Office of Inspector General

January 14, 2005
Supplement to Audit Report No. 04-044
Dated September 29, 2004

FDIC's Allocation of Records Storage Costs

****This is Not an Audit Report.****

This supplement contains copies of correspondence between the Office of Inspector General (OIG) and the FDIC Audit Committee and between the OIG and the Division of Finance subsequent to the issuance of Audit Report No. 04-044, dated September 29, 2004. The intent of this supplement is to show resolution and closure of recommendations that were unresolved at the time the OIG issued the final report.

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I. Audit Committee Assessment of Management Response to the Final Report

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Audit Committee

DATE: January 7, 2005

TO: Patricia M. Black
Acting Inspector General

FROM: John M. Reich [Electronically produced version; original signed by John M. Reich]
Chairman, FDIC Audit Committee

SUBJECT: Assessment of the Corporation's Response to the Final Audit Report Entitled *FDIC's Allocation of Records Storage Costs Report* (Report No. 04-044)

The Audit Committee serves as the final resolution body for all disputed audit recommendations. On December 9, 2004, the Audit Committee, by unanimous vote, agreed to accept management's position on recommendation numbers one and three, contained in the subject report. Accordingly, the Audit Committee has determined that recommendations one and three are hereby resolved, dispositioned, and closed for reporting purposes, with no further management action required.

The Audit Committee noted that the Division of Finance has committed to periodic reviews of the methodology employed to allocate records management costs in the future. In order to fully satisfy recommendation number two, after reviewing its methodology and making any appropriate changes to its future allocations, DOF will report those changes, including a summary of their estimated impact on the insurance funds to the Audit Committee.

cc: James Gilleran
Steven O. App
Fred S. Selby
Russell A. Rau
Thomas E. Peddicord

II. OIG Assessment of Management Response to the Final Report

FDIC
Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20434

Office of Audits
Office of Inspector General

DATE: December 8, 2004

MEMORANDUM TO: Fred S. Selby, Director
Division of Finance

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: Status of Recommendations in Audit Report No. 04-044, *FDIC's Allocation of Records Storage Costs*

In your memoranda of September 24 and October 27, 2004; in meetings with you on October 13 and November 18, 2004; and in our discussions with Division of Finance (DOF) staff on several occasions, you have advised us that you disagree with the three recommendations in the subject audit report.

In particular, DOF took strong exception to recommendation 2 that DOF charge records storage costs as direct expenses for the applicable fund.[1] However, DOF is taking alternative corrective action for the prospective allocation of records storage costs addressed by recommendation 2. Although it disagreed with recommendation 2, DOF informed us that the destruction of records related to the goodwill litigation may distort the composition of the Corporate Services cost pool.[2] Therefore, DOF will reassess the parameters used to allocate the costs in the pool to the Corporation's major business processes and ultimately to the funds for 2005 and future years. While we recommended direct charging, we recognize that a proper allocation methodology can achieve accurate accounting. Therefore, we consider management's planned action responsive to recommendation 2. Recommendation 2 is resolved but will remain undispositioned and open until we have determined that agreed-to corrective action has been completed and is effective.

With regard to recommendation 1 that DOF adjust the funds' balances to address the disproportionate distribution of records storage costs in prior periods, DOF and the Office of Inspector General (OIG) disagree on whether the allocation methodology accurately distributed records storage costs to the funds. The specific issues follow:

- DOF does not agree with OIG that there were allocation errors for prior periods that require correction. DOF stated that the OIG estimate of the allocation of records storage costs to the funds is not accurate. However, DOF has not provided the amounts of records storage costs that it charged to the funds for us to compare to our calculations or an alternative to the method we applied for estimating the allocation of records storage

[1] The FDIC administers the Bank Insurance Fund (BIF), Savings Association Insurance Fund (SAIF), and the Federal Savings and Loan Insurance Corporation (FSLIC) Resolution Fund (FRF).
[2] Corporate Services costs pool, as used throughout this memorandum, refers to transactions that are identified with an organization and program code of CL71 in FDIC accounting systems.

costs to the funds. Rather, DOF has provided detailed descriptions of the cost allocation model with assurances that the methodology ultimately results in appropriate allocations of Corporate Services costs (such as records storage costs) as a whole. We determined that, in most years, insufficient Corporate Services costs were allocated to the FRF in total to provide for a proper accounting of records storage costs. DOF has not otherwise demonstrated that the underallocation of records storage costs was offset by an overallocation of other costs. In our view, there may be a broader issue as to whether an adequate audit trail exists to accurately determine the allocation of the records storage costs to the funds.

- DOF does not intend to adjust the funds' balances and stated that records storage costs had already been fully factored into the fund allocation process. Instead, DOF emphasized that the methodology was validated by the Government Accountability Office (GAO), with participation by the OIG, in annual financial statement audits. The OIG position is that while the overall methodology may have been validated, anomalies may occur for specific transactions or over time and may require correction. Just as DOF is considering adjusting parameters in its allocation methodology for prospective costs, reconsideration should be given to how prior period records storage costs were charged.

- DOF stated that the OIG specifically evaluated the allocation of the Corporate Services cost pool during the 1999 financial statement audit. Actually, in 1999, the FDIC made an adjustment to the recovery rate for the cost pool. The GAO obtained an explanation of the adjustment from the FDIC. The OIG reviewed and accepted the explanation. The information provided by the FDIC at that time did not include the makeup of the pool or the relationship of the individual cost elements to the funds. Therefore, we do not agree with the implication that the actual allocation of the costs was audited by the GAO or OIG.

- Finally, DOF stated that the OIG allocation estimate did not consider recovery of the costs from the receiverships. The example DOF provided was that 50 percent of the cost pool was recovered in 1999. Our analysis of additional information provided by DOF shows that the recovery percentages for the cost pool ranged from none in 2001 to 68 percent in 1997. We estimated that the funds put to better use could be decreased by $1.2 million to $5.4 million, depending on the results of further analysis of the recoveries from receiverships. When a recommendation is resolved, the estimate of monetary benefits may be dispositioned at a different amount, and we would revise our estimate based on updated information. However, it is important to note that a discussion of the monetary benefits is relevant only if we have agreement on adjusting the funds' balances.

As a result of our correspondence and discussions with DOF we have determined that we are unable to resolve recommendation 1, and it remains unresolved, undispositioned, and open. Recommendation 3, to determine whether prior year adjustments should be made to the funds' financial statements, is also unresolved, undispositioned, and open, pending resolution of recommendation 1. However, DOF stated that it has assessed the materiality of the costs that OIG recommended be charged to FRF and has determined that the amount was below the materiality threshold for the FRF. Thus, DOF stated that believed it was not appropriate to make adjustments to the Corporation's financial statements for prior years or to make adjustments to the funds' balances. The OIG position is that while financial statements for prior years may not need to be restated, the FDIC still needs to make the appropriate adjustments to the BIF, SAIF, and FRF balances to properly account for the costs. Since resolution of recommendation 3 is dependent on resolution of recommendation 1, we will review the support for these materiality decisions after a management decision is made.

Conclusion

In this audit, we evaluated the allocation of records storage costs, not the allocation of the related cost pool and methodology as a whole. Nevertheless, the ultimate goal is to accurately account for costs. This can be achieved through proper allocation or direct charging. In our view, the FDIC has not demonstrated that it has achieved that goal for records storage costs.

cc: James H. Angel, Jr., OERM
Stanley J. Pawlowski, DOF

III. Management Response to the Final Report

FDIC
Federal Deposit Insurance Corporation
801 17th St. NW Washington, DC 20429-9990

Division of Finance

October 27, 2004

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Fred S. Selby, Director [Electronically produced version; original signed by Fred S. Selby]
Division of Finance

SUBJECT: Additional Management Comments on Report Number 04-044, *FDIC's Allocation of Records Storage Costs*

In our memorandum of September 24, 2004, we advised you that we did not agree with any of the three recommendations in your draft audit report on *FDIC's Allocation of Records Storage Costs*. In response to your request that we reconsider our position, we met with you on October 13 to discuss further the issues in dispute and the possible resolution of those issues. In addition, subsequent to that meeting, we met with the audit team on several occasions to review in more detail their specific findings. Although we have carefully reconsidered this matter, we have again reached the conclusion that we disagree with all three of the recommendations in the subject report.

In particular, we take strong exception to your recommendation that we abandon the allocation methodology that we are currently using and attempt to direct expense all records storage costs to the appropriate fund. It is simply not administratively feasible to accurately associate with the appropriate funds the various charges we incur for storing millions of cubic feet of records in a constantly changing records inventory. Any attempt to do so would inevitably lead to gross errors and undermine the integrity of our cost accounting process. Moreover, our use of an allocation methodology for these types of costs has been repeatedly validated in the audits of our annual financial statements by the Government Accountability Office in conjunction with the Office of Inspector General (OIG) since 1996.

In fact, our review of the 1999 financial statement audit reflects that 50% of the expenses incurred were deemed recoverable, meaning they were charged to receiverships, therefore, not subject to allocation. Assuming this rate was consistent throughout the period covered by your current audit, the amounts presented in your findings would be overstated by 50%. Additionally, in this audit the OIG specifically sampled the Corporate Services cost pool and concluded that the bases for the allocation and recovery percentages were reasonable.

We do acknowledge that the freeze on the destruction of records related to the goodwill litigation may be gradually distorting the composition of the Corporate Services cost pool and that it is, therefore, appropriate for us to reassess for 2005 and future years the need for refinement of the "driver" that is used to allocate the costs in that pool to the Corporation's major business processes and ultimately to the funds (at least until the destruction of the goodwill records has been completed and our records inventory returns to a more "normal" state). As you know, we will also be implementing a substantially improved and more refined set of support cost pools when the New Financial Environment is implemented in 2005. Considerable management resources have been devoted to reviewing and confirming that new cost management structure over the past year.

As you requested, we also assessed the materiality of the additional costs (a total of $34.6 million from January 1996 through July 2004) that you felt should have been charged to the FRF rather than the BIF and the SAIF. We determined that this amount was below the materiality threshold for the FRF. Thus, even if we agreed with your conclusion that the FRF had been undercharged, we do not believe that it would be appropriate either to make adjustments to the Corporation's financial statements for prior years or to make adjustments to the BIF, SAIF, and FRF balances.

If you have further questions about this matter, please contact Robert C. Nolan at (202) 416-2099.