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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

For Release on Delivery  
Expected at  
10 a.m. October 21, 1975

STATEMENT OF  
ELMER B. STAATS, COMPTROLLER GENERAL OF THE UNITED STATES *SEN00701*  
BEFORE THE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE

on

[ S. 2509, A bill to authorize and direct the General Accounting  
Office to audit the Federal Reserve System ]

We appreciate the opportunity to present our views on  
S. 2509, 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 reported  
favorably by the House Committee on Banking, Currency and  
Housing on July 10, 1975. We testified on the House bill on  
April 22, 1975, and the suggestions we made at that time  
were later adopted by the Committee.

One of the primary purposes of the Federal Reserve  
System is the control and regulation of the supply of money  
and credit. For example, it can expand or contract the supply

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of money and credit by purchasing and selling U.S. Government obligations. As of July 2, 1975, the Federal Reserve System owned U.S. securities totalling nearly \$90 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.

We understand that for the first six months of 1975 operating expenses of the banks were \$304 million and earnings were about \$3.1 billion.

In view of the very important part the Federal Reserve System plays in the Nation's system of money and credit and the sizeable operating costs involved, we agree that it is highly desirable to provide for adequate audits of the various entities of the Federal Reserve System to enable the Congress to carry out its oversight responsibilities.

S. 2509 provides for GAO audits 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.

With one exception--the audit of procedures to cancel and destroy United States currency unfit for circulation--the GAO does not presently have direct authority to make audits of Federal Reserve System entities, although we have, on a number of occasions, assisted various committees of the Congress engaged in particular studies of their own in this area.

Until 1933, the 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.

In subsequent years, there have been numerous legislative proposals to provide for a GAO audit of the Federal Reserve system. We are well aware of the statements that have been made to the effect that a GAO audit would undermine the independence of the Federal Reserve System with respect to its monetary and credit operations and thus damage the Nation's monetary policymaking system.

We do not agree with this criticism. In fact, for the most part such statements come from individuals who have little or no familiarity with the audit procedures or capabilities of the General Accounting Office.

The suggestion that a GAO audit would interfere with the independence of the Federal Reserve System in reaching decisions on monetary policy reflects a basic misunderstanding of our procedures. We would not interfere any more than the

System's own auditors interfere. We do not "tell" any agency what to do. When we make recommendations for improving operations or procedures, we do so only after full consultation with the agency officials concerned and even then our recommendations are not binding; they are advisory only. In any event, there is no reason to fear that we would interfere with the making of policy determinations because we would not be coming in prior to the making of such decisions. Rather, we would plan to look at the overall financial condition and operations of the System--at its internal controls and auditing practices, and at the procedures by which determinations are made.

Except for the provision that we would not include in our reports any recommendations with respect to monetary policy, the bill does not restrict or dictate the scope of our audit authority. I feel this is essential since it leaves us free to carry out our responsibilities in accordance with our usual methods of reviewing Federal agency operations throughout the Government. Many of these operations, incidentally, are equally, if not more sensitive than the Federal Reserve System operations--military assistance, atomic energy programs, State Department activities, Federal energy programs, to name but a few.

We are pleased to note that the bill specifically provides that for purposes of our audits we shall have access to examination reports of member banks. In providing this authority, the bill recognizes that GAO as the independent auditor for the Congress needs access to these reports as a necessity in satisfactorily performing its official duties. We have full access to such records in our audits of the Federal Home Loan Bank System and, to our knowledge, such access has never caused any problems to the Federal agencies or to the savings and loan associations concerned. Bank examinations are an essential tool for the Federal Reserve Board to use in exercising supervision over member banks and for this reason we would have to have access to those reports in order to evaluate the nature and effectiveness of the bank supervisory responsibilities of the Board.

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 and 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 is in conformity with generally accepted principles of auditing and is also essential in avoiding unnecessary duplication and expenditure of effort.

The reason I mention this point is in recognition that there is some auditing 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--but not of the banks--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 report 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 regularly submitted to the Congress, to our knowledge.

In any event, we do not believe that the existing system is adequate to provide the information the Congress needs to have. Under our standards for audit of governmental activities, we believe the 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, or 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 programs and activities for 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 insufficiently 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, agency-wide, opinions as to whether an organization is operating efficiently and economically, but we do try to identify problem areas and make recommendations for greater efficiency and economy. This kind of audit work also includes determining the causes of any inefficient or uneconomical practices found on the basis of which we would propose measures for improvement.

S. 2509 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." We would construe this language as authorizing us to review the processes and procedures followed in the System in making decisions and in carrying them out but at the same time recognizing the restriction in the bill that we should not include in our reports any recommendations with respect to monetary policy.

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 an ever increasing 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 section 204 of the Legislative Reorganization Act of 1970 as amended, which requires us to review and evaluate the results of Government programs and activities carried on under existing law.

Most of the debate on whether there should be a GAO audit of the Federal Reserve System has centered on the possibility of GAO's interfering with the independence of the System and its monetary policy-making machinery. As stated earlier, we do not believe this is a valid fear and, in any event, the bill provides that we not include in our reports any recommendations with respect to monetary policy. Over the years, however, the Congress has given the Federal Reserve System many other responsibilities which we believe should be subject to independent audit by our Office. Attached to my statement is a list of examples of such functions and activities. I believe you will agree that most of these responsibilities

have little, if anything to do with monetary policy. Certainly if they were administered by another agency of the Federal Government, they would have been the subject of GAO reviews and reports to the Congress.

In summary, Mr. Chairman, we endorse S. 2509 as introduced. We believe that it will 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.

ATTACHMENT

EXAMPLES OF FUNCTIONS AND ACTIVITIES OF THE FEDERAL RESERVE  
SYSTEM SUBJECT TO EVALUATION OF EFFECTIVENESS OF RESULTS  
ACHIEVED AS PART OF INDEPENDENT AUDIT BY THE GAO

Board of Governors supervision of Federal Reserve Banks.

Supervision of member banks of the Federal Reserve System.

Reserve bank advances to member banks and others.

Issuance and retirement of Federal Reserve notes.

Redemption of food stamps.

Clearinghouse operations.

Acting as depositaries and fiscal agents of the United States.

Acting as fiscal agents of Government departments and agencies in guaranteeing loans made by banks and other private financing institutions to finance procurement of materials and services for national defense.

Involvement in issue and redemption of U.S. Government securities.

Regulating and supervising the foreign operations of U.S. commercial banks.  
(12 U.S.C. 601-631)

Administration of the Bank Holding Act which is designed to control bank holding company expansion and prevent the expansion of bank holding companies into businesses not related to banking. (12 U.S.C. 1841-1850)

Approval of bank mergers. The Board shares this responsibility with the FDIC and the Comptroller of the Currency. The Board is required to approve mergers in which the acquiring, assuming, or resulting bank is a State member bank. (12 U.S.C. 1828c)

Establishing rules and regulations for carrying out the provisions of the Truth in Lending Act whose purpose is to assure meaningful disclosure of credit terms to consumers. Enforcement is shared with the other bank regulatory agencies and the Federal Trade Commission. (15 U.S.C. 1601)

Establishing rates of interest which may be paid by member banks on time and savings deposits. (12 U.S.C. 371b)