



21101

March 5, 1982

~~RESTRICTED~~ 202633 Not to be released outside the General Accounting Office except on the basis of specific approval by the Office of Congressional Relations.

The Honorable Jack Brooks,
Chairman, Subcommittee on Legislation
and National Security
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

Subject: Review of the Claims Processing Procedures
of the National Flood Insurance Program
(AFMD-82-56)

This report is in response to your request of December 16, 1981 (encl. I), in which you asked us to analyze the response of Mr. Louis O. Guiffrida, Director of the Federal Emergency Management Agency (FEMA), to the recommendations in our September 21, 1981, report "Terminating the Audit of the National Flood Insurance Program's Fiscal 1980 Financial Statements" (AFMD-81-93). We are also reporting the results of our work to date on the two other phases of our review, which was underway at the time of your request:

- A study and evaluation of the internal accounting controls over the processing of flood insurance claims.
- An examination of a sample of flood insurance claims to determine whether policies were in effect when the losses occurred.

The objectives, scope, and methodology of our review are explained in enclosure II.

We concluded from our review that:

- On the whole, except for weaknesses which we discuss later, claims are processed in a manner that provides for valid and accurate payment and recording of claims.
- Policy effective dates were not always adhered to, resulting in an estimated \$2 million of questionable insurance claim payments between January 1, 1978, and September 30, 1981. These questionable payments were the result of problems with policy processing, not claims processing.

(916020)

520928

--FEMA needs to exert a more vigorous effort in response to our recommendations if corrective actions are to be completed for fiscal 1983.

The results of our review are summarized in the remainder of this report. A more lengthy discussion of each phase of our effort is included in the enclosures.

INTERNAL CONTROLS OVER CLAIMS
PROCESSING NEED STRENGTHENING

Electronic Data Systems Federal Corporation (EDSF) has been administering the National Flood Insurance Program (NFIP) since January 1, 1978, including the processing of claims. Claims are processed using both manual and automated means.

We interviewed EDSF employees, observed clerical procedures, and reviewed a sample of transactions to assess the reliability of accounting controls over EDSF's processing of flood insurance claims. We concluded from our review that, on the whole, EDSF provides for the valid and accurate payment and recording of claims. We did, however, identify weaknesses in the internal accounting controls which need strengthening:

- EDSF does not follow satisfactory control techniques to ensure that disbursement drafts ^{1/} are safeguarded and accurately accounted for. We found inadequate physical safeguards over blank drafts, poor use of sequentially numbered drafts, and late reconciliations of bank statements. Failure to maintain proper controls over disbursements increases the possibility of inaccurate accounting, fraud, and abuse.
- EDSF does not adequately separate duties for the processing of manual drafts at both headquarters and flood disaster sites. Inadequate separation of duties increases the possibility that improper payments will be made.
- EDSF does not properly account for reissued and voided drafts. Occasionally, when a draft is issued in payment of a claim, it must be voided and a replacement draft issued. When this occurs, EDSF has not been reducing the claim liabilities account accordingly. Also, EDSF has not been

^{1/}Disbursement drafts are similar to checks. They differ, however, in that they are not automatically paid by the bank (that is, not paid on demand), but require a separate notification from the payer approving the payments before funds will be disbursed. A draft system is often used when large amounts are involved to ensure that the proper funds are disbursed to the intended recipients.

reducing claim losses and claim liabilities for those voided drafts that will never be reissued. The failure to properly account for reissued drafts and the failure to follow up on the status of voided drafts results in misstated account balances.

--EDSF needs to strengthen controls over certain aspects of its automated claims processing. Stronger controls are needed over processing changes to claims master file data, processing notices of loss, and correcting erroneous data. Strengthening controls in these areas will help ensure that all valid data, and only authorized data, will be processed properly, and that rejected data will be corrected and re-entered promptly.

These matters are discussed in more detail in enclosure III.

POLICY DATES NOT STRICTLY ADHERED TO

In addition to its responsibilities for reviewing and settling claims, EDSF is also responsible for accepting insurance premiums, processing applications, and issuing policies. Between January 1, 1978, and December 31, 1981, EDSF received about \$700 million in premium payments. At the end of calendar year 1981, almost 1.9 million policies were in force. EDSF is guided in its policy administration duties by Federal regulations and its own implementing procedures.

We estimated that \$2 million of questionable claim payments were made between January 1, 1978, and September 30, 1981. We examined a stratified random sample of 255 claims from a universe of 5,182 claims where a loss occurred within 10 days after the policy became effective. We found 24 questionable claims. Based on our sample results, we estimate that there are 483 questionable claims in the universe valued at about \$2 million. 1/

These questionable claims involved (1) the lack of any documentation showing that a policy application was received within the time frame required, (2) a disregard for established procedures, and (3) instructions from Federal Insurance Administration (FIA) officials to backdate certain policies.

There was some improvement during 1981. The projected loss discussed above occurred primarily between January 1, 1978, and March 24, 1981. Stricter Federal regulations took effect on March 25, 1981. To determine the effect of the new regulations, our sample included a stratum of 21 claims for losses occurring after the March date. Our analysis of the results of this stratum

1/Using a sampling error formula with a 90-percent confidence level, the true value of questionable claim payments would be between \$1 million and \$3 million.

showed some improvement in overall policy processing procedures over the earlier period--we found only two questionable cases. Based on a statistical projection of this stratum, we estimated that about \$6,500 in claim payments were made on policies that were not in force at the time of the loss. These matters are discussed in greater detail in enclosure IV.

MORE EMPHASIS SHOULD BE PLACED
ON CORRECTIVE ACTIONS

At your request, we analyzed FEMA's response to our earlier recommendations. We considered the adequacy of FEMA's proposed actions to address our recommendations and we reviewed their implementation status. We met with FEMA, FIA, and EDSF officials and examined evidence supporting proposed and completed actions.

FEMA created its Office of Comptroller and assigned an accountant to correct financial reporting deficiencies in the FEMA and NFIP accounting systems. The accountant has worked at documenting reports of flood studies' and surveys' expenditures, and at reconciling cash receipts. He plans to prepare financial statements for NFIP for fiscal 1978 through 1982 when he receives accurate financial data for those years from EDSF.

FEMA proposed a provision to EDSF's contract for its fifth year (Nov. 4, 1981 to Nov. 4, 1982) requiring EDSF to maintain an accounting system capable of providing financial statements in conformity with generally accepted accounting principles. Since the negotiations were ongoing at the time of our review, we were unable to ascertain if the provision will become part of the final contract.

EDSF is implementing several projects to enhance the integrity of NFIP financial reporting. One project is the procurement of a new automated general ledger system. Another is the reconciliation of disbursement records with corresponding bank statements. This had not been done adequately since EDSF began administering the program in 1978. Although EDSF has expended considerable effort on this project, progress has been slow and target dates have slipped. The remaining projects involve the use of contractors to attest to the fiscal 1980 and 1981 cash basis financial statements and to perform operational audits of key NFIP functions. EDSF is expecting an opinion on the financial statements this month, and a report on operational efficiency and internal controls in December 1982.

Finally, FEMA recently assigned a full-time certified public accountant to monitor NFIP's financial activities. FEMA officials expect the monitor will perform internal audit-like functions in verifying the accuracy of NFIP financial data and reports.

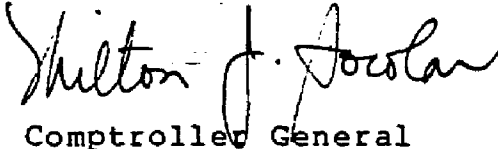
We concluded that FEMA has made progress in implementing the corrective actions. However, a considerable effort is still

necessary to produce prompt and accurate financial statements in conformity with generally accepted accounting principles. We believe the proposed actions, if conscientiously carried out, can solve the problems we identified. Although FEMA has not completed any of the corrective actions, it appears that with a vigorous and sustained effort the fiscal 1983 goal can be achieved. Our detailed analysis is contained in enclosure V.

As you requested, no official comments were obtained from FEMA, FIA, or EDSF on our findings and conclusions. As arranged with your office, unless you publicly announce the contents of this report earlier, we will not distribute it until 30 days from its date. At that time we will send copies to the House Committee on Government Operations, the Senate Committee on Governmental Affairs, the House and Senate Committees on Appropriations, the Director of the Federal Emergency Management Agency, the Administrator of the Federal Insurance Administration, and the Director of the National Flood Insurance Program, Electronic Data Systems Federal Corporation, and we will make copies available to other interested parties.

Because of your need for a quick response, we have not completed our work. We did not formulate and present recommendations in this report, but we anticipate issuing a followup report. We will meet with representatives of the Federal Emergency Management Agency, the Federal Insurance Administration, and the Electronic Data Systems Federal Corporation to discuss our findings and propose appropriate recommendations. We will report to you afterward on the results of these meetings and actions taken or planned in response to this letter.

Sincerely yours,

for 
Comptroller General
of the United States

Enclosures

JACK BROOKS, TEX., CHAIRMAN
 DANTE E. FASCELL, FLA.
 DON FUGUA, FLA.
 ELLIOTT M. LINTAS, GA.
 DAVID W. EVANS, IND.
 HENRY A. WAXMAN, CALIF.

FRANK HORTON, N.Y.
 JOHN M. EDLENSBORN, ILL.
 M. CALDWELL BUTLER, VA.
 WILLIAM F. CLINGER, JR., PA.

225-5147

NINETY-SEVENTH CONGRESS
Congress of the United States
House of Representatives
 LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE
 OF THE
 COMMITTEE ON GOVERNMENT OPERATIONS
 RAYBURN HOUSE OFFICE BUILDING, ROOM B-373
 WASHINGTON, D.C. 20515

December 16, 1981

Mr. Charles A. Bowsher
 Comptroller General
 U.S. General Accounting Office
 441 G Street
 Washington, D.C. 20548

Dear General:

On September 21, 1981, your office issued a letter report entitled "Terminating the Audit of the National Flood Insurance Program's Fiscal 1980 Statements" (AFMD-81-93). The report stated that the General Accounting Office (GAO) was unable to complete the triennial audit of the NFIP required by the Government Corporation Control Act. The report cited a number of systemic deficiencies which precluded an accurate audit and recommended swift correction of the problems.

On November 20, 1981, Louis O. Giuffrida, Director of FEMA, issued a letter to me in which he agreed to undertake corrective actions. However, a timetable was given for implementation of only one of the four GAO recommendations. A copy of the response is enclosed.

I would appreciate a GAO analysis of this response to determine the likelihood of its bringing the program's accounting and reporting system in line with applicable law and professional standards. I would hope for comment from you on the adequacy of the anticipated timetable.

Your staff is currently coordinating with the Subcommittee staff two additional phases of review of the NFIP. One element of the review focuses on the changes which have occurred in the claims processing system, seeking to make current the information on the system for managing the program. The other element seeks to audit a sample of paid claims to determine whether the inadequacies previously discovered by the GAO have compromised the financial interests of the government.

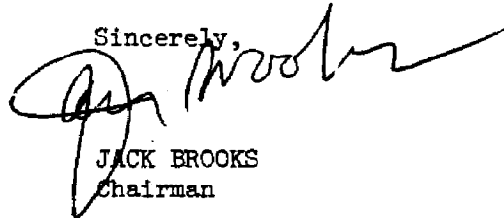
I would appreciate your giving all three phases of the review of the NFIP close attention and top priority. The NFIP is the single most important government program to many of its clients. I sponsored the Act creating the program because flood plain residents require adequate and certain protection from losses in floods in order to prevent dramatic personal hardships and to allow for sustained, sensible economic growth in affected areas. The Congress agreed with me that a cost sharing insurance program with significant government participation was the only feasible method to protect flood plain residents.

The importance of this program to flood plain inhabitants places an extra burden on the government agencies connected with the program. Financial integrity is imperative both to assure that clients receive accurate and timely claims processing and to protect against gratuitous attacks on the program's efficacy.

In Fiscal Year 1981, the program collected \$245,038,471 in premiums and paid \$141,756,588 in claims. Almost two million policies were in effect at the close of the fiscal year.

Both from a fiscal protection standpoint and from a program effectiveness perspective, the GAO work on this program is important. I congratulate you on your efforts to date and look forward to a thorough but prompt continuation of your review.

Sincerely,

A handwritten signature in dark ink, appearing to read "Jack Brooks", written over the typed name and title.

JACK BROOKS
Chairman

Enclosure

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of our review were to:

- Determine the adequacy and reliability of accounting controls over flood insurance claims processing.
- Examine a sample of flood insurance claims to determine whether flood insurance policies were in effect when the losses occurred.
- Analyze FEMA's response to our earlier recommendations.

We performed our review of claims processing and our examination of a sample of claims at the National Flood Insurance Program headquarters in Bethesda, Maryland. Electronic Data Systems Federal Corporation currently administers NFIP at the headquarters facility, including the processing of claims.

We interviewed EDSF employees and observed clerical procedures throughout the claims processing cycle. We analyzed control procedures from the initial notification of a claim to the posting of claim-related transactions to the general ledger. We flow-charted the process and identified the techniques and procedures used to achieve critical control objectives.

To explore areas of potential internal control weakness, we examined a sample of file maintenance transactions. These are transactions used to add, change, or delete permanent data on the automated claims master file, such as policy coverage amount and previous claim payments. We designed a discovery sampling plan to provide assurance, at a 95-percent probability level, of finding at least one improper payment within the sample, if improper payments existed at a level of 2 percent within the universe. An improper payment was defined as a payment made to someone other than the policyholder based upon data added, changed, or deleted by file maintenance transactions. This plan resulted in a sample of 148 cases selected from a universe of 13,263 policies, which had 26,672 file maintenance transactions processed against the policies' claims during fiscal 1979 through 1981.

We also examined a stratified sample of flood insurance claims to determine whether flood insurance policies were in effect when the losses occurred. The sample of 255 cases was randomly selected, using a 90 percent confidence level, from a universe of 5,182 claims, with loss dates within 10 days of policy effective dates for the period January 1, 1978, through October 31, 1981. Two hundred and thirty-four cases were selected from a universe of 5,062 claims for the period January 1, 1978, through March 24, 1981. The remaining 21 cases were selected from a universe of 120 for the period March 25, 1981, through September 30, 1981.

We analyzed FEMA's response to our September 21, 1981, report "Terminating the Audit of the National Flood Insurance Program's Fiscal 1980 Financial Statements" (AFMD-81-93). In doing so, we related the proposed corrective actions to our recommendations and considered their appropriateness. We met with FEMA, FIA, and EDSF officials to determine their understanding of and commitment to the proposed actions. Finally, we examined evidence in support of actions taken, and reviewed the time frames of actions planned.

STUDY AND EVALUATION OF CLAIMS PROCESSING CYCLE

Since January 1, 1978, Electronic Data Systems Federal Corporation has been responsible for processing claims for the National Flood Insurance Program. From January 1, 1978, through December 31, 1981, EDSF paid approximately 165,000 claims totaling more than \$990 million. Approximately two-thirds of these claims were processed and paid at NFIP headquarters in Bethesda, Maryland, and the remaining one-third at flood disaster sites.

Regardless of where a claim is paid, it is processed in generally the same manner. Independent insurance agents report claims to EDSF upon notification of flood damage from policyholders. These agents assign the majority of claims to flood insurance adjusters who investigate and determine the loss amounts. (At flood disaster sites EDSF assigns adjusters.) EDSF examiners verify that individuals submitting claims have valid policies, review adjusters' reports, and submit requests for claim payments. EDSF disbursement and accounting personnel process and account for the payments and other claim-related transactions.

Once reported, a claim is processed by an automated claims system. The automated system

- verifies that individuals claiming losses have valid policies that are contained in the computer-based policy master file,
- maintains a record of previously reported losses for each policyholder, and
- prints the majority of claim payments.

While most payments from headquarters are processed and printed by the automated system, some are typed manually and mailed before being entered into the automated system to record the payments. All payments at the flood disaster sites are typed manually and later entered into the automated system when payment records are returned to headquarters.

Our review of claims processing disclosed that, generally, EDSF processes claims in a manner that provides for valid and accurate payment and recording. Except for the following items, we did not identify any significant weaknesses in the internal accounting controls over the claims processing system which would impair the reliability of information produced by the system.

EDSF DOES NOT MAINTAIN ADEQUATE CONTROL
OVER DISBURSEMENT DRAFTS

EDSF does not follow satisfactory control techniques to ensure that disbursement drafts are adequately safeguarded and accurately accounted for. As a direct consequence of not employing proper

control techniques, the January 27, 1982, bank statement reported 4,367 drafts totaling \$20,158,735 as having been paid--but, without previous notification from EDSF that the particular drafts had ever been issued. These consequences are due, in part, to ineffective control procedures, including:

- Inadequate physical safeguards over blank drafts.
- Poor use of sequentially numbered drafts.
- Late reconciliations of bank statements.

EDSF's physical safeguards over blank drafts are weak. A computer operations employee is responsible for all blank drafts taken from their locked room. We found that 160 drafts, which had been taken by a cashier unit employee, were not recorded as having been removed from the locked room. This incident occurred because the computer operations employee did not accompany the cashier unit employee into the locked room and verify and record the number and sequence of drafts taken. Tight controls over blank drafts is important because the fraudulent use of such drafts could go undetected.

EDSF does not use sequentially numbered drafts in such a way as to facilitate reconciliation of outstanding or missing drafts. EDSF uses blocks of sequentially numbered drafts from a number of boxes rather than maintaining continuity in draft number sequence. This practice negates the control feature of sequentially numbered drafts.

EDSF is not reconciling current bank statements. Since January 1978, when EDSF started administering the National Flood Insurance Program, a backlog of bank reconciliations has built up. This backlog has snowballed to the extent that current bank statements cannot be reconciled. EDSF, however, formed a project team to reconcile bank statements from January 1, 1978, to September 30, 1980. The project team completed its work by late February 1982. According to EDSF, accounting personnel will be responsible for the reconciliation of bank statements from October 1, 1980, to the present. They expect to complete this effort by April 1982. Timely reconciliation of bank statements to disbursement records is especially important for an operation with the volume of NFIP. NFIP must employ rigorous procedures to ensure that public funds are safeguarded. This is especially true where conditions, such as the potential for unaccounted drafts as discussed above, allow a greater possibility of fraud or abuse.

Failure to maintain proper controls over disbursements increases the possibility for inaccurate accounting, fraud, and abuse. Our review did not disclose any specific instances of fraud or abuse; however, loose internal control procedures increase the risk that fraud or abuse will occur. Strong control procedures often provide the most effective and economical deterrent available.

EDSF DOES NOT ADEQUATELY SEPARATE
DUTIES IN PROCESSING MANUAL DRAFTS

EDSF does not have an adequate separation of duties in the processing of manual drafts at headquarters and at flood disaster sites. One individual at each location controls all the critical tasks involved in processing drafts. Allowing one individual to control all critical tasks increases the possibility that improper payments will be made.

One individual within the cashier unit controls the payment of manual drafts at headquarters from initial pickup of the blank drafts to the time the bank is notified of which drafts to honor. This individual

- picks up blank drafts,
- endorses drafts,
- maintains copies of the original drafts,
- mails drafts to payees,
- receives endorsed drafts from the bank,
- compares endorsed drafts with copies, and
- notifies the bank of which drafts to honor.

In addition, the cashier unit representative at flood disaster sites

- safeguards drafts,
- endorses drafts,
- mails drafts, and
- records drafts in the draft register.

To achieve an adequate separation of duties, EDSF should divide the execution of these critical tasks between two or more persons, thereby ensuring proper checks and balances.

EDSF DOES NOT MAINTAIN PROPER ACCOUNTING
CONTROL OVER REISSUED AND VOIDED DRAFTS

EDSF does not properly account for reissued and voided drafts. As a result, claim losses and claim liabilities for the period January 1, 1978, to September 30, 1981, may be overstated by \$5.1 million. For a number of reasons, original drafts for claim payments are occasionally voided. Depending on the reason for voiding the original draft, a replacement or reissued draft may or

may not be issued. When a draft is reissued, the organization should reduce claim liabilities by the amount of the voided draft. When a draft is not reissued, the organization should reduce both claim losses and claim liabilities by the amount of the voided draft.

EDSF should ensure that procedures are in place and are followed to accurately account for reissued and voided drafts. EDSF does not follow procedures which (1) differentiate between original drafts and reissued drafts and (2) determine the status of voided drafts. Consequently, EDSF accounts for reissued drafts as original claim losses rather than as reductions in claim liabilities. In addition, EDSF maintains voided drafts that will never be reissued on the accounting records as previously incurred claim losses and outstanding claim liabilities. They should be removed.

EDSF SHOULD STRENGTHEN CONTROLS OVER AUTOMATED PROCESSING OF CLAIMS

EDSF needs to strengthen the controls over various aspects of its automated claims processing. Stronger controls are needed over

- processing changes to data contained in the claims master file,
- processing notices of loss, and
- correcting erroneous data.

Strengthened controls in these areas will help ensure that all valid data are processed properly, erroneous data are corrected promptly, and unauthorized data are not introduced into the system.

Changing data in the claims master file

EDSF should maintain tighter control over transactions used in making changes to data contained in the claims master file. EDSF does not require that all of these transactions, known as file maintenance transactions, be reviewed and approved before processing. After processing, EDSF does not require that a responsible official review the changes in order to verify that all, and only the proper changes, were made.

If not properly controlled, file maintenance transactions can greatly increase a system's vulnerability to fraud and abuse. File maintenance transactions are very powerful tools that are used to add, change, and delete data in a master file. Data in the claims master file is used in determining who may receive a claim payment, the amount which the individual may be paid, and the address to which the payment will be mailed. Normally, these items in the claims master file are updated with data from the policy master file. File maintenance transactions allow direct update of the

claims master file, thereby bypassing normal separation of duties between policy processing and claims processing.

Given the potential risk in this area and the laxity of controls, we examined a sample of policies which had claims affected by these transaction types. Our universe comprised 13,263 policies which had 26,676 file maintenance transactions processed against the policies' claims during fiscal 1979 through 1981. A random sample of 148 policies was selected for our analysis. (See encl. II for sampling plan.)

We did not identify any improper payments--payments made to someone other than the policyholder--in our sample; therefore, we are 95-percent confident that the rate of improper payments in the universe is less than 2 percent. The principle deficiency noted during our examination was the absence of documentation for about half of the file maintenance transactions. By using other audit procedures, we were able to substantiate the validity of the transactions. Such additional effort, however, should not have been required because the claim files should have contained all the documents needed to explain the actions taken. EDSF concurred with us that each claim file should be fully documented, including all explanations and approvals for file maintenance transactions. Our analysis confirmed that fiscal 1981 reflected a marked improvement--only 10 percent of these files lacked adequate documentation.

Processing notices of loss

EDSF does not use effective automated techniques to assure that notices of loss are accurately entered into the automated claims system. Consequently, notices of loss are entered into and accepted by the automated system for wrong policy numbers and wrong loss dates. For those notices of loss erroneously accepted by the automated system, EDSF must delete the incorrect entries from the claims master file and reenter the correct data; thereby, resulting in inefficient processing of claims and the possibility that some erroneous data might not be caught.

Each loss incurred by a policyholder is identified by the individual's policy number and the date the loss occurred. The combination of policy number and loss date is used to identify the claim throughout both manual and automated processing.

Two techniques often used in automated systems to ensure accurate entry of transactions are (1) secondary identifiers and (2) hash totals. EDSF does not use these techniques in its automated claims system.

Secondary identifiers are used with primary identifiers to verify the uniqueness of items entered into automated systems. A secondary identifier, such as the first four letters of the policyholder's last name, could be entered into the automated claims system along with the policy number. Only if the secondary iden-

tifier and the policy number match, as recorded on the policy master file, would the notice of loss be accepted by the automated system.

Hash totals are manually prepared totals for selected data fields in a group of documents that are compared with totals of the same fields generated by the automated system. Use of hash totals on policy numbers and loss dates would help ensure correct keying of policy numbers and loss dates within a batch of loss notices.

Correcting erroneous data

EDSF does not maintain an automated suspense file to ensure that all erroneous transactions are corrected. EDSF's automated claims system lists rejected items on error reports. Although a control group is responsible for correcting errors listed on the reports, no cumulative record of uncorrected data is kept. Consequently, rejected data may not be corrected promptly or at all.

An effective method for controlling rejected data in a computer-based system is through the use of an automated suspense file. Such a file in the automated claims system would contain all the invalid or incomplete data rejected by the system. Items in the suspense file would continue to be printed until corrected. By aging the suspense file, it would be even easier for supervisors to monitor the timeliness of correction efforts.

POLICY DATES NOT STRICTLY ADHERED TO

In addition to its responsibilities for reviewing and settling claims, EDSF is also responsible for accepting insurance premiums, processing applications, and issuing policies. Between January 1, 1978, and December 31, 1981, EDSF received about \$700 million in premium payments. At the end of calendar 1981, almost 1.9 million policies were in force. EDSF is guided in its policy administration duties by Federal regulations and its own implementing procedures.

EDSF DID NOT CONSISTENTLY FOLLOW PROCEDURES FOR DETERMINING POLICY EFFECTIVE DATES

We estimate that \$2 million in claim payments were made where it was questionable if a flood insurance policy was in force at the time of the loss. Our estimate is based on a sample of claims settled during the period January 1, 1978, through September 30, 1981. The questionable payments included cases where there was no evidence that a policy application was received within the required period and cases where policy dating procedures were applied inconsistently.

As with all insurance, the first criteria for settling a claim is that a policy be in effect at the time of the loss. Because the effective date is so critical, it is essential that applications be processed properly and consistently. The importance of this is recognized by both Federal regulations and NFIP operating procedures. They specifically address the matter of determining policy effective dates and have done so since EDSF assumed contract responsibilities. Prior to October 30, 1978, Federal regulations required a 15-day waiting period from the date a home-owner applied for flood insurance until the insurance became effective. After October 30, 1978, the waiting period was changed to 5 days. In order to process applications consistently and avoid the risk of policy backdating, EDSF adopted a procedure requiring that insurance applications be postmarked within 14 days of the date of application. On March 25, 1981, Federal regulations were tightened to allow only 10 days to get policy applications to EDSF. Furthermore, if it takes longer than 10 days, the appropriate waiting period is calculated from the day EDSF receives the insurance application. Although policy processing procedures have been in place since inception of the EDSF contract, we found that some of them, such as date stamping policy applications and retaining postmarked envelopes, have not been followed consistently.

To determine the effect of EDSF not consistently following procedures, we examined a stratified random sample from a universe of claims with loss dates falling within 10 days of policy effective dates. The universe consisted of 5,182 claims settled between January 1, 1978, and September 30, 1981. We sampled 255 claims using a 90-percent confidence level. (See encl. II

for sampling plan.) We found 24 questionable claims. Based on our sample results, we estimate that there are 483 questionable claims in the universe valued at about \$2 million. 1/

Questionable claim payments included:

- Those claims (11) that lacked any documentation showing that the policy application was received within the period required.
- Those claims (10) where procedures were disregarded.
- Those claims (3) that were backdated on specific instructions from FIA officials.

Consistent with our office policy, we are forwarding the matter to FEMA's Inspector General for his consideration.

STRICTER FEDERAL REGULATIONS IMPROVED RESULTS

Policy effective dates were adhered to more closely after the Federal regulations were tightened. The projected questionable payments discussed above fall primarily between January 1, 1978, and March 24, 1981. Stricter Federal regulations took effect on March 25, 1981. Therefore, to determine if EDSF followed the new regulations in a more consistent manner, we increased our focus on the period following implementation of the new regulations. We did this by stratifying the sample and reviewing 21 claims from a universe of 120 claims occurring after the March date. Our analysis of this sample showed some improvement in overall policy processing procedures over the earlier period. (We found only two questionable claims.) From this we projected that about \$6,500 in claim payments were made on policies that were apparently not in force at the time of loss.

Overall, claims are properly paid on valid policies. EDSF has improved its date stamping procedures to better verify when an application is received. Furthermore, with stricter regulations and new processing procedures, less subjective decisionmaking is required in determining policy effective dates. Nevertheless, EDSF must follow established procedures more consistently to minimize the potential loss of apparently unjustified claim payments.

1/Using a sampling error formula with a 90-percent confidence level, the true value of questionable claim payments would be between \$1 million and \$3 million.

ANALYSIS OF CORRECTIVE ACTIONS IN RESPONSETO GAO'S RECOMMENDATIONS

On September 21, 1981, we issued a report "Terminating the Audit of the National Flood Insurance Program's Fiscal 1980 Financial Statements." In that report, we explained the reasons why we were unable to express an opinion on the National Flood Insurance Program's financial statements. In addition, we made four recommendations to the Director of FEMA to facilitate the preparation of accurate and timely financial statements. As required by Section 236 of the Legislative Reorganization Act of 1970, the Director of FEMA submitted to the House Committee on Government Operations and other congressional committees a written statement of actions to be taken in response to our recommendations. In February 1982, we analyzed the nature of FEMA's proposed corrective actions and the progress made to date.

We concluded that FEMA has made progress at implementing the corrective actions. However, a considerable effort is still necessary to produce timely and accurate financial statements that conform to generally accepted accounting principles. We believe the proposed actions, if conscientiously carried out, can solve the problems we identified. Although FEMA has not completed any of the corrective actions, it appears that with vigorous and sustained effort the fiscal 1983 goal can be achieved.

GAO RECOMMENDATION 1

Staff the FEMA accounting branch with qualified accountants and charge them to improve the NFIP accounting and reporting system.

FEMA'S proposed actions:

- Realign FEMA's organizational structure, including the establishment of an Office of the Comptroller.
- Assign a qualified accountant to review and monitor NFIP's accounting and reporting responsibilities, correct the financial reporting deficiencies stated in the GAO report, assist the NFIP in developing an accounting and reporting system, maintain the flood insurance accounting system in FEMA, prepare financial statements for NFIP, and assist FIA in its monitoring responsibilities.
- Obtain standards, procedures, and literature on the needs and requirements for an insurance accounting system.
- Assist EDSF in reviewing its manual records to ensure accurate and prompt recording of all accounting transactions.
- Review and update the chart of accounts.

--Request fiscal 1978-80 trial balances from EDSF to provide a starting point to verify account balances.

Our analysis of the proposed actions

FEMA has established an Office of the Comptroller which is responsible for maintaining all FEMA financial systems, including those relating to NFIP. The Comptroller assigned an employee from the accounting department to correct financial reporting deficiencies in both the FEMA and NFIP accounting systems. We do not know if one qualified accountant will be enough. Also, we did not verify the accountant's qualifications.

The accountant documented the flood surveys' and studies' expenditures as part of his review of FEMA's general ledger. Still, the FEMA general ledger requires additional improvement. For example, the unreliability of FEMA's automated general ledger forced the accountant to devise a manual system in order to account for flood surveys' and studies' expenditures.

The accountant is currently concentrating his efforts on NFIP. He is reconciling EDSF cash receipts with FEMA records. This reconciliation has not been done since FEMA assumed control of NFIP on October 1, 1979. In addition, he is to be available in the future to assist the financial monitor in evaluating financial information produced by EDSF. (See rec. 4.)

The accountant will prepare financial statements for NFIP for fiscal 1978 through 1982 when he receives accurate financial data for the period from EDSF. He plans to have all financial statements completed by the first quarter of fiscal 1983. He has available to him the American Institute of Certified Public Accountants' Statement of Position "Accounting for Property and Liability Insurance Companies" and other literature to assist in preparing the financial statements.

We were unable to verify the existence of any progress on the other corrective actions listed in FEMA's response. We discussed this matter with officials from FEMA, FIA, and EDSF and determined that:

- FEMA did not provide EDSF with any substantial assistance in reviewing its manual records.
- The EDSF chart of accounts has not been reviewed and updated. EDSF says it will be updated during implementation of the new computer system in the last quarter of fiscal 1982.
- EDSF did not receive any requests for trial balances (for fiscal 1978-80) from FEMA since GAO withdrew from its attempt to audit the fiscal 1980 financial statements.

GAO RECOMMENDATION 2

Require the contractor, EDSF, to use an accounting system which provides for financial statements prepared in accordance with generally accepted accounting principles and standards.

FEMA's proposed action:

- Modify the existing contract to include a provision requiring EDSF to maintain an accounting system that provides timely, accurate, and complete financial statements prepared in accordance with generally accepted accounting principles.

Our analysis of the proposed actions

In the negotiations for the fifth contract year (Nov. 4, 1981, to Nov. 4, 1982), FEMA proposed a provision requiring EDSF to maintain an accounting system that provides timely, accurate, and complete financial statements prepared in accordance with generally accepted accounting principles and standards. The negotiations were ongoing at the time of our review and we were unable to ascertain if the provision will become part of the final contract.

GAO RECOMMENDATION 3

Require EDSF, as insurance program operator, to establish and maintain recordkeeping procedures sufficient to provide FEMA and FIA with accurate, complete, and timely information.

FEMA proposed actions:

- Install a new financial system by October 1982, which will satisfy GAO's requirements.
- Obtain an independent examination to certify the accuracy of account balances.
- Conduct a comprehensive audit of NFIP in 1982 which will provide further verification of the system's conformity to generally accepted accounting principles and standards.

Our analysis of the proposed actions

EDSF is implementing several projects to enhance the integrity of its financial reporting responsibilities. These projects are in various stages of planning and implementation.

To date, the procurement of a new automated general ledger is on schedule. EDSF believes that the new system will provide an improved audit trail from the financial statements to source documents. However, EDSF will be required to develop software for computing accruals as required by generally accepted accounting

principles to supplement the proposed system. The expected date of completion for this new software is the same date as the implementation of the new general ledger system.

Since June 1981, EDSF has been conducting a project to reconcile its cash disbursement records with the bank statements from January 1978 to the present. (See encl. I.) EDSF expects to complete all missing bank reconciliations by April 1982. However, earlier target dates were not met--as of March 1982, EDSF had just completed reconciling the first 33 monthly bank statements which were targeted for completion by October 1981.

In addition to inhouse efforts, FEMA and EDSF are seeking outside assistance in identifying problem areas. FEMA is procuring a comprehensive audit of NFIP. The audit will include an operational review and evaluation of internal controls over claims, policies, financial management, and data processing. The closing date for bids from potential contractors was February 10, 1982. FEMA expects to receive a report on audit results in December 1982.

Finally, EDSF signed a contract with a certified public accounting firm to examine NFIP's cash receipts and disbursements for fiscal 1980 and 1981, for the purpose of rendering an opinion on the fairness of their presentation on the cash basis of accounting. The contractor began work in December 1981 and is scheduled to issue his opinion by March 15, 1982. EDSF did not request a management letter outlining recommended system improvements.

We are concerned, however, that the above actions are focused mainly on future improvements. They do not include immediate corrections to problems we presented in our September 1981 report. We commented on the need to reconcile the general ledger with the monthly reports to ensure that FEMA received accurate and complete information. EDSF still does not perform this reconciliation, but FEMA still receives the report. Therefore, we have to assume that FEMA still is not receiving reliable financial information.

GAO RECOMMENDATION 4

Emphasize to FIA financial monitors that they are responsible for ensuring that adequate control is maintained over Federal funds and that their duties include monitoring all contractor accounting controls and financial reporting procedures.

FEMA's proposed action:

- Employ a full-time qualified accountant who will be dedicated exclusively to monitoring the EDSF financial system, including accounting controls and financial reporting procedures.

Our analysis of the proposed action

FEMA hired a certified public accountant to monitor NFIP's financial activities. The accountant began full-time monitoring activities on February 16, 1982. FEMA officials envisioned the monitor would fulfill an internal audit-like function--verify the accuracy of financial information by evaluating the EDSF financial systems.