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UNITED STATES GENERAL ACCOUNTING OFFICE
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STATEMENT OF
ELMER B. STAATS, COMPTROLLER GENERAL OF THE UNITED STATES
BEFORE THE
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, CURRENCY AND HOUSING
HOUSE OF REPRESENTATIVES

on

H.R. 4316, A Bill to Authorize and Direct the General Accounting
Office to Audit the Federal Reserve System

We appear here today at your request to present our views
on H.R. 4316 which authorizes and directs the General Accounting
Office to audit the Federal Reserve Board, the Federal Advisory
Council, the Federal Open Market Committee, and the Federal
Reserve banks and their branches.

This bill is essentially the same bill that was origi-
nally considered by the House Committee on Banking and
Currency in 1973. The principal changes are the addition
of specific references to the Federal Advisory Council,

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the Federal Open Market Committee, and transactions of the System Open Market Account as being subject to audit by the General Accounting Office.

Proposals for a GAO audit of the Federal Reserve System have a long background. Appended to my statement is a brief resume of the extent of our existing audit authority over the Federal Reserve System and congressional consideration of prior efforts for a more extensive GAO audit (Attachment I).

The Federal Reserve System has a number of important control and regulatory functions relating to the Nation's system of money and credit. For example, it can expand or contract the supply of money and credit by purchasing and selling U.S. Government obligations. As of December 31, 1974, the Federal Reserve System owned U.S. securities totaling nearly \$86 billion.

The financial statements of the 12 Federal Reserve banks for the calendar year 1974 showed total earnings from operations of \$6.3 billion of which 96 percent was derived from interest on U.S. Government securities. Total operating expenses of these banks in that year were \$548 million including about \$41 million in assessments for the expenses and other costs of the Board of Governors. Losses and other deductions amounted to about \$78 million. Member banks were paid dividends of about \$53

million and about \$51 million was transferred to surplus. The remainder of the net earnings of about \$5.5 billion was transferred to the U.S. Treasury.

In view of the very important part that the Federal Reserve System plays in the Nation's system of money and credit, we believe--as we testified in 1973--that the Congress should provide for a GAO audit of that system. H.R. 4316 provides for an annual audit of the several entities of the system together with an annual report to the Congress on the results. Special or preliminary reports are also expected when deemed desirable. Specific provision is made in the bill that such reports shall include any comments and recommendations that the Comptroller General considers advisable, including recommendations for more economical and efficient administration and disclosure of any activities observed during the audits which are carried on without authority of law. The bill also provides for access by the General Accounting Office to all records and properties of the entities subject to audit.

The bill provides no restrictions of any kind on the scope of the GAO audit or on access to records for audit purposes. This is satisfactory to us. In fact, if we are to be authorized and directed to audit the Federal Reserve System, we would recommend that the authorizing law contain no restrictions.

Last year when legislation on this subject was being considered, charges were made that a GAO audit would undermine the independence of the Federal Reserve System with respect to its monetary and credit operations and damage the Nation's monetary policymaking system. Needless to say we do not concur in this view.

Should the Congress wish to restrict the audit to take into account this criticism, one restriction that could be written into the law would be to specifically provide that our audit reports to the Congress or its committees shall not contain conclusions or recommendations with respect to the economic effects (as opposed to the efficiency and economy) of open market and discount operations.

We understand also that there is concern about our examining transactions conducted by Federal Reserve banks on behalf of foreign central banks which have a high degree of sensitivity from an international standpoint. A similar restriction on including information on such transactions in our reports could be provided in the law if Congress wishes to do so.

However, we do not believe it would be desirable to provide any other restrictions on our auditing or reporting if the overall objective of the legislation, as we understand it, is to be achieved.

The bill would require the GAO to make an annual audit. Instead of prescribing that we make an audit each fiscal year of the several entities of the System, we recommend that the requirement be changed to provide simply that the General Accounting Office be directed to audit the named entities of the Federal Reserve System. With this change, coupled with the provision that the audits be made under such rules and regulations as the Comptroller General shall prescribe, the bill would give us the needed flexibility to make selective reviews on a continuing basis of different aspects of the System without the concern that the literal wording of the law requires a complete audit every year. This audit policy has evolved as a satisfactory way of providing useful information and needed assistance to the Congress with respect to other major agencies of the Government and we believe that it should also apply to the Federal Reserve System.

Even if this suggested change is adopted, the bill could still--as it now does--require that we report to the Congress once a year on the results of the audit work performed during the year--in addition to individual reports that we would make during the year.

Under the Budget and Accounting Act of 1921, and the Budget and Accounting Procedures Act of 1950, determination as to the frequency as well as the scope of the auditing

performed in other Government agencies is left to our judgment. These judgments are made in the light of congressional interests in specific programs and problems as they become known to us and, as the 1950 act requires, after giving "due regard to generally accepted principles of auditing, including the effectiveness of accounting organizations and systems, internal audit and control, and related administrative practices."

The bill provides that the GAO audit would be made under such rules and regulations as we would prescribe. In accordance with our regular policy, any rules or regulations that we would prescribe would specifically require our auditors to review and evaluate the nature and effectiveness of the organizations and systems of internal management control of the several entities of the Federal Reserve System in determining the nature and extent of GAO audit work to be performed. In particular, we would want to make a comprehensive review of the internal and external auditing already being done. This step is in conformity with generally accepted principles of auditing and is also essential in avoiding unnecessary duplication and expenditure of effort.

The reason for our mentioning this point is in recognition that some auditing is now being done within the Federal Reserve System. It is our understanding that--

- A firm of independent CPAs makes an annual audit of the accounts of the Board of Governors and renders an opinion on the Board's financial statements which is included in the Board's annual report to the Congress.
- The Board's staff of field examiners examines each Federal Reserve Bank and branch once each year.
- The annual examination of the Federal Reserve Bank of New York includes an audit of the accounts and holdings relating to the System Open Market Account and the foreign currency operations conducted by the New York bank under policies of the Federal Open Market Committee.
- Representatives of a firm of independent CPAs accompany the Board's examiners on their examination of one Reserve bank each year, to evaluate the adequacy of the examination procedures.
- Each Reserve bank has internal auditors who work on a year-round basis. Their work programs are reviewed by the Board's examiners.

Except for the opinion of the CPA firm on the financial statements of the Board of Governors which is included in the Board's annual report, no reports on the auditing being performed within the Federal Reserve System are submitted to the Congress, to our knowledge.

Under our standards for audit of governmental activities we consider that the full scope of an audit should include:

1. An examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.

2. A review of efficiency and economy in the use of resources..
3. A review to determine whether desired results are effectively achieved.

Examinations of financial transactions, accounts, and reports and compliance with applicable laws and regulations include performing enough analysis and verification work to arrive at opinions as to whether financial transactions are carried out in accordance with applicable legal requirements and are properly accounted for, and whether the financial reports present fairly the financial position, changes in financial position, and results of operations of the various entities being audited. Audit reports on such work would disclose any program, financial transaction, or undertaking which, in our opinion, is carried on without authority of law. In performing this kind of an audit we would, as described earlier, first make a careful review of the nature and adequacy of the internal management control systems including the audit work already being performed within the Federal Reserve System before determining how much additional auditing by us would be needed.

In reviewing matters of efficiency and economy, our objective is to find out whether the entities being audited give due consideration to conservation of resources and minimum expenditure of effort in carrying out their operations. We are interested in finding out whether there are unnecessary or inefficient or unjustifiably costly procedures, whether there is unnecessary duplication of effort, whether work is being performed which serves little or no useful purpose, whether equipment is being inefficiently used, whether there is overstaffing, and whether there are faulty buying practices which result in paying unnecessarily high prices or just buying too much.

In carrying out this kind of work, we do not undertake to arrive at overall opinions as to whether an organization is operating efficiently and economically, but we do try to identify problem areas and propose recommendations for greater efficiency and economy. This kind of audit work also includes determining the causes of any inefficient or uneconomical practices found as a basis for proposing constructive recommendations for improvement. H.R. 4316 specifically provides for audit work of this nature since it requires that we include in our reports "recommendations for attaining a more economical and efficient administration of the entities audited."

In reviewing the results of authorized programs or activities, our primary purpose is to find out whether the objectives contemplated by the authorizing body or bodies are being achieved. In other agencies of the Federal Government, we have gained a great deal of experience in making such reviews, and the Congress has expressed a growing interest in obtaining reports from us on the results of this kind of audit work. The most recent general expression by the Congress on GAO auditing is in the Congressional Budget and Impoundment Control Act of 1974. This act provides that we shall review and evaluate the results of Government programs and activities carried on under existing law. These reviews may be made on our initiative, when ordered by either House of Congress, or when requested by any congressional committee having jurisdiction over the programs or activities.

Other than the discount and open market operations, there are numerous functions and activities of the Federal Reserve System on which evaluations of results achieved or effectiveness of operations could be made as a part of our audits. Some examples of these functions are listed in Attachment II to my statement.

Section (d) of H.R. 4316 authorizes us to employ necessary personnel and obtain temporary and intermittent services to carry out the required audit of the Federal Reserve System

without regard to the provisions of title 5, U.S. Code. We recommend that this proposed authority be modified in favor of providing that, in carrying out the responsibilities assigned by the bill, we be authorized to employ experts and consultants at rates not to exceed level V of the Executive Schedule under section 5316 of title 5, U.S. Code. At this time we estimate that it would be desirable to have authority to employ five such individuals. This is similar to a provision included in the Congressional Budget and Impoundment Control Act of 1974 which placed additional responsibilities on the GAO.

Our specific suggestions for changes in H.R. 4316 that I have discussed together with some other minor word changes are shown in Attachment III to my statement.

In summary, Mr. Chairman, we believe that H.R. 4316, with the changes suggested in this statement, would provide for an adequate audit of the various entities of the Federal Reserve System and enable us to provide substantial assistance to the Congress in carrying out its oversight responsibilities of the Federal Reserve System.

BACKGROUND ON PRIOR PROPOSALS TO REQUIRE A GAO
AUDIT OF THE FEDERAL RESERVE SYSTEM

Until 1933, GAO audited the expenditure vouchers of the Federal Reserve Board but not of the banks. The audits were made because of the ruling of the Attorney General in 1914 that the funds obtained by assessment by the Board from the banks to meet the expenses were public moneys. The Banking Act of 1933, however, superseded this ruling by declaring that these funds were not to be construed as Government funds or appropriated moneys. With this change, the GAO audit of the Board's expenditure vouchers was discontinued.

On occasion, the General Accounting Office has assisted the House Committee on Banking and Currency in its work relating to the Federal Reserve System. In 1971, it also completed at the request of the Chairman of the Joint Economic Committee a study of the reporting system operated by the Federal Reserve Bank of New York for dealers in Government securities.

With one exception, however, the GAO does not have the authority to make audits of the several entities of the Federal Reserve System. The exception is the responsibility assigned by the act of May 20, 1966, to audit the cancellation and destruction of United States currency unfit for circulation. Specifically, this act provides that:

"The Comptroller General of the United States shall audit the cancellation and destruction, and the accounting with respect to such cancellation and destruction, of any currency of the United States unfit for circulation, regardless of who is responsible for, and regardless of who performs, such cancellation, destruction, or accounting. The Comptroller General shall have access to any books, documents, papers, and records which he deems necessary to facilitate an effective audit pursuant to this section."

This audit authority was provided in connection with the change in procedures to transfer authority to destroy unfit Federal reserve notes, previously vested by law in the Comptroller of the Currency, to the Secretary of the Treasury. The destruction of most unfit currency is carried out in Federal Reserve banks. GAO has since reviewed these activities of the Federal Reserve banks on a selected basis each year. Three reports on this work have been submitted to the House Committee on Banking and Currency. In addition, 20 reports have been submitted to the presidents of the specific Reserve banks.

Generally, GAO has not found major deficiencies in the administrative procedures and controls over these activities.

The question of whether there should be a GAO audit of the Federal Reserve Board and the Reserve banks was discussed during consideration of the legislation which resulted in the Government Corporation Control Act of 1945. The primary purpose of this act was to provide greater congressional control over wholly-owned and partly-owned Federal corporations. It was determined that the Federal Reserve Board and banks should be excluded from the audit provisions of that act. Apparently, the main reasons for this determination was that the Board exercised strong control over the Reserve banks and all of the stock of those banks was owned by member banks rather than by the Government.

A bill introduced on July 20, 1959, in the 86th Congress, H.R. 8302, would have directed the Comptroller General to conduct an audit of the Federal Reserve System for the period commencing with the enactment of the Federal Reserve Act, December 23, 1913, and ending December 31, 1958. The Comptroller General objected to this measure because it would have required an audit for a 45-year period which, as he then stated, constituted "a tremendous task which would drain our audit manpower assigned to defense and other important Government expenditures."

In subsequent years other bills were introduced, but not enacted, which would have required GAO to audit the Federal Reserve System. In commenting on such legislation, the Comptroller General offered no opinion on whether such an audit by the GAO was advisable, but stated that if the Congress wanted such an audit made, it would carry out the congressional intent by making whatever audits the Congress wished.

During the 93rd Congress, H.R. 10265 was considered which included provision for a GAO audit. In testifying on this bill before the House Committee on Banking and Currency, the Comptroller General, for the first time, took the position that, in view of the important part the Federal Reserve System plays in the Nation's system of money and credit, a GAO audit should be provided for.

The Committee reported this bill with certain amendments on October 12, 1973. The amended bill provided that:

1. The Comptroller General make, under such rules and regulations as he shall prescribe, an audit for at least one of each three fiscal years of the Federal Reserve Board and the Federal Reserve banks and their branches, the Federal Advisory Council, and Federal Open Market Committee, and all clearing facilities. However, the scope of the audit was specifically restricted to exclude--
 - a. Examination reports of member banks
 - b. Transactions conducted on behalf of foreign central banks.
 - c. Operations concerning open market transactions and discount policy determined by the Federal Reserve Board to be sensitive until at least one year after the operations.

2. Representatives of the GAO were to have access to records and properties necessary for making the audits and they were to be afforded full facilities for verifying transactions with balances or securities held by depositaries, fiscal agents, and custodians of such entities.

The bill provided for reports for each year for which audits were made plus special audit reports to the Congress, with copies to the President of the United States, the Federal Reserve Board, and the Federal Reserve banks. The reports were to include such comments and recommendations as the Comptroller General deemed advisable, including recommendations for obtaining a more economical and efficient administration of the entities audited and disclosure of any program, financial transaction, or undertaking observed in the course of the audits which, in the opinion of the Comptroller General, had been carried on without authority of law.

The bill also provided authorization for employing additional personnel and obtaining other services necessary for carrying out the required audits without regard to civil service and classification laws and 5 U.S.C. 3109b.