to the Social Security System.

The value of vested and nonvested benefits, assets available for benefits, and unfunded pension cost related to FCIC employees cannot be determined as this is a multiemployer plan. Although FCIC funds a portion of pension benefits under the CSRS relating to its employees and makes the necessary payroll withholding from them, it does not disclose the assets of the CSRS, nor does it disclose actuarial data with respect to accumulated plan benefits or the unfunded pension liability relative to its employees. Reporting of such amounts is the responsibility of the U. S. Office of Personnel Management.

September 30, 1988 and 1987

note allowed the advance of no more than $113 million at any one time, with any outstanding balance originally due January 1, 1988. Interest on the unpaid principal balance outstanding is payable semiannually on January 1 and July 1 at a rate equal to the current average market yield on outstanding obligations of the United States of comparable maturities during the month preceding the issuance of such notes or obligations.

Interest, however, does not accrue unless FCIC's cash balance with the U.S. Treasury falls below $113 million. When this occurs, interest is calculated on a daily basis on the difference between $113 million and FCIC's cash balance. No interest expense was incurred during fiscal year 1988 and 1987 as FCIC's cash balance with Treasury did not fall below $113 million. On October 15, 1987, the due date of this note was extended from January 1, 1988 to January 1, 1990.

(6) Litigation

FCIC is a defendant in various litigations arising in the normal course of business. Damages claimed in such litigations exceed $100 million. However, approximately $6 million is considered by counsel to be a possible loss as of September 30, 1988 and $8 million in 1987.

Approximately $6 million in fiscal year 1988 and $7 million in 1987 of potential overpayments to reinsured companies have been identified by the Office of Inspector General, the General Accounting Office and the FCIC Compliance Division. These overpayments represent potential revenue if collection is ultimately made. However, these claims are subject to rebuttal and appeal by the reinsured companies, and collections subsequent to September 30, 1988 have been immaterial. Realization of this potential revenue is subject to considerable uncertainty and, accordingly, no receivable accruals were reflected in the financial statements for fiscal year 1988 and 1987.

(7) Capital Stock

Section 504(a) of the Act, as amended, directs and authorizes capital stock of $500 million subscribed by the United States of America. There has been no change in capital stock issued since

September 30, 1988 and 1987

	FISCAL YEAR 1988	FISCAL YEAR 1987
Net Loss Including depreciation	$(626,373)	$(60,530)
Depreciation expense	249	271
Retirements of furniture and equipment, net	217	1,149
Net book value of assets contributed	0	1,191
Allowance for uncollectible accounts	(9,000)	(3,500)
Increase in unearned premium	12,220	(14,957)
Increase in receivable from reinsured companies	(29,228)	(204,081)
Decrease in receivable from producers	12,665	17,556
Decrease in due to U.S. Treasury	(8,637)	28,071
Decrease in administrative and other receivables	972	26,245
Increase in losses payable	544,317	55,475
Increase in accrued loss adjustment costs and commissions	22,024	(30,936)
Decrease in contingent liabilities	(1,900)	0
Decrease in experience rating refund due reinsured companies	(16,893)	6,893
Increase in premium subsidy	121,143	25,242
Other, net	(6,581)	(4,196)
Total adjustments to net loss	641,568	(95,577)
Net Cash Outflow from Operating Activities	$ 15,195	$(156,107)

(3) Federal Premium Subsidy

Section 508(b)(3) of the Act, as amended, requires FCIC to pay up to 30% of each producers' premium on any coverage up to a maximum of 65% of recorded or appraised average yield, and provides appropriation for this purpose. FCIC's share of producers' premium is paid by this subsidy, which is recognized as revenue in the same manner as premium paid by the producer. Premium earned from subsidy included in the statement of loss and accumulated deficit was $104 million in fiscal year 1988 and $87 million in 1987.

A summary of earned and unearned premium, showing both producer premium and the premium subsidy, is shown in the following table for fiscal years 1988 and 1987(in thousands of dollars):

September 30, 1988 and 1987

is required to remit to FCIC the amount of the loss upon submission of the monthly accounting reports prior to filing the annual settlement report. In fiscal year 1988 reinsured companies incurred losses of $8 million in excess of underwriting gains; however, the net amount of $8 million was not determined and recorded until fiscal year 1989. If there is a gain, FCIC is required to remit the gain to the reinsured company at annual settlement time. In fiscal year 1987 reinsured companies experienced a gain, so FCIC recorded a liability to refund $17 million to the companies.

Total 1988 reinsurance administrative expenses were 37% of reinsurance premium. The 1988 reinsurance agreement provided for an expense reimbursement equal to 34% of premium plus expense reimbursement for premium taxes (about 2% of premium) for policies reinsured under the agreement, and another 1% of premium for additional claim expenses if warranted by the companies loss ratio. These amounts aggregated $155 million for fiscal year 1988, of which $60 million was shown as a payable to reinsured companies at September 30, 1988.

Total 1987 reinsurance administrative expenses were 35% of reinsurance premium. The 1987 reinsurance agreement provided for an expense reimbursement equal to 33% of premium plus expense reimbursement for premium taxes (about 2% of premium) for policies reinsured under the agreement. These amounts aggregated $107 million for fiscal year 1987 of which $44 million was shown as a payable to reinsured companies at September 30, 1987.

(g) Operating Appropriations

In addition to the annual appropriation for premium subsidy, FCIC also receives an annual appropriation for administrative, operating, reinsurance and program expenses except for uncollectible accounts.

The administrative appropriation is intended to cover substantially all expenses other than losses incurred and provision for uncollectible accounts. When the administrative appropriation is sufficient to cover applicable expenses, the Corporation's accounting policy is to prorate the appropriation between fiscal years as premiums are earned.

September 30, 1988 and 1987

(c) Claims Recognition

Liability for claims payable and related claims adjustment expenses is established using estimates of incurred but unpaid claims based on historical experience adjusted for changes in crop growing conditions. Since the calculation of claims payable and claims adjustment expenses payable is necessarily based on estimates, the ultimate liability may be more or less than the estimates.

Commissions, claim adjustment expenses and insurance administrative expenses are usually covered by operating appropriations; however, these expenses may be paid from program funds if appropriated funds are not sufficient to pay these expenses. Indemnity losses are paid from premium proceeds when appropriations are sufficient to cover all other expenses.

In fiscal year 1988, because claims incurred exceeded the risk premium earned, a premium deficiency existed as defined in the Statement of Financial Accounting Standards No. 60 "Accounting and Reporting by Insurance Enterprises" (FASB 60). Accordingly, since the aggregated loss ratio for 1988 was 2.5 ($2.50 loss for every $1.00 of premium), total losses of $1,040 million have been recognized in the statement of operations and $71 million of losses have been carried forward to fiscal year 1989 to offset the deferred premium of $71 million carried forward to fiscal year 1989. In fiscal year 1987, $59 million of premium and $46 million of losses and $13 million of related insurance adminstrative expenses were carried forward to fiscal year 1988.

(d) Acquisition costs

FCIC includes only agents' commissions and reinsurance administrative expenses as acquisition costs since they are the only expenses that vary with, and are directly related to, acquiring new and renewal business. FASB 60 requires insurance companies to capitalize and amortize deferred acquisition costs in proportion to premium revenue recognized. As of year-end, FCIC did not have any deferred acquisition costs because of the premium deficiency which existed in fiscal year 1988.

Statement of Cash Flows

FOR FISCAL YEARS ENDED SEPTEMBER 30, 1988, AND SEPTEMBER 30, 1987
INCREASE (DECREASE) IN CASH
(in thousands of dollars)

	FISCAL YEAR 1988	FISCAL YEAR 1987
CASH FLOW FROM OPERATING ACITVITIES:		
Cash inflows:		
From insurance operations	$404,909	$247,957
From operating appropriations	216,864	188,317
From subsidy appropriations	121,143	25,242
Cash outflows:		
Paid for indemnity claims	(512,452)	(337,780)
Paid for direct sales and reinsurance administrative expenses	(153,698)	(134,038)
Paid for other expenses	(61,571)	(145,805)
Net cash inflow/(outflow) from operations(note 2.k)	15,195	(156,107)
CASH FLOW FROM INVESTING ACTIVITIES:		
Cash outflows:		
Investment in furniture and equipment	(217)	0
Net cash outflow from investing activities	(217)	0
CASH FLOW FROM FINANCING ACTIVITIES:		
Cash inflows:		
Receipt of additional paid-in capital (Commodity Credit Corporation)	900,000	300,000
Net cash inflow from financing activities	900,000	300,000
Net increase in cash	914,978	143,893
Cash balance, beginning of fiscal year	533,669	389,776
Cash balance, end of fiscal year	$1,448,647	$533,669

The accompanying notes are an integral part of the statements.

Financial Statements

Statement of Financial Position

FOR FISCAL YEARS ENDED SEPTEMBER 30, 1988, AND SEPTEMBER 30, 1987
(in thousands of dollars)

ASSETS	FISCAL YEAR 1988		FISCAL YEAR 1987	
Cash(note 4)				
Administrative Fund	$88,165		$79,335	
Insurance Program Fund	1,360,482	$1,448,647	454,334	$533,669
Accounts receivable				
Reinsured companies	237,853		208,626	
Producers, net of allowance for uncollectible accounts of $11,000 in 1988 and $20,000 in 1987	32,397		36,062	
Administrative & other	504	270,754	1,475	246,163
Total Current Assets		1,719,401		779,832
Furniture and Equipment, net of accumulated depreciation of $1,977 in 1988, and $1,628 in 1987(note 2.h)		703		920
Total Assets		$1,720,104		$780,752
LIABILITIES AND EQUITY				
Current Liabilities:				
Claims payable(note 2.c)	$837,789		$293,473	
Agent's commissions(note 2.e)	7,956		5,759	
Claims adjustment(note 2.c)	4,402		1,277	
Reinsured companies(note 2.f)	60,388		43,685	
Experience rating refund due reinsured companies(note 2.f)	0		16,893	
Administrative & other(note 2.i)	12,594		18,995	
Due to U.S. Treasury(note 2.j)	1,434		12,309	
Unearned premium(note 3)	71,074		58,854	
Unearned premium subsidy(note 3)	181,080		59,936	
Total Current Liabilities		$1,176,717		$511,181
Loan payable to U.S. Treasury(note 5)		113,000		113,000
Litigation - Liability(note 6)		6,100		8,000
Total Liabilities		1,295,817		632,181
Equity:				
Capital stock(note 7)	500,000		500,000	
Paid-in capital(note 8)	1,687,978		787,978	
Invested capital(note 2.h)	703		920	
Accumulated deficit	(1,769,035)		(1,142,911)	
Unexpended appropriations	4,641		2,584	
Total Equity		424,287		148,571
Total Liabilities and Equity		$1,720,104		$780,752

The accompanying notes are an integral part of the statements.

We did not qualify our opinion due to this internal control weakness because we were able to verify that transaction register entries were properly supported by detailed records and the related amounts were accurately recorded in accounts and included in the financial statements. To make this determination, we (1) obtained computer tapes from NFC showing how Corporation salary and other expense transactions were processed, (2) compared the tapes to the detailed transaction registers received from NFC to validate that the transaction registers accurately represented transactions processed by NFC, and (3) chose a random sample of line items from the validated transaction registers and compared them to source documents. We did not find any material errors in the processing of our sample items.

Conclusions

Although the Corporation's oversight of reinsured companies has improved as indicated by a decrease in the overpayment rate, management needs to continue to strengthen its oversight activities. The Corporation's recent implementation of statistically valid sampling techniques and efforts to develop criteria for evaluating reinsured companies' loss adjustment performance should result in improved oversight.

The Corporation still lacks adequate internal controls over certain administrative expenses, a weakness we reported in our prior reports. The Corporation needs a system to reconcile salary and other expense transactions to NFC records to ensure that these transactions are properly processed and accurately recorded in its accounts.

Recommendation

We recommend that the Board of Directors direct the Comptroller to develop procedures to be used by all cost centers for reconciling salary and other administrative expense vouchers sent to NFC with the monthly detailed transaction registers. The Comptroller should then ensure that such procedures are followed to verify that all vouchers are properly processed.

Comments of Cognizant Officials

We provided a draft of this report to responsible Corporation officials for comment. They concurred with our findings and recommendation and indicated their commitment to correct the problems noted.

reviewed crop year 1988 claims and found that the overpayment rate was about 13 percent.[3] We believe that the Compliance Division, which was established in 1986, contributed to the decreased overpayment rates by monitoring reinsured companies' compliance with Corporation standards, particularly those pertaining to loss adjustments. However, our 1988 analysis indicated that the Compliance Division reviews did not provide a reliable basis for conclusions about the overall quality, and thus the acceptability, of a reinsured company's loss adjustment process.[4] Further, we reported that the Compliance Division reviews were (1) limited in scope, (2) not statistically valid, and (3) lacking essential criteria to determine acceptable levels of performance. We recommended that the Corporation emphasize the use of statistically valid sampling techniques and develop criteria to use in evaluating the results of compliance reviews and for determining the acceptability of a reinsured company's loss adjustment performance.

Corporation officials agreed with the recommendations in our October 1988 report. As part of our fiscal year 1988 audit, we reviewed the Corporation's progress in implementing the recommendations. Corporation officials stated that they had implemented procedures designed to statistically sample and evaluate the results of compliance reviews. We reviewed a judgmental sample of the Corporation's audit reports and found that the statistical sampling technique was used to assess reinsured companies' loss adjustment performance.

As of September 15, 1989, a Corporation task force had drafted criteria for evaluating the results of compliance reviews and for determining the acceptability of a reinsured company's loss adjustment performance. USDA's legal counsel and Corporation officials have approved the criteria and have instructed Corporation staff who evaluate reinsured company performance to use the criteria as a guide.

[3] Federal Crop Insurance Corporation Crop Year 1988 Insurance Contracts With Claims, USDA Office of Inspector General, Audit Number 05600-1-Te, September 1989.

[4] Crop Insurance: FCIC Needs to Improve Its Oversight of Reinsured Companies (GAO/RCED-89-10, October 19, 1988).

Report on Internal Accounting Controls

We have audited the financial statements of the Federal Crop Insurance Corporation for the year ended September 30, 1988, and have issued our opinion thereon. As part of our examination, we made a study and evaluation of the system of internal accounting controls to the extent we considered necessary to evaluate the system as required by generally accepted government auditing standards.

The purpose of our study and evaluation was to determine the nature, timing, and extent of the auditing procedures necessary for expressing an opinion on the Corporation's financial statements. For purposes of this report, we have classified the significant internal accounting controls into the following categories:

- administrative expenses,
- reinsurance,
- cash,
- direct insurance premiums and claims, and
- financial reporting.

We tested all of the control categories listed above, except we did not evaluate the internal accounting controls over all functions within any of the categories because it was more efficient to expand our substantive tests. Substantive audit tests can also serve to identify weaknesses in internal control policies and procedures.

The Corporation's management is responsible for establishing and maintaining an effective system of internal controls. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system of internal accounting controls are to provide management with reasonable assurance that (1) obligations and costs are in compliance with applicable laws, (2) funds, property, and other assets are safeguarded against waste, loss, and unauthorized use or misappropriation, and (3) assets, liabilities, revenues, and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over the Corporation's assets. Because of inherent limitations in any system of internal accounting controls, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with procedures may deteriorate.

In response to concerns about the plight of the Corporation, the Congress established the Commission for the Improvement of the Federal Crop Insurance Program in 1988. The Congress charged the Commission with the task of providing recommendations to improve the Corporation so as to lessen, if not eliminate, the need for additional disaster payments, while providing producers more equitable, efficient, and predictable protection from natural disasters. In July 1989, the Commission issued its principal report to congressional agricultural committees and to the Secretary of Agriculture. The report included recommendations for increased responsiveness to producers' needs, broadened producer participation, program simplification, and improved program administration. The Commission will continue to monitor the program and report on the Corporation's implementation of its recommendations through 1990.

The Corporation anticipates that, due to continued drought conditions, fiscal year 1989 will result in a net loss of about $500 million. Without significant changes in insurance program operations, the Corporation will continue to suffer losses, and its ability to pay them will depend on additional assistance from the Commodity Credit Corporation or on other sources of congressional funding.

Donald H. Chapin for

Charles A. Bowsher
Comptroller General
of the United States

September 15, 1989

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-114834

To the Board of Directors
Federal Crop Insurance Corporation

We have audited the accompanying statement of financial position of the Federal Crop Insurance Corporation as of September 30, 1988, and the related statements of operations and of cash flows for the year then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit. In addition to this report on our audit of the Corporation's fiscal year 1988 financial statements, we are also reporting on our consideration of the Corporation's system of internal accounting controls and on its compliance with laws and regulations.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Corporation's 1987 financial statements were audited by another auditor whose report, dated May 25, 1988, expressed a disclaimer of opinion. This occurred because the auditor was unable to verify whether the Corporation had adequate accounting controls over administrative expenses sent for processing to the U.S. Department of Agriculture's National Financial Center. In order for us to express an opinion on the Corporation's financial statements for fiscal year 1988, we expanded our audit tests to verify that entries in these accounts were adequately supported by detailed records.

In our opinion, the 1988 financial statements referred to above present fairly, in all material respects, the financial position of the Federal Crop Insurance Corporation as of September 30, 1988, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

The following section provides supplementary comments relating to the Corporation's financial outlook in light of its continuing losses.

Contents

Abbreviations

NFC	National Finance Center
USDA	U.S. Department of Agriculture