

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

National Flood Insurance Program's Management
Letter for FY 2012 DHS Consolidated
Financial Statements Audit
(Redacted)





OFFICE OF INSPECTOR GENERAL
Department of Homeland Security

Washington, DC 20528 / www.oig.dhs.gov

APR 30 2013

MEMORANDUM FOR: David Miller
Associate Administrator
Federal Insurance and Mitigation Administration
Federal Emergency Management Agency

FROM: Anne L. Richards 
Assistant Inspector General for Audits

SUBJECT: *National Flood Insurance Program's Management Letter
for FY 2012 DHS Consolidated Financial Statements Audit*

Attached for your information is our final report, *National Flood Insurance Program's Management Letter for FY 2012 DHS Consolidated Financial Statements Audit*. This report contains observations related to internal control deficiencies that were not required to be reported in the *Independent Auditors' Report on DHS' FY 2012 Financial Statements and Internal Control over Financial Reporting*. Internal control deficiencies that are considered significant deficiencies were reported, as required, in the Independent Auditors' Report, dated November 14, 2012, which was included in the DHS FY 2012 *Annual Financial Report*. We do not require management's response to the recommendations.

The independent public accounting firm KPMG LLP conducted the audit of DHS' FY 2012 financial statements and is responsible for the attached management letter dated November 14, 2012, and the conclusions expressed in it. We do not express opinions on DHS' financial statements or internal control, nor do we provide conclusions on compliance with laws and regulations.

Consistent with our responsibility under the *Inspector General Act*, we are providing copies of our report to appropriate congressional committees with oversight and appropriation responsibility over the Department of Homeland Security. We will post a redacted version of the report on our website.

Please call me with any questions, or your staff may contact Mark Bell, Deputy Assistant Inspector General for Audits, at (202) 254-4100.

Attachment



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

November 14, 2012

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

Ladies and Gentlemen:

We have audited the balance sheet of the U.S. Department of Homeland Security (DHS or Department) as of September 30, 2012, and the related statements of net cost, changes in net position and custodial activity, and combined statement of budgetary resources for the year then ended (referred to herein as the "fiscal year (FY) 2012 financial statements"). The objective of our audit was to express an opinion on the fair presentation of these financial statements. We were also engaged to audit the Department's internal control over financial reporting of the balance sheet as of September 30, 2012, and the related statements of net cost, changes in net position and custodial activity, and the combined statement of budgetary resources for the year then ended based on the criteria established in Office of Management and Budget Circular No. 123, *Management's Responsibility for Internal Control*, Appendix A.

Our *Independent Auditors' Report* issued on November 14, 2012, describes a limitation on the scope of our audit that prevented us from performing all procedures necessary to express an unqualified opinion on DHS' FY 2012 financial statements and an opinion on DHS' internal control over financial reporting as of September 30, 2012. In addition, the FY 2012 DHS *Secretary's Assurance Statement* states that the Department was unable to provide assurance that internal control over financial reporting was operating effectively at September 30, 2012. We have not considered internal control since the date of our *Independent Auditors' Report*.

During our FY 2012 DHS audit, we noted certain matters involving the Federal Emergency Management Agency's (FEMA) National Flood Insurance Program (NFIP) internal control and other operational matters that are presented for your consideration. These observations and recommendations, all of which have been discussed with the appropriate members of management of the named insurance companies (where applicable), FEMA's Office of the Chief Financial Officer, and FEMA's Federal Insurance and Mitigation Administration and communicated through a Notice of Finding and Recommendation, are intended to improve internal control or result in other operating efficiencies and are summarized in Exhibit I of this letter. These comments are in addition to the material weaknesses and significant deficiencies presented in our *Independent Auditors' Report*, dated November 14, 2012, included in the FY 2012 DHS *Annual Financial Report*. The status of our prior year observations is presented in Exhibit II.

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



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

FEMA's written response to the observations and recommendations identified in this report, presented in Exhibit III, has not been subjected to auditing procedures and, accordingly, we express no opinion on it. Our auditors' response is presented in Exhibit IV.

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

Very truly yours,

KPMG LLP

I. BACKGROUND

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

II. INTERNAL CONTROL DEFICIENCIES RELATED TO CLAIMS

A. Internal Control Deficiencies and Errors Identified over Claims Paid

Observation:

We selected nine insurance companies at which to perform audit procedures over claims paid for the periods October 1, 2011, through March 31, 2012, April 1 through June 30, 2012, and July 1 through August 31, 2012. For the nine companies selected, we tested a sample of claims paid totaling 434 items covering the three testing periods identified above. During this testing, we noted the following internal control deficiencies and errors:

- 1) Based on March 31, 2012, testwork, for one sample item, the date of loss was incorrectly reported.

Company	Policy No.	Date of Loss Per Sample	Date of Loss Per Claim File
		09/07/2011	08/27/2011

- 2) Based on March 31, 2012, and June 30, 2012, testwork, for six sample items, the insurance company did not request a 60-day Proof of Loss waiver.

March 31, 2012, Testwork Results:

Company	Policy No.	Date of Loss	Days Between Date of Loss and Proof of Loss
		09/03/2011	69
		10/28/2011	63
		04/25/2011	147
		08/23/2011	83
		08/23/2011	62

June 30, 2012, Testwork Results:

Co any	Policy No.	Date of Loss	Days Between Date of Loss and Proof of Loss
[REDACTED]	[REDACTED]	03/15/2012	70

- 3) Based on March 31, 2012, testwork, for two sample items, the insurance company requested a 60-day Proof of Loss waiver subsequent to the claim payment.

Co any	Policy No.	Pay ent Date	Waiver Request Date
[REDACTED]	[REDACTED]	12/11/2011	03/02/2012
[REDACTED]	[REDACTED]	02/24/2012	03/13/2012

- 4) Based on March 31, 2012, testwork, for one sample item, the Proof of Loss modification letter was not issued in a timely manner.

Co any	Policy No.	Pay ent Date	Date of Letter
[REDACTED]	[REDACTED]	12/20/2011	03/02/2012

- 5) Based on June 30, 2012, testwork, for one sample item, the 60-day Proof of Loss waiver obtained referenced the incorrect Proof of Loss. The insurance company issued the claim payment upon receipt of improper waiver approval.

Co any	Policy No.	Date of Loss	Pay ent Date
[REDACTED]	[REDACTED]	08/28/2011	06/15/2012

- 6) Based on June 30, 2012, and August 31, 2012, testwork, for three sample items, the amount of the payment did not agree to the final report.

June 30, 2012, Testwork Results:

Co any	Policy No.	Date of Loss	(Under)/Overpay ent
[REDACTED]	[REDACTED]	08/28/2011	\$(3)
[REDACTED]	[REDACTED]	08/28/2011	\$10

August 31, 2012, Testwork Results:

Co any	Policy No.	Date of Loss	(Under) Pay ent
[REDACTED]	[REDACTED]	05/18/2012	\$(0.03)

- 7) Based on June 30, 2012, testwork, for one sample item, the claim payment was not made timely.

Co any	Policy No.	Proof of Loss	Pay ent Date
[REDACTED]	[REDACTED]	02/11/2012	04/17/2012

8) Based on June 30, 2012, testwork, for two sample items, the accident month per the sample did not match the accident month per the claim file supporting documentation:

Company	Policy No.	Accident Month Per Sale	Accident Month Per Claim File
[REDACTED]	[REDACTED]	March 2012	May 2012
[REDACTED]	[REDACTED]	April 2012	March 2012

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

Recommendations:

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

- 1) Follow-up with each of the insurance companies to determine if appropriate corrective action has been implemented to address the exceptions noted.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure claim files are being processed and reviewed in accordance with NFIP guidelines before the approval and issuance of claim payments.

B. Internal Control Deficiencies and Inaccuracies Identified over Claims’ Loss Reserves

Observation:

We selected nine insurance companies at which to perform audit procedures over the operating effectiveness of controls related to the establishment and maintenance of loss reserves for the periods October 1, 2011, through March 31, 2012, April 1 through June 30, 2012, and July 1 through August 31, 2012. For the nine companies selected, we tested a sample of claims paid totaling 434 items covering the three testing periods identified above. We also performed audit procedures over the accuracy and completeness of loss reserves established as of March 31, 2012, and August 31, 2012, over all insurance companies. As of these dates, we tested a sample of 130 loss reserves reported. During these audit procedures, we noted the following loss reserve errors:

- 1) Based on our March 31, 2012, and August 31, 2012, substantive testwork, for five sample items, the insurance company did not close the claim and/or related loss reserve without payment in a timely manner, causing reserves to be overstated.

March 31, 2012, Substantive Testwork Results:

Company	Policy No.	Date of Loss	Overstatement
[REDACTED]	[REDACTED]	04/27/2011	\$21,400
[REDACTED]	[REDACTED]	06/12/2010	\$30,000
[REDACTED]	[REDACTED]	08/28/2011	\$51,196

August 31, 2012, Substantive Testwork Results:

Co any	Policy No.	Date of Loss	Overstatement
		03/12/2009	\$46,800
		08/27/2011	\$4,000

- 2) Based on our March 31, 2012, control testwork, for one sample item, the insurance company established the incorrect type of loss reserve related to the claim transaction.

Co any	Policy No.	Date of Loss	Correct Loss Reserve Type
		10/31/2011	Building

- 3) Based on our March 31, 2012, control testwork, for one sample item, the insurance company did not properly update the loss reserve related to the claim transaction to move reserves from Building to Contents, causing Building reserves to be overstated and Contents reserves to be understated.

Co any	Policy No.	Date of Loss	Amount Improperly Classified
		09/08/2011	\$36

- 4) Based on our March 31, 2012, and June 30, 2012, control testwork and our March 31, 2012, and August 31, 2012, substantive testwork, for 35 sample items, the insurance company did not properly update the loss reserve related to the claim transaction to reflect claim payments or additional adjuster reports, causing reserves to be misstated.

March 31, 2012, Control Testwork Results:

Co any	Policy No.	Date of Loss	Over/(Under) State ment
		06/21/2011	(\$29,693)
		08/28/2011	(\$52,561)
		04/16/2011	(\$17,050)
		09/08/2011	(\$4,300)
		11/29/2011	\$15,000
		01/20/2012	\$1,000
		08/28/2011	(\$3,432)
		08/27/2011	(\$17,652)
		08/26/2011	(\$1,000)
		09/03/2011	(\$388)
		08/27/2011	\$4,000
		08/28/2011	\$8,000
		08/21/2011	\$9,102
		08/21/2011	\$4,318
		08/23/2011	\$1,086
		08/23/2011	\$7,773
		08/23/2011	\$6,838
		08/26/2011	\$3,675

March 31, 2012, Substantive Testwork Results:

Co any	Policy No.	Date of Loss	Over/(Under) State ent
		03/07/2012	(\$54,000)
		09/07/2011	\$55,573
		09/06/2011	\$100
		09/07/2011	(\$100,000)
		03/08/2012	\$12,000
		03/12/2012	\$2,000
		03/12/2012	(\$10,000)
		08/28/2011	\$13,563
		06/13/2008	\$32,200
		08/28/2011	\$5,000
		09/17/2004	\$30,958

June 30, 2012, Control Testwork Results:

Co any	Policy No.	Date of Loss	Over/(Under) State ent
		08/28/2011	\$6,203
		08/27/2011	\$4,916

August 31, 2012, Substantive Testwork Results:

Co any	Policy No.	Date of Loss	Over/(Under) State ent
		07/20/2012	(\$5,678)
		05/13/2012	\$20,000
		09/07/2011	\$337
		07/20/2012	\$8,001

- 5) Based on our March 31, 2012, substantive testwork, for one sample item, the insurance company incorrectly re-established reserves for a claim that was previously closed without payment, causing reserves to be overstated.

Co any	Policy No.	Date of Loss	Overstatement
		08/29/2005	\$30,000

- 6) Based on our March 31, 2012, June 30, 2012, and August 31, 2012, control testwork, for 27 sample items, the insurance company did not establish a loss reserve related to the claim transaction for an Increased Cost of Compliance (ICC) claim or supplemental payment request. Payment was not made in a timely manner, causing reserves to be understated.

March 31, 2012, Control Testwork Results:

Co any	Policy No.	Date of Loss	(Under-State ent)
		08/29/2011	(\$9,771)

June 30, 2012, Control Testwork Results:

Co any	Policy No.	Date of Loss	(Under-State ent)
		03/14/2010	(\$8,635)
		08/27/2011	(\$12,500)
		08/28/2011	(\$15,000)
		08/28/2011	(\$19,599)
		08/29/2011	(\$900)
		08/28/2011	(\$22,392)
		08/28/2011	(\$1,238)
		08/28/2011	(\$2,400)
		08/28/2011	(\$119,125)
		08/27/2011	(\$12,063)
		08/27/2011	(\$9,250)
		08/27/2011	(\$3,850)
		08/27/2011	(\$3,915)
		08/28/2011	(\$2,432)
		08/28/2011	(\$2,412)
		08/28/2011	(\$1,254)
		08/28/2011	(\$14,850)
		08/28/2011	(\$2,999)
		08/29/2011	(\$14,714)
		06/11/2008	(\$1,463)
		08/27/2011	(\$472)
		08/27/2011	(\$2,330)
		08/28/2011	(\$5,816)
		09/08/2011	(\$5,791)

August 31, 2012, Control Testwork Results:

Co any	Policy No.	Date of Loss	(Under-State ent)
		08/28/2011	(\$30,103)
		08/28/2011	(\$2,000)

7) Based on our March 31, 2012, control and substantive testwork, we noted that one insurance company's procedures did not require the adjustment of loss reserves based on the final report. As a result, for 20 sample items at that company, the insurance company did not update the loss reserve related to the claim transaction upon receipt of the final report.

March 31, 2012, Control Testwork Results:

Co any	Policy No.	Date of Loss	Over/(Under) State ent
		08/21/2011	(\$9,982)
		08/27/2011	\$5,921
		08/27/2011	(\$4,902)
		08/27/2011	\$37,132
		08/28/2011	\$22,243
		08/28/2011	(\$758)
		08/28/2011	(\$18,960)
		08/28/2011	\$5,512
		08/28/2011	(\$2,300)
		08/28/2011	(\$3,318)
		08/28/2011	\$11,098
		08/30/2011	\$3,813
		08/31/2011	\$16,637
		09/07/2011	(\$936)
		09/08/2011	\$10,714
		09/08/2011	\$74,122
		09/08/2011	(\$1,992)
		09/09/2011	\$11,230

March 31, 2012, Substantive Testwork Results:

Co any	Policy No.	Date of Loss	Over/(Under) State ent
		08/28/2011	(\$14,471)
		08/27/2011	\$12,416

8) Based on our June 30, 2012, control testwork, for two sample items, the insurance company did not take a prior payment into account when loss reserves were re-established, causing reserves to be overstated.

Co any	Policy No.	Date of Loss	Overstatement
		08/28/2011	\$15,000
		09/08/2011	\$7,000

9) Based on our June 30, 2012, control testwork, we noted that the loss reserve system at one insurance company autocorrected the loss reserve amount after the examiner correctly entered the estimate per the adjuster report. As a result, for six sample items at that company, the loss reserve related to the claim transaction was overstated.

Co any	Policy No.	Date of Loss	Overstatement
		08/28/2011	\$1,377
		08/28/2011	\$1,247
		08/28/2011	\$4
		03/29/2012	\$447
		03/30/2012	\$336

Co any	Policy No.	Date of Loss	Overstatement
		05/22/2012	\$90

10) Based on our August 31, 2012, substantive testwork, for one sample item, the examiner was unable to produce the adjuster report evidencing the reserve update.

Co any	Policy No.	Date of Loss	Overstatement
		09/09/2011	\$156,121

FEMA’s Federal Insurance and Mitigation Administration did not provide adequate oversight to ensure the specific and consistent establishment and reporting of loss reserves and subsequent adjustments to the loss reserves.

Recommendations:

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

- 1) Follow-up with each of the insurance companies noted above to determine if appropriate corrective action has been implemented to address the exceptions noted.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure the specific and consistent establishment and reporting of loss reserves and subsequent adjustments to the loss reserves.
- 3) Require insurance companies to update current policies, mandating that loss reserves be established for supplemental and ICC claims that will not be paid within a specified time period.

C. Internal Control Deficiencies and Errors Identified over Premiums Written

Observation:

We selected nine insurance companies at which to perform audit procedures over the operating effectiveness of controls related to premiums written for the periods October 1, 2011, through March 31, 2012, April 1 through June 30, 2012, and July 1 through August 31, 2012. For the nine companies selected, we tested a sample of premiums written totaling 450 items covering the three testing periods identified above. We also performed audit procedures over the existence and accuracy of premiums written over all insurance companies during the same periods identified above, resulting in a sample of premiums written totaling 46 items. During these audit procedures, we noted the following deficiencies and errors:

- 1) Based on our March 31, 2012, and June 30, 2012, control testwork, for two sample items, an underwriter did not review and approve the policy in a timely manner:

March 31, 2012, Control Testwork Results:

Co any	Policy No.	Effective Date	Approval Date
		07/21/2011	12/08/2011

June 30, 2012, Control Testwork Results:

Co any	Policy No.	Effective Date	Approval Date
[REDACTED]	[REDACTED]	04/25/2012	06/26/2012

2) Based on our March 31, 2012, June 30, 2012, and August 31, 2012, control testwork and August 31, 2012, substantive testwork, for 18 sample items, the designated flood zone per the policy declaration page did not agree to the FEMA flood maps for the insured property address.

March 31, 2012, Control Testwork Results:

Co any	Policy No.	Over/(Under) State ent
[REDACTED]	[REDACTED]	(\$2,016)
[REDACTED]	[REDACTED]	(\$821)
[REDACTED]	[REDACTED]	\$475
[REDACTED]	[REDACTED]	\$53
[REDACTED]	[REDACTED]	\$43
[REDACTED]	[REDACTED]	(\$322)
[REDACTED]	[REDACTED]	(\$1,042)
[REDACTED]	[REDACTED]	\$0

June 30, 2012, Control Testwork Results:

Co any	Policy No.	Over/(Under) State ent
[REDACTED]	[REDACTED]	\$(941)
[REDACTED]	[REDACTED]	\$(401)
[REDACTED]	[REDACTED]	\$(9,644)
[REDACTED]	[REDACTED]	\$0

August 31, 2012, Control Testwork Results:

Co any	Policy No.	Over/(Under) State ent
[REDACTED]	[REDACTED]	\$(542)
[REDACTED]	[REDACTED]	\$677

August 31, 2012, Substantive Testwork Results:

Co any	Policy No.	Over/(Under) State ent
[REDACTED]	[REDACTED]	\$(827)

- 3) Based on our June 30, 2012, and August 31, 2012, control testwork, for two sample items, we noted that the insured property address information provided on the policy declaration page was insufficient to determine the correct flood zone.

June 30, 2012, Control Testwork Results:

Co any	Policy No.	Policy Zone
[REDACTED]	[REDACTED]	AE

August 31, 2012, Control Testwork Results:

Co any	Policy No.	Policy Zone
[REDACTED]	[REDACTED]	X

- 4) Based on our August 31, 2012, control testwork, for one sample item, we noted that the insurance company calculated the premium using the incorrect elevation information on the elevation certificate.

Co any	Policy No.	Elevation Rate Used	Correct Elevation Rate
[REDACTED]	[REDACTED]	-5	-4

FEMA’s Federal Insurance and Mitigation Administration did not provide adequate oversight to ensure premiums written were properly approved. Additionally, FEMA’s NFIP Flood Insurance Manual does not require all flood zones included in the insurance policy application to be verified by the underwriter.

Recommendations:

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

- 1) Follow-up with each of the insurance companies noted above to determine if they have implemented the appropriate corrective action to address the exceptions identified.
- 2) Provide increased oversight to insurance companies participating in the NFIP to ensure they process and review underwriting files in accordance with NFIP guidelines.
- 3) Revise the *NFIP Flood Insurance Manual* to require that all flood zones included in insurance policy applications are subject to verification by an underwriter through the use of risk-based sampling techniques.

D. Deficiency Identified Related to the Preparation and Review of the Retrospective Reserve Analysis

Observation:

The December 31, 2011, retrospective review completed by the third party contractor actuary and reviewed by the FEMA Chief Actuary did not include a documented discussion of the large (\$1.3 billion) redundancy (i.e., the amount estimated in excess of the actual liability) of the actuarial insurance liability calculated as of September 30, 2011.

Although the third party actuary and FEMA Chief Actuary discussed the large redundancy noted in the retrospective review of the September 30, 2011, actuarial insurance liability and how the methodology used to calculate this liability could be changed to provide a better estimate in the future, it was determined that formal documentation of this analysis was not required.

Recommendation:

We recommend that FEMA incorporate a documented comprehensive analysis of all large redundancies noted in the actual to estimate comparison of the insurance liability during the retrospective review.

STATUS OF PRIOR YEAR OBSERVATIONS

The status of each observation reported in our letter dated November 11, 2011, to the Office of Inspector General, U.S. Department of Homeland Security, and Associate Administrator, Federal Insurance and Mitigation Administration, Federal Emergency Management Agency, U.S. Department of Homeland Security, is summarized in the table below. For each repeated observation, we provided the current year Observation Number and Notice of Findings and Recommendations (NFR) Number.

2011 Observation No.	Description	Disposition	
		Closed	Repeat (2012 Observation No./ NFR No.)
II.A	Internal Control Deficiencies Identified over Claims Paid		II.A/ FEMA 12-07 and 12-07a
II.B	Inaccuracies in Claims' Loss Reserves		II.B/ FEMA 12-20 and 12-20a

MANAGEMENT'S RESPONSE

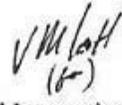
U.S. Department of Homeland Security
Washington, DC 20472



FEMA

MAR 21 2013

MEMORANDUM FOR: Anne L. Richards
Assistant Inspector General for Audits
Office of Inspector General

FROM: David J. Kaufman 
Associate Administrator for
Policy, Program Analysis and International Affairs

SUBJECT: FEMA Response to OIG Draft Report: "National Flood Insurance Program's Management Letter for the FY 2012 DHS Consolidated Financial Statements Audit" - For Official Use Only - OIG Project No. 12-073-AUD-FEMA.

Thank you for the opportunity to comment on the draft management letter for the FY 2012 DHS Consolidated Financial Statements Audit.

It may be helpful if FEMA and KPMG meet to discuss the operations of the National Flood Insurance Program and walk through the complexities of the government insurance program and how it differs from a private sector insurance program.

In response to Reserves (a case loss reserve in the private-sector insurance industry is a liability that represents dollars set aside to pay that claim); the case loss reserve is the estimate of future payments yet to be made on an individual claim, and it is a good business practice for the case loss reserve to be redundant by 5-15%.

Contrary to the private sector industry, the NFIP sets a loss reserve at the end of the fiscal year that is an estimate of future payments yet to be made on flood events that occurred on or before the year-end; the case loss reserve is not shown on the financial statement. What is carried on the financial statement is a liability on the balance sheet for all expected future claims payments, including payments on claims that had not yet been reported to the NFIP by the end of the fiscal year. This latter set of claims is known as Incurred But Not Reported (IBNR). Finally, the loss reserve estimate is a liability on the financial statement and does not impact cash balances.

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FEMA believes that the auditor's concerns over the current case reserve procedures is misplaced since the case reserves they have analyzed are not directly reported on the financial statement. And while the loss reserve estimate that is carried on the financial statement is, in part, influenced by the case reserves, the NFIP actuaries have demonstrated in analyses that have been shared with prior KPMG auditors that even a large change in the adequacy of the case loss reserves from the historical pattern has only a very small influence on the year-end estimated loss reserve. Due to the differences of opinions on this matter, FEMA's Claims and Appeals Branch believes it would be helpful to meet and discuss these concerns and issues with KPMG.

Regarding Underwriting findings, Condition 1: *Insurance policies can be issued without proper timely review and approval of the underwriting files, including application and supporting documentation.* The report had identified an error which FEMA has agreed is an error, but this does not mean FEMA accepts the practice of allowing policies to be issued without underwriting review and approval. FEMA requires that policies be rated and issued correctly, the files documented as required, and that service be provided in a timely manner as directed in the service guidelines.

The report also includes findings listed as Conditions 2 and 3: *FEMA's NFIP Flood Insurance Manual does not require all flood zones included in the insurance policy application to be verified by the underwriter.* It is important to note that Companies are required to verify that the version of the Flood Insurance Rate Map (FIRM) used in determining the flood zone for a building is the current map, unless the grandfathering rule applies, which permits the use of an earlier map in determining the flood zone. If the grandfathering rule applies, the Company is required to document the file to show that the building is eligible for grandfathering.

Companies maintain contractual arrangements with agents who submit the applications. It is the responsibility of the agent to determine the correct flood zone for the property and to supply this information on the application. In addition, companies are required to obtain flood zone determinations to verify flood zones only for Preferred Risk Policies in order to verify the building's eligibility for this lower-cost policy.

FEMA informed the auditors that their findings listed under Conditions 1 and 2 are incorrect based on the documentations provided by the writing companies.

Thank you again for the opportunity to comment on OIG Draft Report: "*National Flood Insurance Program's Management Letter for the FY 2012 DHS Consolidated Financial Statements Audit*" – *For Official Use Only: OIG Project No. 12-073-AUD-FEMA*". Please direct any questions regarding this response to Gary McKeon, FEMA's Chief Audit Liaison, at 202-646-1308.

AUDITORS' RESPONSE

FEMA's response to the draft of this letter discussed our findings related to case reserves. During the FY 2012 audit, we received a letter from FEMA's third party contractor actuary describing the data elements to be utilized in computing the actuarial insurance liability estimate as of September 30, 2012. This letter, which guided our testing approach related to the insurance liability estimate, included case reserves as one of the data elements used in the calculation. Our testing of data elements occurred throughout FY 2012. FEMA's year-end analysis demonstrated that case reserves were not a significant factor in the calculation of the insurance liability estimate as of September 30, 2012; we took this information into consideration in determining the severity of the conditions identified, which we concluded to be control deficiencies, not more severe significant deficiencies.

In addition, in FEMA's response, management indicated disagreement with certain conditions cited in this letter.

Regarding Condition C.1 in Exhibit I, FEMA did not provide documentation to support that our conclusions for the two sample items cited were incorrect; therefore, we believe that our conclusions are accurate based on the evidence provided during the audit.

Regarding Condition C.2 in Exhibit I, at the time the audit work was performed and the exceptions were initially communicated to FEMA and the insurance companies, concerns with the identified exceptions were not communicated to us. Subsequently, when FEMA did indicate that certain exceptions may not be accurate, FEMA did not provide documentation to support that our conclusions for these sample items were incorrect; therefore, we believe that our conclusions are accurate based on the evidence provided during the audit.



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Appendix A
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