

GAO

Report to the Ranking Minority Member,
Committee on Banking and Financial
Services, House of Representatives

February 1996

FEDERAL RESERVE BANKS

Internal Control, Accounting, and Auditing Issues





United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-265899

February 9, 1996

The Honorable Henry B. Gonzalez
Ranking Minority Member, Committee on Banking
and Financial Services
House of Representatives

Dear Mr. Gonzalez:

Based upon your request and discussions with your staff, we agreed to audit the Federal Reserve Bank (FRB) of Dallas to address your concerns about the lack of independent financial statement audits of the FRBS. After we began our work, the Board of Governors of the Federal Reserve System contracted for external, independent audits of the combined financial statements of the FRBS for each of the next 5 years. We commend the Board for taking this step and believe that instituting regular, external independent audits will help enhance accountability over the operations of the Federal Reserve System. Additionally, this step places the United States on a par with the practices of other central banks, such as those in France, Germany, and the United Kingdom.

The purpose of this report is to summarize the results of our work related to the Dallas FRB. During our audit we (1) identified and communicated to Federal Reserve officials various weaknesses and suggested corrective actions related to financial accounting and reporting controls and electronic data processing (EDP) general controls that warranted management's attention, (2) found an opportunity to improve the efficiency and consistency of Federal Reserve note accounting, for which we are making recommendations to the Board, and (3) identified auditing issues that need the attention of the Board and its auditor because the auditor cannot fully rely on traditional audit procedures to substantiate the FRBS' largest assets (U.S. Treasury securities) and liabilities (Federal Reserve notes, the nation's paper currency).

Results in Brief

Our work at the Dallas FRB, its three branches, and the Federal Reserve Automation Services (FRAS) identified internal control issues that we considered significant enough to warrant management's attention. These issues included how (1) the accounting records of the Dallas FRB and its branches are reconciled, reviewed, maintained, and reported, (2) accountability over assets is maintained, and (3) automated systems are utilized by the Dallas FRB and its branches, many of which are

controlled by FRAS. Our findings were reported to officials of the Dallas FRB¹ and FRAS,² as applicable. In these reports, we provided suggestions for improvements and documented the many corrective actions Dallas FRB and FRAS officials have taken to date.

During the audit, we also found an opportunity for the Federal Reserve to improve the consistency and efficiency of its note accounting procedures. The FRBS have historically accounted for notes issued based on the FRB identifier imprinted on the face of each note. However, each FRB's reported net liability balance for notes does not reflect the notes in circulation bearing its unique identifier, as the financial statements imply. Changes in the Federal Reserve Act have eliminated the provisions that gave rise to this long-standing accounting practice. Continuing to use these identifiers as the basis for recording note liabilities appears to be unnecessary and inefficient.

The Board has contracted with a public accounting firm for annual audits of the FRBS' combined financial statements for each of the next 5 years. Additionally, the firm is required to audit each of the individual FRBS once during this period. We concur with this overall audit strategy, which focuses on the combined financial statements. The auditor will face significant challenges, arising principally from (1) the lack of independent parties to confirm the ownership and original cost of U.S. Treasury securities, which results from the FRBS' unique role as Treasury's fiscal agent, (2) the impossibility of confirming amounts held by the hundreds of millions of note holders, and (3) the notes' unusual characteristics (for example, they never mature or expire and can be destroyed by events the FRBS cannot control).

Background

The Federal Reserve System was created by the Federal Reserve Act in 1913 as the central bank of the United States to provide a safe and flexible banking and monetary system. The System is composed primarily of 12 FRBS with 25 branches (organized into 12 districts), the Federal Open Market Committee, and the Federal Reserve Board, which exercises broad supervisory powers over the FRBS.

The primary functions of the Federal Reserve System are to (1) conduct the nation's monetary policy by influencing bank reserves and interest rates, (2) administer the nation's currency in circulation, (3) buy or sell

¹Dallas FRB Internal Controls (GAO/AIMD-96-31R, January 18, 1996).

²FRAS General Controls (GAO/AIMD-96-32R, January 18, 1996).

foreign currencies to maintain stability in international currency markets, (4) provide financial services such as check clearing and electronic funds transfer to the public, financial institutions, and foreign official institutions, (5) regulate the foreign activities of all U.S. banks and the domestic activities of foreign banks, and (6) supervise bank holding companies and state chartered banks that are members of the System. The FRBS also provide various financial services to the U.S. government, including the administration of Treasury securities.

The FRBS' assets are comprised primarily of investments in U.S. Treasury and agency securities. As of December 31, 1994, the FRBS reported a securities portfolio balance of \$379 billion (87 percent of total assets). These securities primarily consist of Treasury bills, Treasury notes, and Treasury bonds that the FRBS buy and sell when conducting monetary policy. The FRBS act as Treasury's fiscal agent by creating Treasury securities in electronic (book-entry) form upon authorization by the U.S. Treasury and administering ongoing principal and interest payments on these securities.

Treasury securities are maintained on electronic recordkeeping systems operated and controlled by the FRBS. The U.S. Treasury maintains an independent record of total Treasury securities outstanding but not individual ownership records. The FRBS maintain records of securities held by depository institutions, by the central banks of other countries, and which they hold for their own account. These records do not indicate whether securities held by the depository institutions are for their own accounts or on behalf of their customers. The portion of these securities owned by the FRBS is maintained on recordkeeping systems that the New York FRB operates.

A security's historical cost is comprised of the security's face value (par) and any difference between this face value and the security's purchase price. These differences are referred to as premiums when the purchase price is higher than the face value and as discounts when the price is less than the face value. These amounts are reduced over the life of the security to adjust interest income.

Federal Reserve notes are the primary paper currency of the United States in circulation and the FRBS' largest liability. As of December 31, 1994, the FRBS reported a Federal Reserve note balance of \$382 billion (89 percent of total liabilities). Notes are printed by the U.S. Treasury's Bureau of Engraving and Printing and shipped to the FRBS, who store them in their

vaults until they are withdrawn by financial institutions. Notes do not mature or expire and are liabilities of the FRBS until they are returned to the FRBS. The amount the FRBS report as their liabilities for outstanding notes is actually a running balance of all notes issued from inception that have not been returned to the FRBS.

The Federal Reserve Act designates certain assets of each FRB as eligible collateral for the reported Federal Reserve note liability. The majority of the assets pledged as collateral are each FRB's Treasury securities. In addition, the FRBS have entered into cross-collateralization agreements under whose terms the assets pledged as collateral to secure each FRB's notes are also pledged to secure the notes of all the FRBS. Therefore, as long as total collateral assets held by the FRBS equal or exceed the FRBS' total liabilities for notes, the note liability of each individual FRB is fully secured.

Scope and Methodology

To conduct our work, we (1) gained an understanding of relevant accounting and reporting policies and procedures by reviewing and analyzing documentation and interviewing key FRB and Board personnel, (2) reviewed documentation supporting selected significant balance sheet amounts originating at the Dallas FRB, and (3) tested the effectiveness of certain internal controls in place at the Dallas FRB and the Federal Reserve Automation Services (FRAS) in Richmond, Virginia, and Dallas, Texas.

We conducted our work primarily at the Federal Reserve Banks of Dallas and New York; the Dallas FRB's branches in Houston, San Antonio, and El Paso; the two FRAS sites mentioned above; and the Board of Governors of the Federal Reserve System in Washington, D.C., between July 1994 and November 1995 in accordance with generally accepted government auditing standards.

We requested written comments on a draft of this report from the Chairman, Board of Governors of the Federal Reserve System. The Secretary of the Board provided us with written comments. These comments are discussed in the "Agency Comments and Our Evaluation" section and are reprinted in appendix I.

Dallas FRB's and FRAS' Internal Controls Can Be Strengthened

Our work at the Dallas FRB, its three branches, and the Federal Reserve Automation Services identified internal control issues that we considered to be significant enough to warrant management's attention. Our findings were detailed in separate reports to officials of the Dallas FRB and FRAS, as applicable.³ In these reports, we provided suggestions for improvements and documented the many corrective actions either taken, underway, or planned by Dallas FRB and FRAS officials.

The issues we identified at the Dallas FRB include weaknesses in controls over financial reporting, those aspects of automated systems that were controlled in Dallas, check processing, and Federal Reserve note inventories. For example, (1) reconciliations of general ledger accounts and activity were not always based on independent records, (2) the automated systems did not prohibit access by all terminated employees, (3) accounting adjustments related to check processing activity were not appropriately reviewed, and (4) inventory counts of Federal Reserve notes at some branches were not always properly conducted and documented. The management of the Dallas FRB has already taken action on some of our suggestions to resolve these issues.

We also identified weaknesses in general controls⁴ over the automated systems maintained and operated by FRAS and used by the Dallas FRB. These weaknesses involved controls over access to sensitive information and the computer center, changes to system software, testing the disaster recovery plan, and the use of special privileges on automated tasks. For example, (1) access to job management software was not restricted to authorized individuals, (2) access to the FRAS computer center was inappropriately granted to contractor personnel, (3) FRAS lacked policies and procedures for testing and certifying software changes prior to implementation, and (4) FRAS had not tested the communication network linking the Federal Reserve System. FRAS officials agreed with our suggestions for improvement and, in most cases, initiated corrective actions prior to the conclusion of our work.

³See footnotes 1 and 2.

⁴General controls are policies and procedures that apply to the overall effectiveness and security of an entity's computer operations and create the environment in which other related computer controls operate. General controls include the organizational structure, operating procedures, software security features, and physical protection designed to ensure that (1) only authorized changes are made to computer programs, (2) access to computer systems and data is appropriately restricted, (3) back-up and recovery plans are adequate to ensure the continuity of essential operations, and (4) computer security duties are segregated.

Opportunity Exists to Improve Federal Reserve Note Accounting and Reporting

The FRBS used different practices to track new note issuances than they used to track the notes they held in their vaults, resulting in inconsistent note accounting and reporting. Furthermore, various changes to the Federal Reserve Act, the notes' interchangeable nature, and the way in which the FRBS meet their note collateral requirements appear to have made the tracking of note issuances by identifier unnecessary.

When new notes are issued, the FRB whose identifying marking appears on the note records a liability for the note amount. Notes that are held in each FRB's vault, regardless of identifier, reduce this liability to arrive at the reported amount of notes outstanding. Consequently, for each FRB, the reported amount of notes outstanding does not accurately reflect the actual amount of outstanding notes bearing that FRB's identifier.

Various changes to the act have also diminished the importance of these FRB identifiers. Originally, the act required an identifier on each note to help ensure that each FRB satisfied statutory gold reserve requirements for its notes in circulation. However, these gold reserve requirements have since been repealed. Additionally, in response to changes in the act, notes in the vault are no longer sorted and recorded by identifier.

Historically, the identifiers facilitated the FRBS' sorting of notes to comply with other note-related provisions. For example, the act originally prohibited the FRBS from paying out notes with other FRBS' identifiers to customers. To comply with the act, each FRB sorted notes received from customers and returned notes to the other FRBS, as appropriate. The Congress eliminated these provisions to reduce costs and inefficiencies in the FRBS' note-related operations.

Additionally, under the act's original provisions, the FRBS were required to return all excessively worn notes to the Comptroller of the Currency for destruction. Each FRB was credited with the amount of its notes to be destroyed. To further reduce costs, the Congress amended the act to modify these requirements. As a result, unfit notes may be destroyed at any FRB and the Board of Governors then apportions the note destructions among the FRBS. The act allows the Board to determine the method by which note destructions will be apportioned.

Other factors affecting notes further diminish the importance of using identifiers to associate each note with a specific FRB for accounting and reporting purposes. As the nation's currency, all notes are accepted at any FRB and are used interchangeably, regardless of their identifiers. In

addition, the FRBS comply with the act's collateral requirements by pledging each FRB's eligible assets as collateral to secure the notes of all the FRBS. Individual FRB note liabilities are less meaningful than the combined note liability because of the notes' cross-collateralization. Thus, continuing to use specific note identifiers to record note liabilities appears to be unnecessary.

The FRBS have responded to the inefficiencies involved in using identifiers to track notes by automating the note accounting and reporting process. This has eliminated much of the effort involved in tracking notes manually. However, the inconsistency between how the issuances of new notes and the contents of the vault are accounted for and reported has continued.

FRB Financial Statements to Be Externally Audited

In November 1994, the Board contracted with an independent accounting firm to audit the asset accounts allocated among the FRBS for calendar years 1994 through 1999. The contract also requires audits of the combined financial statements of the FRBS as of December 31 for each of the years from 1995 through 1999. During these years, the financial statements of each individual FRB will also be audited once based on the schedule shown in table 1.

Table 1: Planned External Independent Audits of Federal Reserve Banks

Year of audit	Federal Reserve Bank
1995	Atlanta and St. Louis
1996	New York, Richmond, and Dallas
1997	Boston, Philadelphia, and Minneapolis
1998	Chicago and San Francisco
1999	Cleveland and Kansas City

Under this contract, the combined financial statements will be audited more frequently than the individual statements. This audit approach is appropriate in light of the needs of users of the combined financial statements. The FRBS operate under agreements which specify that assets pledged as collateral by each FRB for its outstanding notes are available to secure the notes of all the FRBS. Accordingly, the combined assets of the FRBS are used to determine whether the notes are adequately collateralized, thus making this combined presentation the most meaningful.

These audits of the FRBS' combined financial statements will give the Federal Reserve the opportunity to make audited financial statements publicly available. These annual audits enhance the credibility of reported information and conforms to the practices of the central banks of many other major industrialized nations. Although the Federal Reserve's past annual reports have included the FRBS' financial statements, these statements were not audited and lacked adequate disclosure of key information, such as significant accounting policies followed by the FRBS. In contrast, the central banks of France, Germany, the United Kingdom, and Canada issue publicly available annual reports that include audited financial statements and the independent auditors' reports.

Presently, there is no requirement that the combined financial statements of the FRBS be audited in accordance with generally accepted government auditing standards (GAGAS). Audits conducted under the contract will be performed in accordance with generally accepted auditing standards (GAAS). We believe that performing these audits under GAGAS would enhance the value of these audits. GAGAS audits incorporate the GAAS requirements, but go further by requiring additional tests of internal controls and compliance with laws and regulations and reports on these matters.

The unique role of the FRBS and the nature of records underlying reported balances of Treasury securities and notes preclude full reliance on traditional auditing procedures. For example, confirming account balances with independent parties is an effective audit procedure to substantiate reported balances. However, this procedure cannot be performed for the FRBS' Treasury security investments and Federal Reserve note liabilities.

As part of functions it performs on behalf of Treasury, the New York FRB maintains the ownership records for Treasury securities, including those in the FRBS' portfolio. However, the New York FRB also maintains the related accounting records for these securities. In contrast, Federal Reserve notes are held by parties independent of the FRBS. However, records of specific note holders cannot be maintained because notes continuously circulate throughout the country and the world. Consequently, the FRBS' ownership of Treasury securities and the amount of notes outstanding cannot be independently confirmed.

The FRBS retain supporting documentation for the cost of securities transactions for about 2 years. As a result, verifying the entire historical cost of securities that have been in the FRBS' portfolio for extended periods

is difficult. However, by retaining support and detailed records for the price paid for new security purchases, the FRBS could eventually support the entire cost of the securities portfolio when the current holdings either are sold or mature. The portion of recorded cost that cannot be readily supported relates to security premiums and discounts. The recorded amounts of premiums and discounts were not significant to the FRBS' total Treasury security account balance as of December 31, 1994. However, auditing the completeness of these recorded amounts is complicated by the lack of supporting documentation and records.

Certain Federal Reserve note characteristics affect related accounting and further complicate audit efforts. For example, notes do not mature or expire. In some countries, such as the United Kingdom and France, after a new currency issue is placed in circulation, the old issue is no longer valid for trade, and the liability for the old currency is removed after an appropriate period. However, the United States does not invalidate old note issues when a new note issue is placed in circulation. All notes issued are recorded as liabilities until returned to the FRBS. Additionally, many notes are held by collectors or are held in foreign countries and may never be returned to the FRBS.

Destructibility, another note characteristic, also affects the note balance and complicates the FRB audits. Since notes were first issued, they have been destroyed by fires, wars, and other accidents and natural disasters beyond the FRBS' control. The value of notes destroyed in this manner in a single year is unlikely to be large relative to the balance. However, the cumulative effect of these destructions and of other notes that may not be returned to the FRBS is unknown. The existence of these factors is not disclosed in the FRBS' financial statements.

Conclusions

We commend the Board for taking the step to contract for external, independent financial statement audits over the next 5 years. We believe that the Board's current commitment to auditing the FRBS' combined financial statements should be sustained and become a permanent part of the Board's operating practices.

Presenting audited, combined FRB financial statements that contain appropriate disclosures will enhance the credibility of the Federal Reserve's annual report and will help meet the needs of financial statement users, including the Congress and the public. Institutionalizing such annual, external independent audits will also place the Federal

Reserve System on a par with the central banks of other major industrialized nations with respect to financial reporting practices. In conducting these audits, the FRBS' external auditors will need to address the audit challenges posed by the FRBS' unique roles.

Recording note liabilities based on bank identifiers is an inefficient use of FRB resources, and reporting this liability under the current approach does not serve a meaningful purpose. Discontinuing the practice of tracking and recording each FRB's note liability based on note identifiers would increase efficiency and provide a consistent basis for the note liabilities reported by the FRBS.

Recommendations

To bring about consistency and improve the efficiency of Federal Reserve note accounting and reporting procedures, we recommend that in conjunction with planning and implementing future changes to the automated systems used to account for and report notes, the Board of Governors of the Federal Reserve System consider

- incorporating changes in the function of these systems to allow FRBS to account for and report notes without regard to the identifiers printed on the notes;
- directing the FRBS to discontinue using specific FRB identifiers printed on notes as the basis for recording each FRB's liability for Federal Reserve notes;
- stopping the tracking of shipments by FRB identifiers;
- directing each FRB to record its note liability based on the Federal Reserve notes it actually receives and holds without regard to FRB identifiers; and
- apportioning note destructions among FRBS on an appropriate basis without regard to FRB identifiers.

To enhance the combined financial statements as a vehicle for informing Federal Reserve management, the Congress, and the public about the operations of Federal Reserve Banks, we recommend that the Board of Governors of the Federal Reserve System do the following:

- Adopt a policy to institutionalize annual, external independent audits of the FRBS' combined financial statements as a routine operating procedure. These audits should be performed in accordance with GAGAS.
- Make the FRBS' audited combined financial statements and independent auditor's report publicly available upon issuance. For example, these

documents could be included in the Federal Reserve System's annual report.

- Include disclosures in the financial statements that (1) appropriately describe the significant accounting policies followed, such as the basis for the reported note liability and the treatment of the notes held in the vault, and (2) provide the information typically included in financial statements of other central banks and private sector financial institutions.

Agency Comments and Our Evaluation

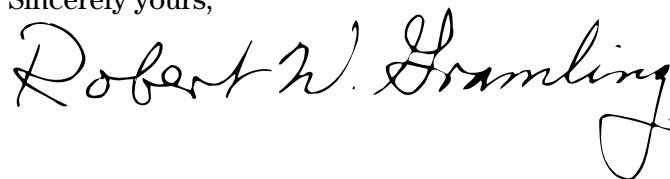
Regarding our recommendations to bring about consistency and improve the efficiency of Federal Reserve note accounting and reporting procedures, the Board acknowledged in a letter dated January 11, 1996, that changes to the Federal Reserve Act and Federal Reserve policies have blurred the distinction among Federal Reserve notes with different unique identifiers. The Board acknowledged that the accounting process for note destructions offers an opportunity for further efficiencies to be gained in this area. The Board stated it will give consideration to the accounting method used for Federal Reserve notes as the accounting and tracking systems associated with the notes are reviewed for possible redesign.

Our other recommendations were intended to enhance the Federal Reserve Banks' combined financial statements as a vehicle for informing Federal Reserve management, the Congress, and the public about the operations of the Federal Reserve Banks, and we believe implementing them would enhance management's accountability. The Board stated it will give careful consideration to our recommendations concerning the use of external auditors, presentation of financial statements, and the application of auditing standards.

We are sending copies of this report to the Chairman of the Board of Governors of the Federal Reserve System; the Secretary of the Treasury; the Chairman of the House Committee on Banking and Financial Services; the Chairman and Ranking Minority Member of the Senate Committee on Banking, Housing, and Urban Affairs; and the Director of the Office of Management and Budget. Copies will be made available to others upon request.

Please contact me at (202) 512-9406 if you or your staff have any questions. Major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink that reads "Robert W. Gramling". The signature is written in a cursive style with a large, prominent 'R' and a long, sweeping tail on the 'g'.

Robert W. Gramling
Director, Corporate Audits
and Standards

Comments From the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

January 11, 1996

Mr. Gene L. Dodaro
Assistant Comptroller General
Accounting and Information Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Dodaro:

The Board is pleased to have this opportunity to comment on the draft report of the General Accounting Office (GAO) entitled Federal Reserve Banks: Internal Control, Accounting and Auditing Issues. This report was prepared by the GAO pursuant to the request of the Honorable Henry B. Gonzalez for a financial audit of a Federal Reserve Bank. The GAO subsequently selected the Federal Reserve Bank of Dallas for this audit. We appreciate the GAO's endorsement of the Board's current approach to auditing Reserve Banks, which includes publishing a combined set of financial statements for the Reserve Banks, audited by a public accounting firm.

The Board is also interested in the GAO's perspectives on the internal controls of the Dallas Federal Reserve Bank and Federal Reserve Automation Services (FRAS) that are to be reported in management letters. We will be pleased to receive copies of these reports when they are available.

The two primary recommendations to the Board contained in the draft report are: (1) promote institutionalizing our current audit approach and (2) propose changes in the accounting for Federal Reserve Notes. The report also identifies certain audit challenges presented by the Reserve Banks' central bank functions, specifically related to government security holdings and currency issuance.

Accounting for Federal Reserve Notes

The report recommends that the Board discontinue the practice of tracking and accounting for Federal Reserve Notes (FR Notes) based on the Reserve Bank identifier imprinted on each FR

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Note. The report indicates that this will improve the efficiency and consistency of Reserve Banks' accounting and reporting procedures.

The Board acknowledges that changes to the Federal Reserve Act and Federal Reserve policies have blurred the distinction among FR Notes with different unique identifiers. The Federal Reserve System, however, has maintained, from an accounting sense, the basic concept that a Reserve Bank incurs a liability upon issuance of a Federal Reserve Note containing its identifier. This liability is reflected by each Reserve Bank as "FR Notes Outstanding" and is reflected on the FR Note Statements that accompany the Federal Reserve Banks' Statements of Condition, published weekly, and in the Board's annual report. As shown on these reports, a Reserve Bank's ultimate liability for FR Notes is reduced by the amount of currency held by that Reserve Bank. This offsetting practice is appropriate, in our view, given a Reserve Bank's legal right to satisfy its obligation with FR Notes issued by other Reserve Banks. This approach provides the reader with both the gross amount of a District's liability, based on the identifier, and the net liability that requires collateralization.

As stated in the draft report, the Reserve Banks have eliminated most of the inefficiencies related to FR Note accounting with the use of automated tracking and accounting systems. Further, the draft recommendation regarding the "apportionment" of FR Note destructions seems to recognize that the most cumbersome process remaining, i.e., the reallocation of FR note destructions among Reserve Banks that results in one or two "extra" accounting entries per month, will be required under any FR Note accounting methodology.

As recommended, the Board will give consideration to the accounting method used for FR Notes as the accounting and tracking systems associated with FR Notes are reviewed for possible redesign. Until then, we believe it is prudent to continue the current, theoretically sound and historically accepted accounting basis for these Reserve Bank liabilities.

Audit of Federal Reserve Bank Financial Statements

The Federal Reserve Act requires that the Board order an annual examination of each Reserve Bank. The Board has satisfied that requirement through its Financial Examination Program, with support provided by the internal audit function of each Reserve Bank. Because these examinations are a critical component of the Board's general oversight responsibility, a public accounting firm has been engaged routinely to perform a quality assurance review of the Program. Recently, as noted in the draft report, the Board contracted with a public accounting firm to perform financial audits of all twelve Reserve Banks over

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a six year period. Certifications of individual financial statements for Reserve Banks audited by the outside firm and those audited by the Board's Financial Examination program will lead to presentation of a combined set of financial statements at the System level that will be audited by the firm.

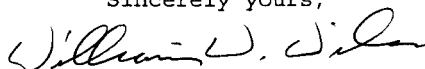
The Board appreciates the positive acknowledgment of this initiative by the GAO. As the Board continues to evaluate the effectiveness of its oversight mechanisms, it will give careful consideration to the recommendations concerning the use of external auditors, presentation of financial statements, and the application of auditing standards.

Audit Challenges

The Board recognizes that some of the unique features of the Federal Reserve Banks, especially in their central bank capacities, create novel challenges with regard to both the preparation and audit of financial statement information. The draft report specifically identified the application of traditional audit procedures to both the System's holdings of Treasury Securities and to the Reserve Bank's liabilities for FR Notes as problematic. Two large internationally recognized public accounting firms, however, have rendered opinions on these accounts in each of the last three years. Given the ability of these firms to reach a positive conclusion regarding these balances in the past, we are confident that they will continue to employ acceptable audit techniques that will enable them to render independent opinions of the combined Reserve Bank financial statements for year-end 1995 and beyond.

We appreciate this opportunity to comment on the draft report.

Sincerely yours,



William W. Wiles
Secretary of the Board

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