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Report to the Thrift Depositor Protection Oversight Board Resolution Trust Corporation

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# FINANCIAL AUDIT

# Resolution Trust Corporation's Internal Controls at December 31, 1992

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Thrift Depositor Protection Oversight Board
Resolution Trust Corporation

This report presents findings from our evaluation of the Resolution Trust Corporation's internal controls conducted during our audit of the Corporation's financial statements for the year ended December 31, 1992.[1] Through that date, the Corporation had used nearly $80 billion in loss funds to pay the costs associated with resolving failed thrift institutions and protecting their depositors. As part of its resolution process, the Corporation has managed or disposed of nearly $400 billion in failed thrifts' assets. Due to the high cost of resolutions and the volume of its assets, the Corporation needs a strong internal control structure to protect against loss and provide accurate reporting. To address this need, the Corporation has implemented procedures to assess the effectiveness of its internal accounting and administrative controls, to report the results of that assessment, and to track the status of weaknesses identified by the internal process as well as those identified by the Corporation's Inspector General and GAO.

## Results in Brief

Although the Corporation's internal accounting controls provided reasonable assurance that assets were safeguarded against loss and that transactions were executed in accordance with management's authority and with significant provisions of laws and regulations, they did not provide reasonable assurance that the Corporation properly recorded, processed, and summarized transactions for its financial statements or other financial reports. In its draft financial statements, the Corporation understated by $1.5 billion a component of its loss allowance calculation for subrogated claims (claims paid to or on behalf of the depositors of failed institutions). While the Corporation's management reviewed the overall calculation for the loss allowance estimates, no procedures were in place to review certain computer-generated data used in the calculation and, as a result, a significant error in the data went undetected by management. To address this material weakness,[2] the Corporation made the audit adjustment we proposed to its final December 31, 1992,

[1] Financial Audit: Resolution Trust Corporation's 1992 and 1991 Financial Statements (GAO/AIMD-93-6, June 30, 1993).

[2] A material weakness is a reportable condition in which the design or operation of the internal controls does not reduce to a relatively low level the risk that losses, noncompliance, or misstatements in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of their assigned duties.

allowance for loss on subrogated claims and has acted to prevent such data errors from occurring in future calculations.

We also identified other weaknesses in the Corporation's internal controls that, although not considered to be material, represent significant deficiencies that should be corrected by management. The significant weaknesses discussed in this report relate to: (1) use of the wrong data base to estimate claims losses for representations and warranties,[3] (2) lack of required check receipts reconciliations in consolidated field offices, and (3) posting errors to various receivership general ledger accounts. If uncorrected, these weaknesses could result in inaccurate financial reports and/or losses to the Corporation.

## Background

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) created the Resolution Trust Corporation on August 9, 1989, to resolve the problems of failed thrift institutions previously insured by the Federal Savings and Loan Insurance Corporation and placed into conservatorship or receivership from January 1, 1989, until August 9, 1992. The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 extended the Corporation's resolution responsibility through September 30, 1993. Under the Chairmanship of the Secretary of the Treasury, the Thrift Depositor Protection Oversight Board monitors the Corporation's operations, provides general policy direction, and reviews its performance. Under existing law, the Corporation will terminate no later than December 31, 1996, and all remaining assets and liabilities will be transferred to the FSLIC Resolution Fund, which is administered by the Federal Deposit Insurance Corporation.

Through December 31, 1992, the Resolution Trust Corporation resolved 653 failed thrifts at an estimated cost of $79.5 billion and had another 81 failed institutions in conservatorship awaiting resolution at an expected cost of $12 billion. The Corporation has reported proceeds of $330 billion from asset sales and principal collections through year-end 1992, more than 83 percent of the book value of failed institutions' assets at the time of takeover. However, approximately $100 billion in assets remained in receiverships and conservatorships at December 31, 1992, of which nearly 40 percent were considered among the Corporation's hard-to-sell assets (delinquent loans, real estate owned, and investments in the subsidiaries

[3]The Corporation and its receiverships provide representations and warranties, in the form of factual disclosure, about certain assets being sold and are expected to stand behind the accuracy of those statements. Representations and warranties create contingent liabilities which require the Corporation to estimate related potential losses and reflect these estimates in its financial statements.

of failed institutions). It is particularly difficult for the Corporation to predict the recovery value and timing of sale for these kinds of assets. If assets sell later or for less than predicted, the Corporation's costs will most likely be higher than estimated. Conversely, higher or earlier recoveries will likely lower the Corporation's final costs.

## Objectives, Scope, and Methodology

As part of our audit of the Corporation's 1992 financial statements, we assessed internal accounting controls at the Corporation's headquarters and its consolidated field offices. Our primary objectives were to determine whether controls provided reasonable assurance that (1) assets were safeguarded against loss from unauthorized use or disposition, (2) transactions were executed in accordance with management's authority and with laws and regulations, and (3) transactions were properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with generally accepted accounting principles and to maintain accountability for assets.

In order to assess the Corporation's control structure, we identified, evaluated, and tested relevant internal controls over the following significant cycles, classes of transactions, and account balances:

- resolved institutions, consisting of policies and procedures related to (1) resolution activities, (2) receipts and disbursements in receiverships, and (3) valuation of the Corporation's net receivables from resolution transactions and assistance;
- unresolved institutions, consisting of policies and procedures related to identifying and estimating the cost of future resolutions and of providing advances to institutions in conservatorship;
- Federal Financing Bank borrowings, consisting of policies and procedures related to the borrowing, use, and repayment of working capital;
- treasury, consisting of policies and procedures related to Corporate cash receipts and disbursements; and
- financial reporting, consisting of policies and procedures related to the processing of journal entries into the general ledger and the preparation of financial statements.

We did not evaluate all the internal controls that would be included in a Federal Managers' Financial Integrity Act (FMFIA) evaluation, such as those controls relevant to ensuring efficient operations. We limited our work to accounting and other controls necessary to achieve the objectives described above.

We performed our work from July 1992 through May 1993, at the Corporation's headquarters offices in Washington, D.C., and Rosslyn, Virginia, and at nine consolidated field offices and one financial service center open at the end of 1992. We also tested transactions from six field offices that were closed or in the process of closing. We conducted our audit pursuant to the provisions of section 21A(k)(1) of the Federal Home Loan Bank Act (12 U.S.C. 1441 a(k)(1)) and in accordance with generally accepted government auditing standards. At the end of our field work, we discussed a draft of this report with the Corporation's Chief Financial Officer and other Corporation officials. Their comments have been incorporated where appropriate.

## Material Weakness in Controls Resulted in Undetected Error

In performing our audit procedures, we found that the Corporation had understated a component of its loss allowance calculation for subrogated claims. These claims represent payments made by the Corporation to or on behalf of the depositors of failed institutions, only a portion of which will be recovered from the sale of the failed institutions' assets in receiverships. The Corporation estimates its losses on subrogated claims quarterly by performing a series of calculations that include: (1) estimating the recovery values of a sample of receivership assets and projecting the sampled results to all remaining assets, (2) estimating losses due to claims arising from representations and warranties offered with the sale of certain loans and servicing rights, (3) estimating credit losses from securitization transactions,[4] and (4) estimating general and administrative overhead costs not allocable to individual receiverships. Subrogated claims amounts not recovered from receiverships represent losses to the Corporation which must now be funded by appropriations.[5] To provide the Congress with the best information for making appropriation decisions, the Corporation's loss estimates must be accurately calculated and based on all available information.

In its fourth quarter calculation of asset recovery values, the Corporation inadvertently used June 1992 data instead of December 1992 data to allocate its loan asset balances between performing and nonperforming

[4]Securitization refers to the practice of grouping assets (usually performing mortgage loans) and selling securities backed by the underlying future cash flows of those assets. Purchasers of the securities demand some protection against credit losses which may occur due to defaults and delinquencies on the underlying loans.

[5]Through June 1993, the Corporation was provided with $86.7 billion for resolution losses. Of that amount, $30 billion represented bond proceeds from the Resolution Financing Corporation and $1.2 billion was contributed by the Federal Home Loan Banks. All remaining funds were provided through appropriations.

categories. Because the June data contained generally higher percentages of performing loans in relation to the December data and because performing loans have a higher recovery value than nonperforming loans, this error overstated the Corporation's estimated recoveries from receivership assets by $1.5 billion. Although the Corporation's management reviewed the overall calculation for the loss allowance estimates, no procedures were in place to review the computer generated data used in the calculation and, therefore, the error went undetected.

The Corporation did, however, make our proposed audit adjustment to correct its final December 31, 1992, allowance for loss on subrogated claims and has taken steps to prevent such errors from occurring in future loss calculations. In the future, staff from the systems development and asset operations departments will perform the asset recovery calculations together and will execute the procedures several times to ensure processing integrity. The results of the performing/nonperforming asset split will be validated by comparison with several existing asset reports and spreadsheets for selected receiverships. In addition, the Corporation has updated its estimated cost recovery technical guidelines to reflect these enhancements and highlight potential problem areas.

We believe that the Corporation has implemented the proper control procedures to prevent errors from occurring in the components of its future loss calculations. We will continue to test these calculations as part of our yearly financial audit work.

## Other Significant Weaknesses Could Result in Losses/Inaccuracies

During our 1992 evaluation of the Corporation's system of internal controls, we identified the following weaknesses that, while not material, represent significant deficiencies that should be corrected by the Corporation's management. These weaknesses could adversely affect the entity's ability to safeguard its assets from unauthorized use or disposition or to ensure its financial reports, including its financial statements, are complete and accurate.

### Wrong Data Base System Used to Accrue Claims Losses

Generally accepted accounting principles require the Corporation to record a liability for claims losses arising from representations and warranties offered with the sale of loans and servicing rights. The Corporation's receiverships are required to set aside funds in reserve accounts to pay those claims when filed. The amount of the required reserve is based on the risks involved with each sales transaction and is calculated as a percentage of the unpaid principal balance of the loans and servicing rights sold. Information on required reserves is tracked in the Corporation's Warranties and Representations Accounts Processing System (WRAPS). The Corporation also tracks how much has been set aside to fund each established reserve in its Claims Administration Reserves Account Tracking System (CARATS). To the extent that required reserves are underfunded or overfunded, the information on WRAPS will not match the information on CARATS.

In determining the claims reserve amount to be reported in its financial statements, the Corporation used information from CARATS (funded reserves) instead of WRAPS (required reserves). Because the Corporation's funded reserves were less than the amounts required, the resulting financial statement loss accrual was understated. We also found that both WRAPS and CARATS did not include data on all sales subject to representations and warranties. In particular, neither system is complete with respect to data on relevant asset sales that occurred before 1991. To correct the understatement caused by using the wrong data system and incomplete data systems to calculate its reserve amount, the Corporation made our recommended adjustment of $467 million to increase its loss reserves for representations and warranties.

## Lack of Proper Reconciliations Could Result in Losses

In order to safeguard its assets, the Corporation must have controls to ensure that all checks received are either (1) deposited and properly recorded as receipts in the general ledger, (2) properly held for research, or (3) properly released to third parties. The Corporation's Field Accounting Manual requires the field offices to perform a daily reconciliation of key receipts documents; however, the Manual does not specify how the reconciliation should be done or provide a standard format for the reconciliation. Without a daily reconciliation of check receipts, the Corporation may not detect checks withheld from deposit, lost, stolen, or improperly released to third parties.

During 1992, 9 of the Corporation's 13 field offices that received checks were not performing a reconciliation of their daily log of checks received to the posted journal entry, the deposit slip, the held checks log, or the report of checks released to third parties. To determine whether all checks received in those offices were either deposited or otherwise properly accounted for, we attempted to reconstruct the required reconciliations; however, most field offices could not provide sufficient documentation to enable us to complete that task.

Three of the field offices that did not perform reconciliations implemented the required procedures during the latter part of 1992, and five of the field offices have been closed. However, one open field office had still not instituted the required reconciliation procedures at December 31, 1992.

## Posting Errors Could Cause Inaccurate Reporting

The Corporation's management has a chart of accounts that defines the specific general ledger accounts to be used for reporting receivership accounting data. The Field Accounting Manual assigns to field offices the responsibility for ensuring that all receivership journal entries are accurately recorded and appropriately classified and that posting errors are identified, documented, and corrected on a daily basis. Posting errors result in inaccurate financial reports to management.

During our 1992 testing, we found that 22 of the 122 wire disbursements we tested had one or more account posting errors. Because most of the errors occurred within expense account categories, they did not affect the amount reported on the Corporation's financial statements for estimated recoveries from its receiverships. However, based on the results of our tests, we estimate that approximately 11 percent of all wire disbursements to third parties contained at least one account posting error.[6] If such a high error rate continues in its field offices, the Corporation faces the risk that future errors could occur between receivership balance sheet and income statement accounts and, therefore, the Corporation's financial statement accounts related to recoveries from receiverships could be inaccurate.

## Conclusions

The Corporation has implemented the proper control procedures to prevent errors from occurring in the components of its future loss calculations. However, other significant deficiencies we identified could result in future losses or inaccurate financial reporting.

## Recommendations

We recommend that the Corporation's Chief Financial Officer direct the Corporation staff to take the following actions.

- Use the WRAPS data base to calculate future financial statement loss accruals for representations and warranties. The WRAPS data should be tested for completeness and accuracy and the necessary adjustments made before the required reserve amounts are calculated for all sales.

[6]Based on the results of our sample, we can conclude with 90 percent confidence that between 4.1 percent and 16.9 percent of all wire disbursements to third parties contain at least one posting error, with the most likely error rate at 10.5 percent.

- Explain more clearly the check receipts reconciliation requirement in its Field Accounting Manual and include a specific reconciliation format to be followed. Field personnel in the remaining open offices should be trained to ensure procedures are properly implemented and consistently followed.
- Review the field offices' journal entry preparation and review processes to determine the reason for high error rates relating to wire disbursements. Based on the results of that review, control procedures should be strengthened or enforced accordingly and field offices should be periodically tested and evaluated to ensure required procedures are being followed.

## Agency Comments

We discussed the results of our internal control evaluations with the Corporation's Chief Financial Officer and other Corporation officials who acknowledged the weaknesses we identified and stated their intention to address these problems.

As a mixed-ownership government corporation, the Corporation is not subject to the requirement in 31 U.S.C. 720 that agency heads submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs, the House Committee on Government Operations, and the House and Senate Committees on Appropriations. However, we are requesting that the Corporation provide us with such a statement within 60 days of the date of this letter to assist our follow-up actions and allow us to keep the appropriate congressional committees informed of the Corporation's activities.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who may be reached at (202) 512-9406 if you or your staff have any questions.

Donald H. Chapin
Assistant Comptroller General

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